BANK OF UGANDA

BANK SUPERVISION FUNCTION

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DEPUTY GOVERNOR'S MESSAGE

The health of Uganda's financial sector has been impaired by Uganda's political and social turmoil. The troubles of the 1970s and early 1980s produced a severe contraction of Uganda's monetary economy, a decline in financial intermediation and a loss of financial depth. This in turn led to the failure of some Non-bank Financial Institutions (NBFI's) (mainly building societies) and impacted negatively on financial sector deepening. In addition, there emerged a concentration of financial services in the hands of a few commercial banks of which two banks, Uganda Commercial Bank and Co-operative Bank controlled 70% of the banking business. The same years were also characterized by the politicization of commercial life and the reneging on the normal legal restraints and disciplines of business life. The economy became severely demonetized with M2-GDP ratio falling to below 7% in fiscal year 1987. During the same years, the two big banks mentioned above became insolvent, and significant risks posed by a weak banking sector began to emerge. The use of credit instruments such as cheques declined and Uganda's economy became overly a cash economy.

In order to address weaknesses in the economy and the financial sector in particular, the Government of Uganda in May 1987 embarked upon an Economic Recovery Program (ERP). The program was supported by credits from the World Bank, the IMF and other donors in line with the World Bank's country assistance strategy.

The programme's main objectives focussed on macroeconomic stability, liberalization of the foreign exchange, trade, price and marketing systems. Government also put in place conditions to improve the incentive structure and business climate so as to promote savings mobilization and investment as well as the rehabilitation the country's economic, social and institutional infrastructure. By the end of 1992, the Government had achieved considerable progress in implementing the Economic Recovery Programme. From 1987 to 1992 Real GDP was growing at an annual average rate of 5.9%. The annual inflation was down from 240% in 1987 to 30% by end of 1992. The foreign exchange current accounts and interest rate regimes were fully liberalized by 1994. Price controls were eliminated (except for utilities and petroleum products).

In spite of these achievements, the financial sector remained weak. The Government sought more financing from the World Bank and the IMF. The two institutions granted financial support under the programme known as the Financial Sector Adjustment Credit (FSAC) for further restructuring of the financial sector.

Under the FSAC programme, the legal and regulatory framework was strengthened with five pieces of financial sector legislation enacted during the period under implementation. These included the Bank of Uganda Statute 1993, the Financial Institutions Statute 1993, the Non-Performing Assets Recovery Trust Statute 1994, the Capital Markets Statute 1996 and the Insurance Statute 1996.

The Bank of Uganda continued with the restructuring of the banking sector.
Two private banks namely Nile & Sembule were sold to strategic investors during 1995. In early 1998 Uganda Commercial Bank Ltd. (UCBL) the largest state owned bank, was partially privatized and 49% shareholding was sold to private investor Westmont Land (Asia) BHD. However due to the poor Westmont's management of UCBL, BOU in April 1999 seized UCBL and put it under statutory management. In late 1998 and early 1999 three insolvent banks namely ICB, Greenland & Co-operative were closed and put under liquidation. The closure of banks and restructuring of the state owned bank management as well as the re-capitalization of other local insolvent banks has been a necessary transition towards a stronger, more soundly capitalised and prudentially managed financial sector.

This is further evidenced by the growth in the number of banks in the sector with new entrants of reputable international backing such as Citibank and DFCU banks. Public confidence in the banking sector has also been enhanced as evidenced by the increase of Shs348m or 56% in total deposits from Shs.691bn in December 1998 to Shs1,039bn in December 1999. There has also been growth of Shs73bn in total assets from Shs1,279bn to Shs1,352bn during the period under review. Some of the stronger private sector banks have diversified their financial products and expanded their operations by opening new branches and increasing the size of their loan portfolio. Good fiscal discipline as well as prudent monetary policies coupled with the financial restructuring have led to a further drop in inflation rate from 30% in 1992 to as low as 5% in 1999.

Future Outlook

The financial sector still faces a number of challenges. These challenges include lack of depth and outreach. The sector has to develop new products, for our markets to become sophisticated. With new products, risk management and good corporate governance practices becomes more involved. If our financial institutions are to cope with the increased complexities of a liberalized financial sector as well as the sophistication brought on by new products, they will require more capital investment both in human resources as well as acquisition of new technology. The sector must also not have cartels where margins remain fixed for a long time but must explore new frontiers intended to reduce intermediation costs.

In standing to these challenges, the BOU has also refocused its efforts on the regulation and supervision of banks and other financial institutions. It is our stronger belief that the stability and soundness of the financial sector will largely depend on the efficiency and effectiveness of the supervisory process. In this regard, BOU has embarked on a number of measures, which are aimed at revamping the entire financial system in the country. The measures include raising the minimum unimpaired capital requirements, improved supervisory capacity and management, and enhanced frequency of on-site inspection as well as strengthening the legal framework. In order to improve further financial sector outreach, Bank of Uganda also aims to promote the growth of the micro-finance industry. In this respect, BOU developed a policy on micro-finance business in the country. The policy supports approaches that will increase access to financial services by the majority of the poor but in a safe, sound and sustainable way. This will greatly help in deepening the financial sectors. The draft law governing the regulation of the micro-finance sector is now before the Cabinet.

Increasing emphasis will also be placed on regional cooperation and harmonisation of supervisory techniques. Compliance to internationally important issues such as good corporate governance in financial institutions, transparency and disclosure in the financial sector and core principles for effective banking supervision will need to be pursued with vigor. In the context of East African Cooperation, the banking supervision departments in the three central banks are cooperating to enhance their capacities and harmonize banking supervision and regulation practices in accordance with the Basle Core Principles for effective banking supervision. A law to criminalise money laundering will need to be urgently passed by the House. To this end an anti-money laundering committee was formed in Sept. 2000 by the Minister of Finance, Planning and Economic Development. The committee's task is to recommend a national strategy and develop a new law to criminalise money laundering.

Regional banking supervision seminars and workshops will continue to be held regularly in the East and Southern African region (ESAF).

All these initiatives point to one direction, that is, the strengthening of the financial sector within the region to avoid contagion effects that may arise due to weakness of the member states' supervisory standards.

Finally, it is my hope that the public will find this report useful. The Bank of Uganda looks forward to receiving continued support from all stakeholders to enable us meet the diverse challenges that lie ahead.

Louis Kasekende (Ph.D.)
DEPUTY GOVERNOR

December, 2000

CHAPTER 1

Evolution of Banking Supervision in Uganda

The beginning of financial institutions regulation in Uganda can be traced back to the early 20^{th} Century when the East African Currency Board was established. Although its major function was the exchange of currencies, there were loose arrangements for guiding the banking industry in areas of conducting commercial banking business, which was mostly dominated by foreign banks. The East African Currency Board was dissolved after political independence of East African nations and the national Central Banks were established. Bank of Uganda was established under the Bank of Uganda Act 1966 and during its first year of operation the department of Banks Supervision came into being. Under the Banking Act 1966, the Bank was mandated to safeguard the value of the Uganda shilling, promote macro-economic stability and ensure a sound financial sector conducive to sustained economic growth.

Later on in 1969, the Banking Act was also enacted to empower Bank of Uganda through the Supervision department, to regulate and supervise banks. The powers to license banks and credit institutions were however vested with the Ministry of Finance. All international bank branches were required to incorporate locally and were put under Bank of Uganda supervision and regulation.

In 1992, as part of the general restructuring programme in Bank of Uganda, Bank Supervision department was elevated to Supervision Function with two departments namely Commercial Banking and Non-Banking Financial Institutions.

The introduction of NBFI department required a back up law to regulate other financial institutions, which were not originally under the supervision of BOU. Subsequently in 1993, the Financial Institutions Statute 1993 was enacted and it replaced the Banking Act

1969. This Statute empowers BOU to regulate, supervise and control commercial banks and other non-banking institutions.

CHAPTER 2

2.0 Regulation and Supervision of Banks

2.1 Introduction

Bank regulation encompasses the legislative framework and guidelines which govern bank activities. Supervision of banks is a process primarily aimed at promoting and maintaining a safe and sound banking system and preventing financial instability. It also aims at fostering efficient and competitive banking as well as protecting depositors' funds.

2.2 Rationale for the Regulation and Supervision of Banks.

Banking institutions play an important role in the economic life of any country with the result that continued strength, stability and soundness of the entire banking system is a matter of public concern.

Banking institutions act as the principal depository for public funds. The safety and ready availability of these funds for transactions and other purposes is essential to the stability and efficiency of the financial system. Banks also employ these funds to make loans and investments in addition to being the main vehicle through which monetary policy is implemented. Finally commercial banks provide the backbone of the national payment system.

For all these reasons, the Bank of Uganda exerts influence and control over the banking system by enforcing regulations and implementing supervisory actions over banks and other financial institutions.

2.3 Role of Banking Supervision:

Bank Supervision aims at fostering the soundness and hence stability of the financial sector in three stages:

(i) At Licensing, supervision screens new applicants to ensure that they are financially strong, fit and proper.

(ii) During the life of the financial institutions, Supervision ensures that financial institutions operate in accordance with the law and inline with prudential norms. Bank of Uganda does this through off-site surveillance and on-site inspection of financial institutions. It should however be noted that in so doing, Supervision cannot guarantee that financial institutions do not fail.

(iii) At exit stage, supervision ensures smooth and orderly exit of failed institutions so as to minimize disruption in the provision of financial services to the public.
It is stated Government policy not to bail out insolvent financial institutions. However in liaison with the management of the financial institution, Supervision ensures that management promptly corrects weaknesses identified.

2.4 Methodology of Supervision

Prudential supervision over the banking industry is carried out through two main methods namely, off-site surveillance and on site examination.

2.4.1 Off-site Surveillance

Off-site surveillance method involves the collection of financial data through specific statistical and statutory returns. The data is used to generate key financial ratios and other information, and analyze trends that allow the bank supervisors to evaluate the condition and performance of individual banks and the banking industry as a whole.

The periodic statutory returns submitted by the financial institutions to the Central Bank are:

a) Daily foreign exchange return;
b) Weekly statistical report;
c) Weekly Inter-bank transactions report;
d) Weekly return on lending in foreign currency;
e) Monthly statement of assets and liabilities (BS100);
f) Monthly report on foreign exchange transactions;
g) Monthly Interest rate return;
h) Quarterly capital adequacy return(BS100A);
i) Quarterly return on income and expenditure(BS110);
j) Quarterly return on non-performing advances;
k) Quarterly return on provisions for bad debts (BS120);
l) Quarterly return on large exposures and credit concentration(BS130);
m) Quarterly return on credit extended to insiders(BS140); and
n) Annual audited accounts.

The analysis of these reports focuses primarily on the level and trend of key ratios of CAMEL, (Capital adequacy, Asset quality, Management, Earnings and Liquidity) as well as giving a bank's performance relative to its peers. The CAMEL rating technique recognizes risk-based evaluation as opposed to traditional compliance based supervision. The ratings are then made as to whether each financial institution is operating in a Strong Satisfactory, Fair, Marginal, or Unsatisfactory manner. **Strong** financial institutions are basically sound in every respect and have no cause for supervisory concern. **Satisfactory** financial institution are fundamentally sound, findings are of minor nature and can be handled through routine supervision. The bank is stable and can withstand business fluctuations. Supervisory concerns are limited. **Fair** financial institutions show clear signs of weaknesses (financial institutions with problems) in at least one or two key financial areas and need more than the normal supervision to address deficiencies. **Marginal** financial institutions show serious financial weaknesses. Unsafe and unsound conditions may exist which are not being satisfactorily addressed. There is high potential for failure. Such financial institutions need close supervision and surveillance and definite plan for correcting of weaknesses. **Unsatisfactory** financial institutions have high or near term probability of failure. Severity of weaknesses is too critical that urgent aid from shareholders or other financial sources is necessary. Without immediate corrective actions, such institution will likely require liquidation, merger or acquisition.

This analysis is forwarded to respective financial institutions for their information and action.

The off-site surveillance method is designed to accomplish the procedures of the most important evaluation tool known as an "Early Warning Device" which helps detect emerging financial problems in banks. In order for off-site surveillance to be effective, banks must submit timely and accurate returns. The system contributes to a more efficient use of supervisors resources giving priority to the on-site examination of banks that are experiencing problems or appear to be significantly increasing their risk exposure.

2.4.2 On-Site Examination

On-site examinations are usually conducted by teams of examiners who visit the financial institution to extract, verify and assess the accuracy of information submitted by these institutions to the Central Bank through off-site surveillance system. Unlike off-site surveillance system, on-site examinations need not necessarily be periodical but random and based on the warning signals detected from the off-site analysis.

As a matter of policy, each financial institution should be inspected at least once a year. However, depending on the results of the off-site analysis or other unforeseen circumstances, a financial institution may be inspected more than once a year. This is more so for problem financial institutions. The on-site examination deals with the important areas of CAMEL, foreign exchange, and internal controls. Other supervisory matters such as cash management and the whole balance sheet structure are also examined. The inspectors examine accounts and records, review internal and external auditors' reports, and also hold discussions with the staff, officers, and management. Following the conclusion of the on-site examination, examiners hold discussions with management on critical findings.

On completion of both the inspection and discussion with the Management of the bank in question, a consolidated report of findings will then be discussed with the Board of Directors of the concerned financial institution. Action would then be taken depending on the performance of the institution subject to the report. These include:

i) If the financial institution is conducting business in a *satisfactory* manner, just bring it to the attention of the Board of Directors.

ii) If the financial institution has got *minor* problems, write a supervisory letter for the attention and action of management of the concerned institution.

iii) If the institution has *significant* problems, a written agreement (MOU) in reference to the operations and management is made between the Bank of Uganda and the Board of Directors and Management of the concerned institutions.

iv) If the institution has *severe* problems, cease and desist orders are instituted. This may be followed by Bank of Uganda taking over management and control of the institution, arrange a merger, take over or liquidation under the provisions of sections 30, 31 and 33 of FIS 1993.

2.5 Deposit Protection Scheme

The Supervision Function also administers the Deposit Protection Scheme, which insures small depositors of banks. The deposit protection fund in addition aims at improving depositors' confidence and enhancing deposit mobilization in the country. Membership to the fund is mandatory for all deposit taking institutions operating in the country. The assessment criteria of the premium is based on the total local and foreign deposits as at end of the calendar year. The annual premium rate is 0.2% of total deposits. An individual's protected deposits amount to the aggregate credit balance(s) of any account(s) he/she maintains in a bank less his/her liabilities to the bank. The maximum amount insured is Ushs.3m. During 1999, the insured category accounted for 30-40% of the total deposits and 95% of the account holders in the banks.

CHAPTER 3

3.0 Performance of the Financial Sector

3.1 Introduction

The condition and performance of all financial institutions in Uganda is evaluated in relation to their capital adequacy, asset quality, earnings, liquidity, management and foreign exchange operations. The purpose of this chapter therefore is to reflect the more important trends and industry statistics that are apparent from the information received from the registered financial institutions particularly the commercial banks and credit institutions. However, before a detailed cast of the performance of the sector is given, it is appropriate to first get a glimpse of the structure of the financial sector and the developments that underpin the current state of affairs.

3.2 The structure of the financial sector in Uganda

Currently, the formal financial sector includes the Central Bank (Bank of Uganda); 18 commercial banks 7 credit institutions; 3 development banks; 26 insurance companies; one leasing company; a savings and credit union with over 2000 members; a post office savings bank; and the National Social Security Fund. In addition, there are over 79 registered operators that offer micro finance business and consist of co-operatives, various non-governmental organisations (NGOs) and other savings and credit associations. One commercial bank (Centenary Rural Development Bank (CERUDEB)) also operates in the micro finance sector. It offers individual savings and loans services for small clients. The financial sector has few financial products and types of financial institutions and therefore needs to be deepened further. It lacks medium to long-term finance and has a low saving to GDP ratio of about 7%.

3.3 Financial Sector Developments

In 1993, Bank of Uganda closed Teefe Bank. And more recently four banks were closed between 1998 and 1999. The closed banks were mainly indigenous, namely International Credit Bank (ICB), Greenland Band (GBL), Co-operative Bank Ltd. (Co-op) and Trust Bank (U) Ltd.

The main cause that led to the closure of these banks was insolvency brought about by imprudent banking practices and poor internal governance. The existence of insolvent banks in the financial sector greatly compromises the safety of depositors' funds and brings contagion in the financial sector.

In order to ensure safety of the depositor's money and soundness of the financial sector, Bank of Uganda is therefore under obligation to exit insolvent institutions.

Following closure of these banks, Government decided to pay all depositors except public and interbank deposits. The banks that assumed the deposits and liabilities were paid Promissory notes so as to ensure that the rescue of depositors does not exercaberate inflationary pressures. Bank of Uganda in 1999 also intervened in Uganda Commercial Bank (UCBL) following an inspection report that revealed imprudent banking practices by Westmont management. Bank of Uganda sacked the Westmont management, dismissed its board and took over management to streamline and stabilise the operations of UCBL.

3.4 Performance Rating

3.5.1 Overview

The financial sector is now stronger than before as a result of the closure of these banks and the improvement in the supervisory capacity.

The overall performance of the banking sector in 1999 was rated Satisfactory. Tables 3.0 and 3.0a show a comparative summary of the ratings for all the banks and credit institutions for 1998 and 1999.

TABLE: 3.0 Performance Rating for Banks as at year-end.

	1998					1999				
Performance Category	Capital Adequacy	Asset Quality	Earnings	Liquidity	Overall	Capital Adequacy	Asset Quality	Earnings	Liquidity	Overall
	No. Of Banks	No. Of Banks	No. Of Banks	No. Of Banks	No. Of Banks	No. Of Banks	No. Of Banks	No. Of Banks	No. Of Banks	No. Of Banks
Strong	4	0	0	0	0	6	0	0	0	0
Satisfactory	7	6	5	13	5	7	4	5	15	7
Fair	2	1	3	3	7	0	6	3	1	6
Marginal	0	2	0	0	4	0	2	2	0	2
Unsatisfactory	4	8	9	1	1	4	5	7	1	2
Total	**17**	**17**	**17**	**17**	**17**	**17**	**17**	**17**	**17**	**17**

TABLE:3.0A Performance Rating for Credit Institutions as at year-end.

	1998					1999				
Performance Category	Capital Adequacy	Asset Quality	Earnings	Liquidity	Overall	Capital Adequacy	Asset Quality	Earnings	Liquidity	Overall
	No. Of Credit Inst.	No. Of Credit Inst.	No. Of Credit Inst.	No. Of Credit Inst.	No. Of Credit Inst.	No. Of Credit Inst.	No. Of Credit Inst.	No. Of Credit Inst.	No. Of Credit Inst.	No. Of Credit Inst.
Strong	6	0	1	2	0	3	0	0	0	0
Satisfactory	0	1	0	4	4	2	1	1	5	1
Fair	0	2	2	0	1	0	3	0	0	4
Marginal	0	0	0	0	1	0	0	1	0	0
Unsatisfactory	1	1	4	1	1	0	1	3	0	0
Total	**7**	**4**	**7**	**7**	**7**	**5**	**5**	**5**	**5**	**17**

From tables 3.0 and 3.0a, as at 31st December 1999, out of the total of seventeen banks, seven banks were rated Satisfactory, Six banks Fair, while four banks were rated below Fair. A similar pattern is depicted for 1998. However, almost all banks obtained a Satisfactory composite rating on liquidity except for one bank. Thirteen banks were rated Satisfactory and above on the capital adequacy indicator as opposed to eleven banks during 1998.

In a case of Credit Institutions, the number of credit institutions dropped from 7 in 1998 to 5 in 1999. One credit institution voluntarily ceased operations in 1999. From table 3.0a, out of the five credit institutions, only one obtained a composite rating of Satisfactory while the rest were rated Fair. All credit institutions obtained a satisfactory rating on capital adequacy and liquidity indicators. This pattern follows closely that of 1998.

3.5.2 Financial Position of commercial banks and credit institutions

The balance sheet structure

The balance sheet structure is analysed to determine the type and spread of a bank's business activities, as well as to consider the impact of any changes thereto on the risk profile of the banking sector. The aggregate balance sheet of the banking sector in Uganda as at 31st December 1999 equalled. Shs1.352.275m as compared to Shs 1.278.656 for 1998. This represented a growth of 5.8% between 1998 and 1999. The composition of the balance sheet structure as at 31st December 1999 is shown graphically in Figures 3.1a and 3.1b below.

From figures 3.1a and 3.1b, (see also tables 3.1A and 3.1B in the appendix), as at 31st December, 1999, deposits from the public constituted the main source of funding for the banking sector, namely shs.1.039.762m, which represented 76% of total funding.

Owners' funds played a marginal role in the funding to the banking sector. A similar pattern has been revealed for the period between 1995 and 1998.

Figure 3.1a: Composition of Assets

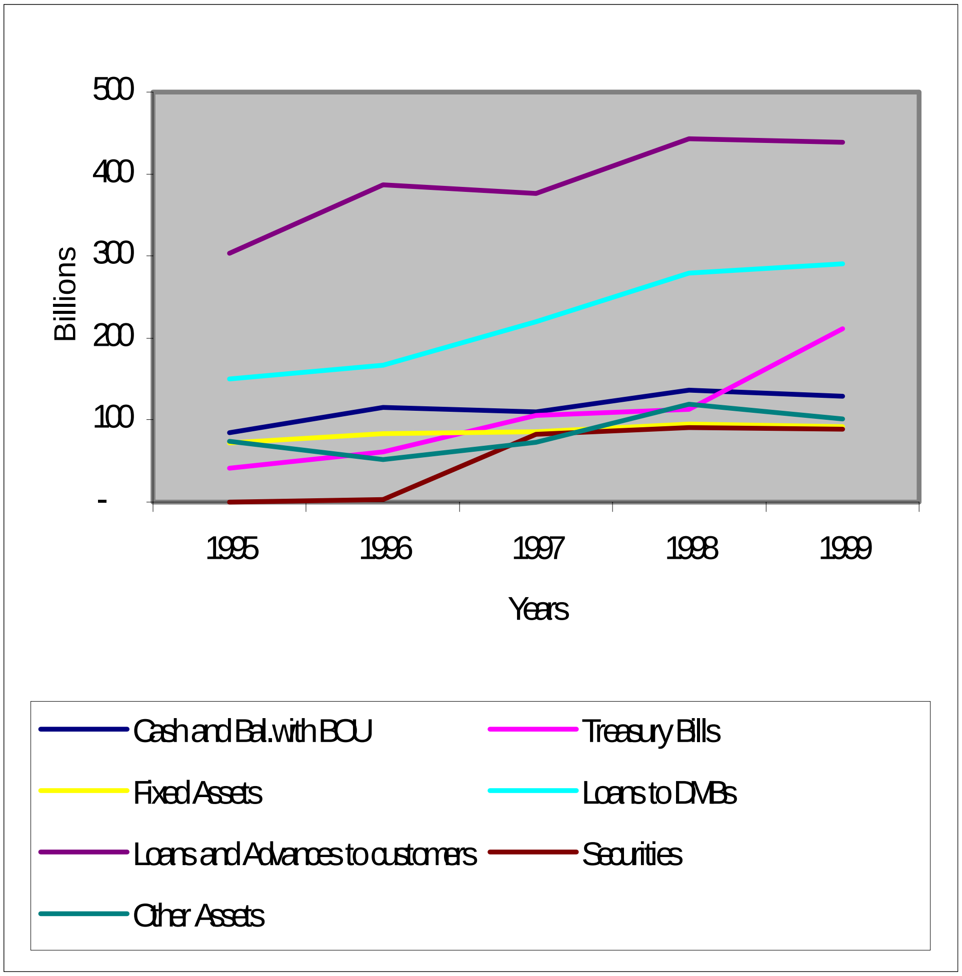
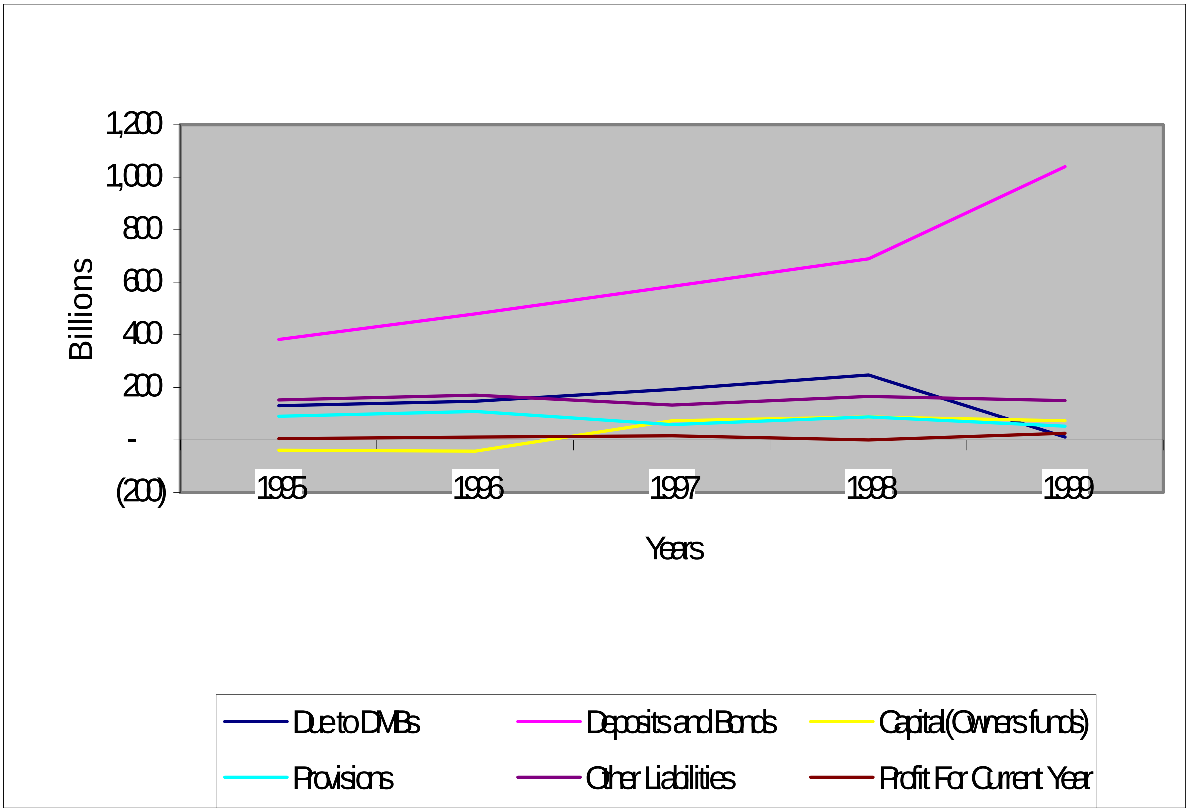


FIGURE 3.1B : LIABILITIES



With respect to total banking sector assets, loans and advances constituted the major item for the application of funds. This is evidenced by the fact that loans and advances represented 32.5% of the total assets in 1999. Investments in government securities continued to increase over the period. As at 31st December 1999, government securities amounted to Shs.211.715m, representing 15.7% of total assets compared to shs.40,854m in 1995, a growth of 418% during the period between 1995 and 1999. This is an indication that many banks have re-designed their Investment portfolio. Banks are becoming risk averse and therefore very reluctant to lend, due to the high NPA ration on their books. The increased levels of NPAs, have necessitated high provision that have continued to impact on the banks' earnings and capital. Many banks have therefore been forced to look for other safer alternative investments than lending, such as the treasury bills.

Liabilities

The year on year comparison of the composition of liabilities as reflected in figure 3.1B above reveals that there are major changes with respect to the growth and composition of deposits and owners' funds.

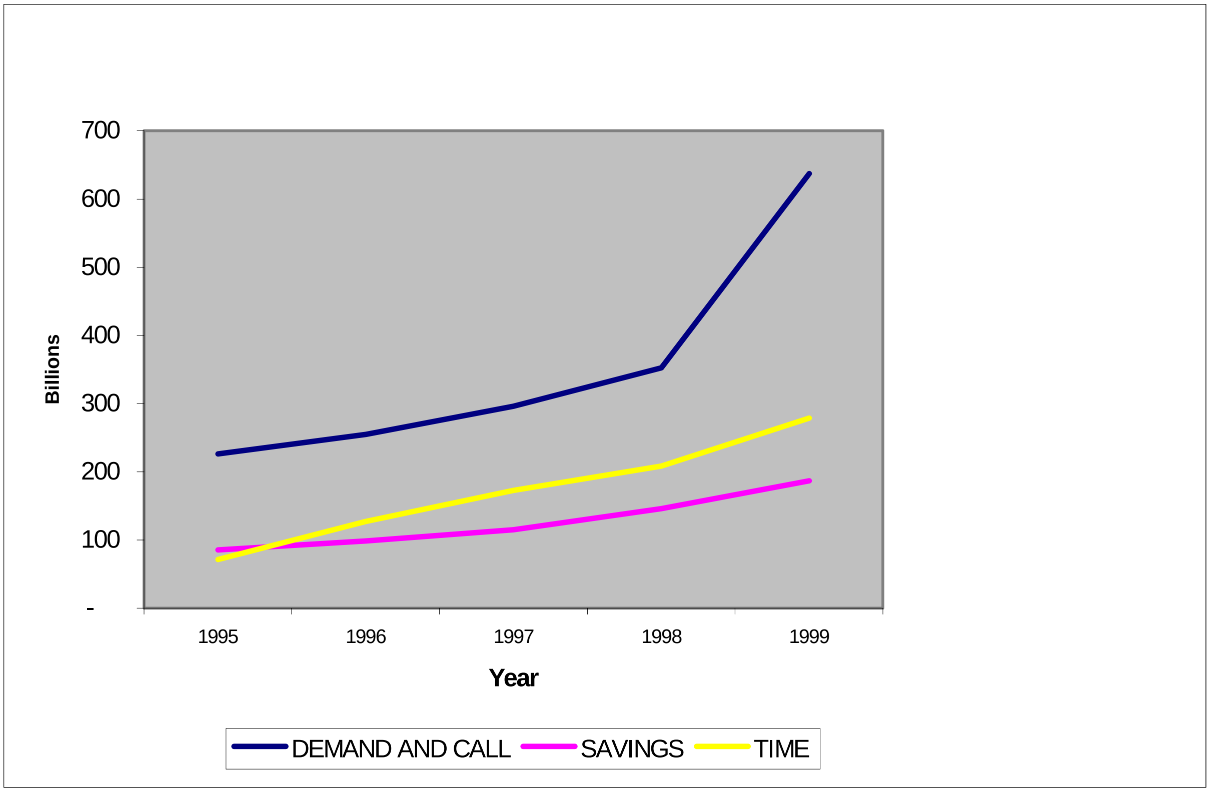
Composition of deposits

Deposits from the general public, as at 31st December 1999, amounted to Shs1.039.762mcompared to shs.690.950m as at 31st December 1998. Despite a closure of the three banks mentioned above, the public maintained confidence in banks as is evidenced by the growth in the deposit base, which increased by 50.5% during the period between 1998 and 1999. Figure 3.2 below shows the year on year composition and growth in deposits during the period between 1995 and 1999. From Figure 3.2, it can be observed that the banking sector has experienced a steady but marginal growth in deposits and the composition has remained fairly static. Demand deposits continued to claim a large proportion of the deposit base and represented a 171.2% growth during the period under review. Whereas, time deposits grew by 95%, savings deposits increased by 263%during the same period.

The change in deposits from 690bn in 1998 to Shs.1.039bn, in 1999 was mainly on account of a change in Bank of Uganda's reporting requirements. Banks stopped reporting fixed deposits held on behalf of other banks as inter-bank and started reporting them as normal deposits.

This also subsequently affected the figures of "Due to Deposit Money Banks" causing a decline from Shs246.549m in 1998 to Shs9.463 in 1999.

FIGURE: 3.2 ANALYSIS OF DEPOSITS



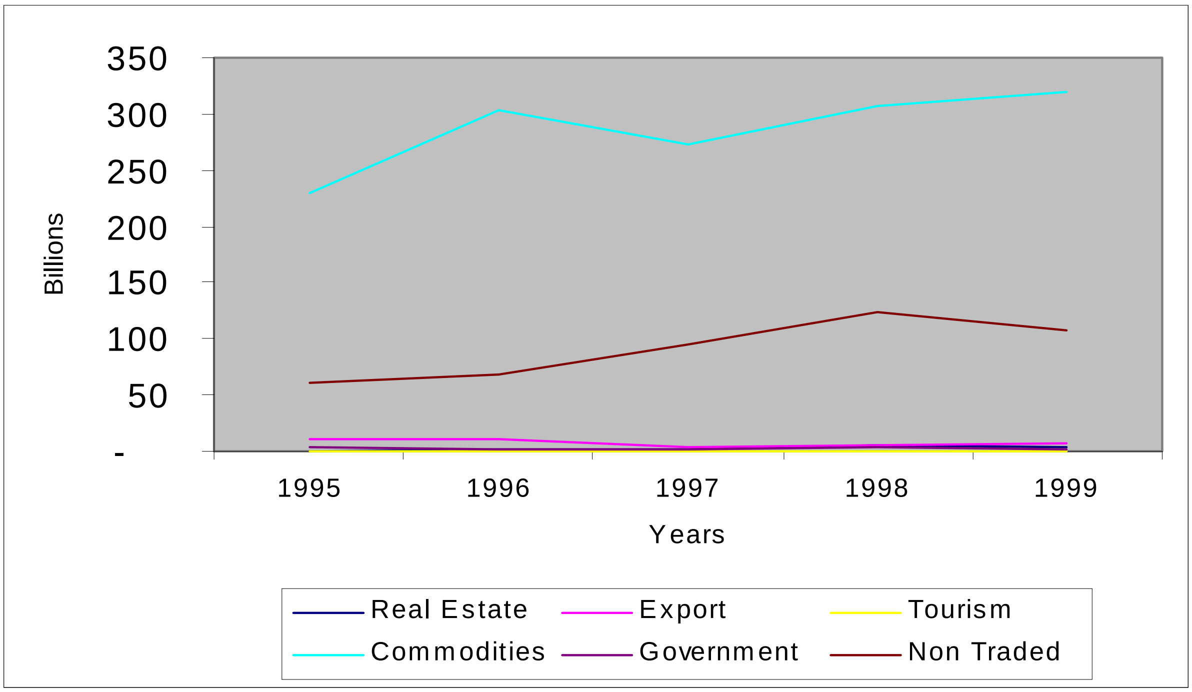
As at 31st December 1999, demand deposits were 58.8% of the total deposits, while time represented 25% of the total deposit base and savings were 16% of the total deposit base. The growth in deposits of 50.5% between 1998 and 1999 is mainly explained by changes in the reporting formats, which amalgamated local deposits with foreign deposit effective March 1999. However, the increase in the deposit base in 1998 and 1999 was not proportionately distributed across banks. There was flight to quality where some banks lost deposits to other banks.

Composition of loans and advances

The composition of loans and advances is shown graphically in Figure 3.3. As at end of 31st December 1999 loans and advances of shs. 438.869m constituted 32.5% of the banking sector's assets.

During the period 1995 to 1996, lending to the Tradeable commodities sector accounted for over 70% of the sector's credit stock Credit to the export sub sector registered a decline of 37% during the same period. Lending activities to Non trade sector showed an increase of 79% overall during the period 1995 to 1999. Apart from the above sectors, there were also lending activities in Real estate and Government though with not much emphasis. No lending was registered in the Tourism sector.

FIGURE 3.3: CREDIT DISTRIBUTION



Capital Adequacy

Capital provides a safety net to depositors and other providers of loan finance against losses that a bank might incur. It is important that only banks that are adequately capitalised be authorised to accept deposits from the public. The existence of adequate capital does not, however, provide a guarantee against the future failure of a bank that is badly managed.

- **Total capital and reserves in the banking sector**

The total capital held by the banking sector at the end of December 1999 amounted to shs.72.317m. The overall capital position of the banking sector stood at deficits of Shs.39,788m and shs.42,959m for 1995 and 1996 respectively. This is explained mainly by the huge values of prior years-accumulated losses and high provisions. By December 1997, the position had been reversed and owners' funds were recorded at shs.73,636m though in 1999 capital dropped as shown below in Fig.3.4b.

FIGURE 3.4A: CORE ADEQUACY INDICATOR-CORE CAPITAL TO RISK WEIGHTED ASSETS (RWA)

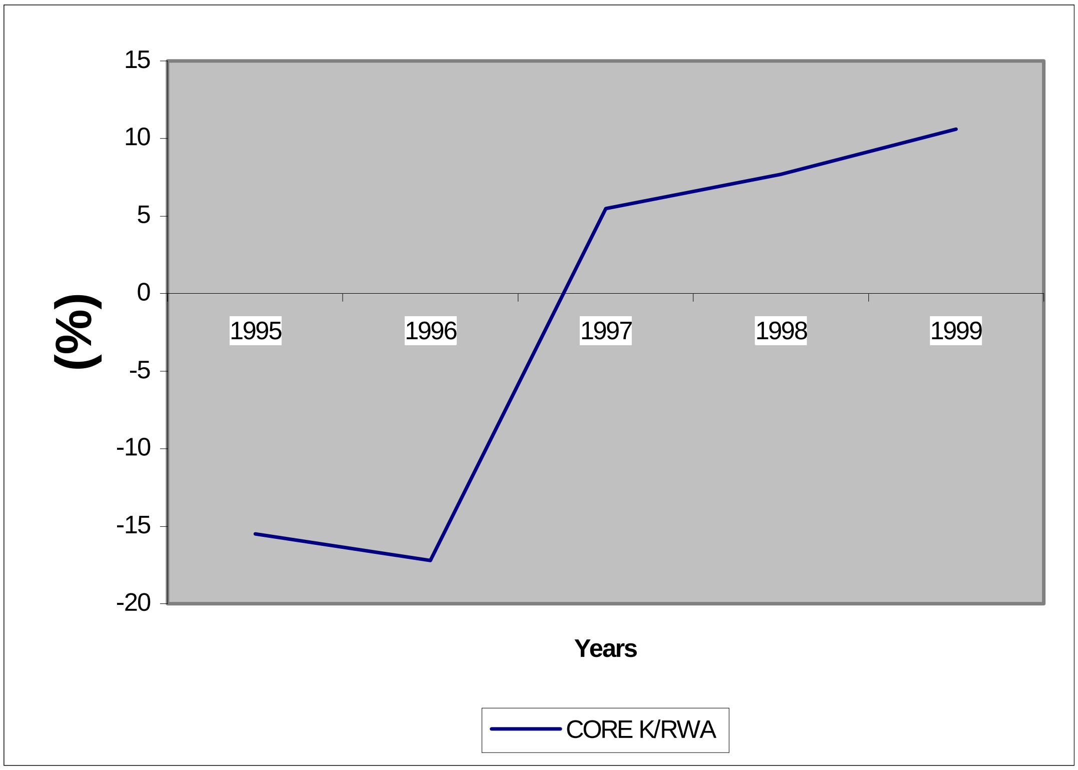


FIGURE 3.4B CAPITAL ADEQUACY INDICATOR- OWNERS' FUNDS

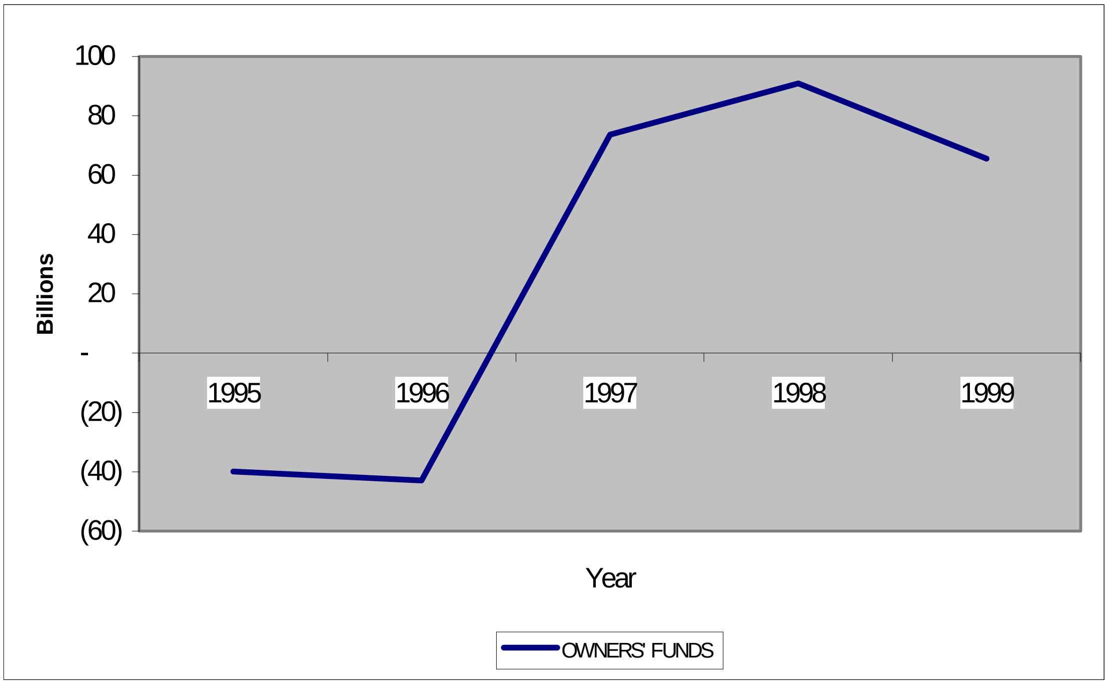


Figure 3.4b shows the movements in owners' funds between 1995 and 1999. As a result of the above developments, core capital to risk weighted assets for the banking sector for December 1995 and 1996 was –15.5% and –17.2% respectively. Core Capital to Risk Weighted Assets Ratio (RWA) had risen to 5.5% in 1997 and by December 1999, it was registered at 10.6% as shown in the graphs 3.4a. The improvement was due to the re-capitalisation of most banks especially the state owned bank, which is the largest bank in the sector. Improvement in the Capital adequacy was also due to the closure of insolvent banks in 1998 and 1999. During 1999, 15 banks were complying with the on going capital requirement currently at 4% of the risk weighted assets.

In recognition of the fact that a strong capital base is a precondition for a sound banking sector, the minimum unimpaired paid up capital was raised to Shs2bn. Both the on-going capital and total capital to Risk Asset Weighted requirement were raised to 8% and 12% respectively effective 1/01/2000. This change was gazetted under statutory instruments Supplement No.28 dated 19th November 1999. The same statutory instrument stipulates a minimum unimpaired capital for banks of shs.4bn by the year 2003

Asset Quality

The continued growth of Non Performing Assets (NPA) remains a concern of the Bank of Uganda. The ratio of NPA/Total advances in the banking sector remained relatively higher than the internationally acceptable level of below 10% and below the NPA to Total Advances fluctuated between 26% and 39% between 1995 and 1999. At the same time, specific provisions as percentages of NPAs ranged between 36% and 69% during the same period declining. Figure 3.5a below shows the trend in NPA ratios and Specific Provisions depicting a declining trend.

Commercial Banks on the other hand, continued to try to enforce recovery by realisation of collateral through court action although the disposal of court cases has been relatively slow. It is hoped that the commercial court which was set up in 1999 will help in speeding up the enforcement and realisation of collateral attachment and disposal.

FIGURE 3.5A: ASSET QUALITY

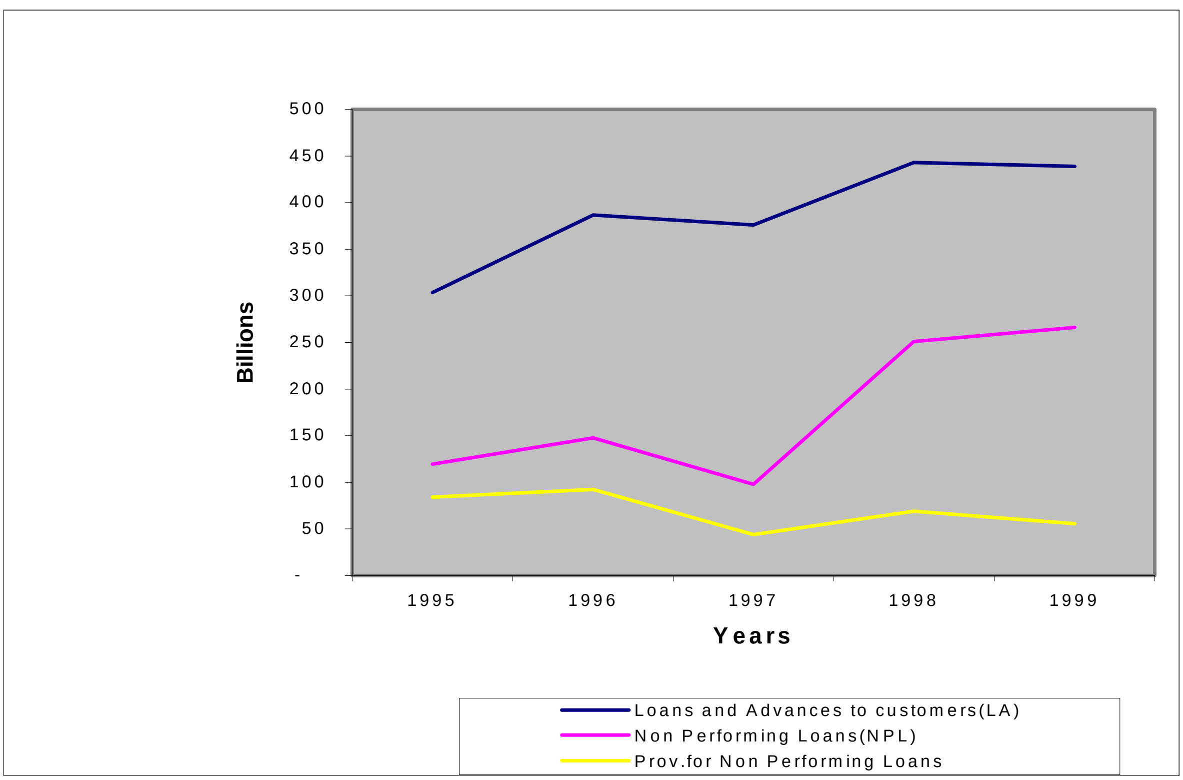
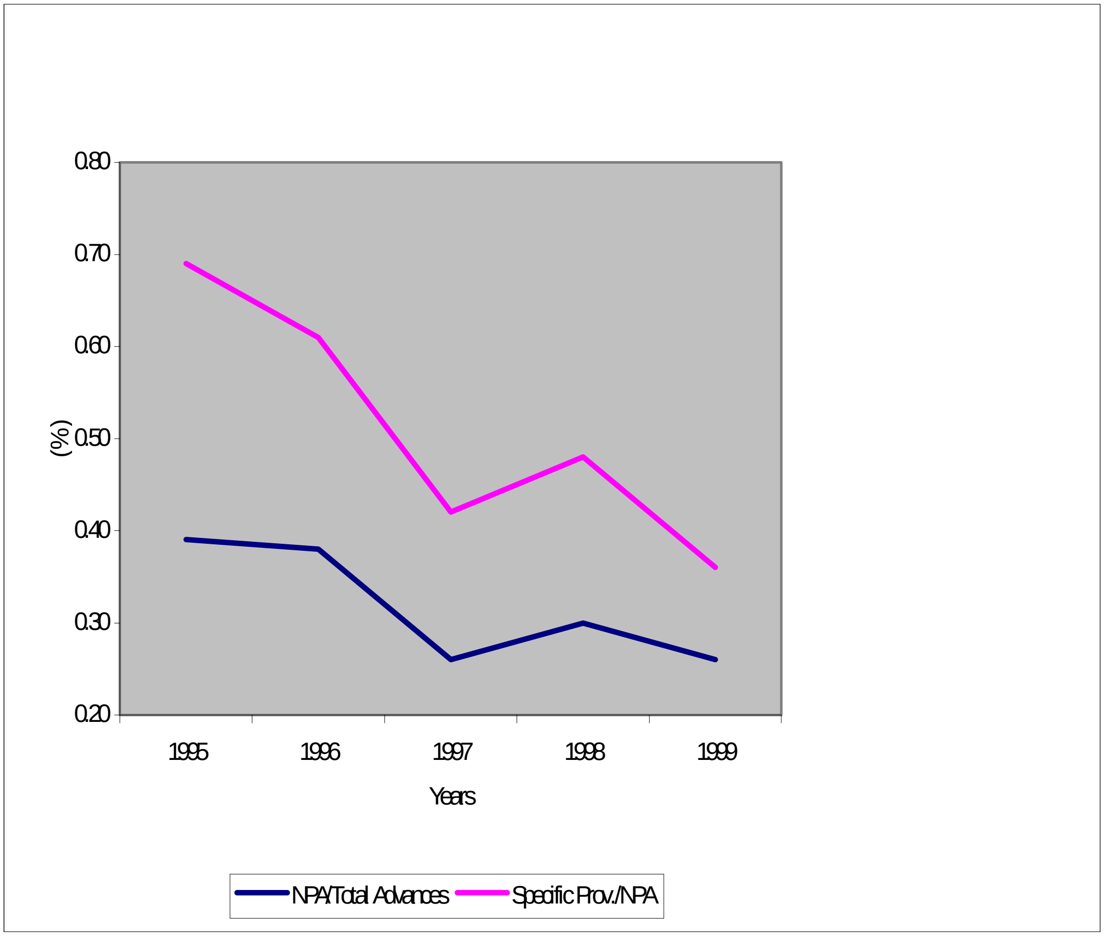


FIGURE 3.5B: ASSET QUALITY INDICATORS



Earnings

The evaluation of the profitability of banks hinges on the assessment of the quality of income and the long-term sustainability of the activities that generate that income.

Figures 3.6a, 3.6b, 3.6c and 3.6d shows composition of the income and the composition of the income and expenditure as a percentage of Total Assets.

FIGURE 3.6A :INCOME AS A PERCENTAGE OF TOTAL ASSETS-1998

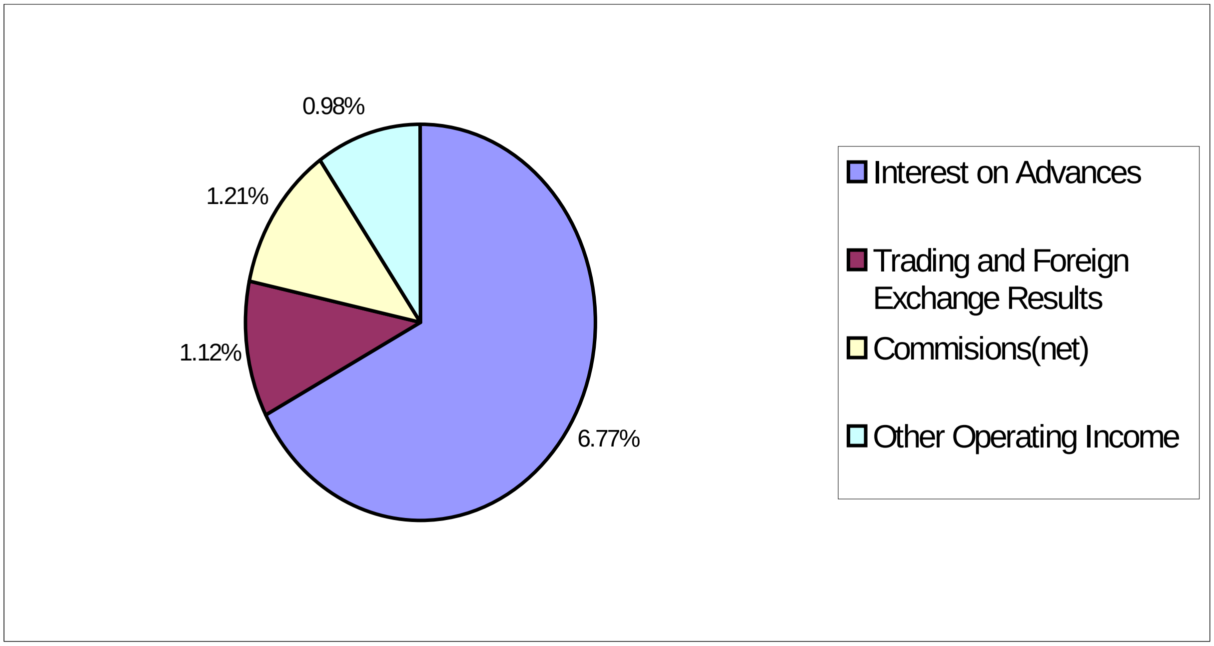
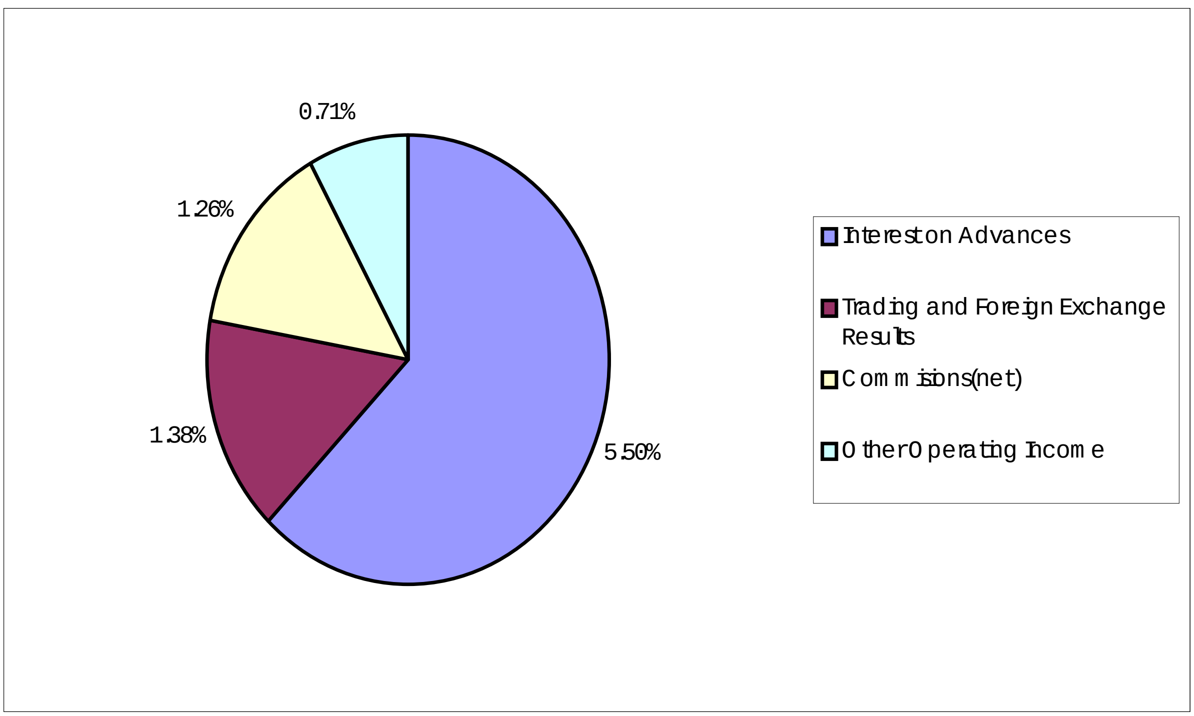


FIGURE 3.6B INCOME AS A PERCENTAGE OF TOTAL ASSETS-1999



From the figures 3.6a and 3.6b, the income from intermediation function which, consists of interest margin (an average of 5.50% of total assets for the year, 1999, as opposed to 6.77% in 1998) and income from forex operations (an average of 1. 38% of total assets for 1999, as opposed to 1.12% for 1998) constitutes the main source of income from banks. It can be observed that income from the inter-mediation function of shs. 74.568m was generally not sufficient to cover the sum of operating expenses and provisions which for the year 1999 amounted to shs.82.769m, which is 6. 10% of the total assets. It is thus clear that generation of additional income remains critical for purposes of ensuring the continued profitability of banks. It can be noted therefore that non-interest income averaged 3. 35% of the total assets, which supports adequately the net interest margin from the inter-mediation function.

Interest derived from advances continued to be the largest component of the total interest income. Interest income on advances earned during the year was equivalent to 5.50% of the total assets in 1999 as opposed to the 6.77% during1998. Although interest income from advances dropped by 18.0% during the year and interest expense dropped by 7.0% compared to 1998, the banking sector registered a 25.2% growth in the interest margin during the year. The interest margin has been argumented by other interest income from investments in government securities, which equaled to 15.7% of the total assets during the year.

The main components of interest expense during the year were the interest expense relating to demand, savings and time deposits. Initially, no interest would be paid on demand deposits but due to increased competition many financial institutions have began to pay interest on these deposits. In addition, there has been a steady growth in savings and time deposits over the years and between 1995 and 1999; deposits grew by 171.5%.

FIGURE 3.6C: EXPENSES AS A PERCENTAGE OF TOTAL ASSETS-1998

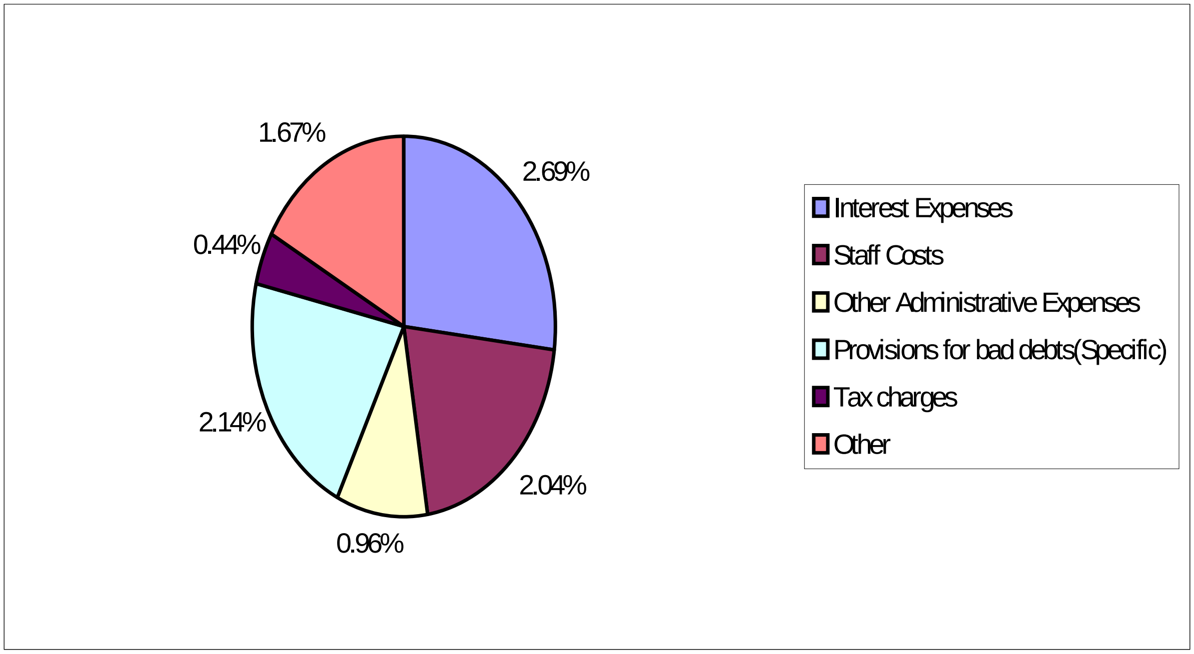
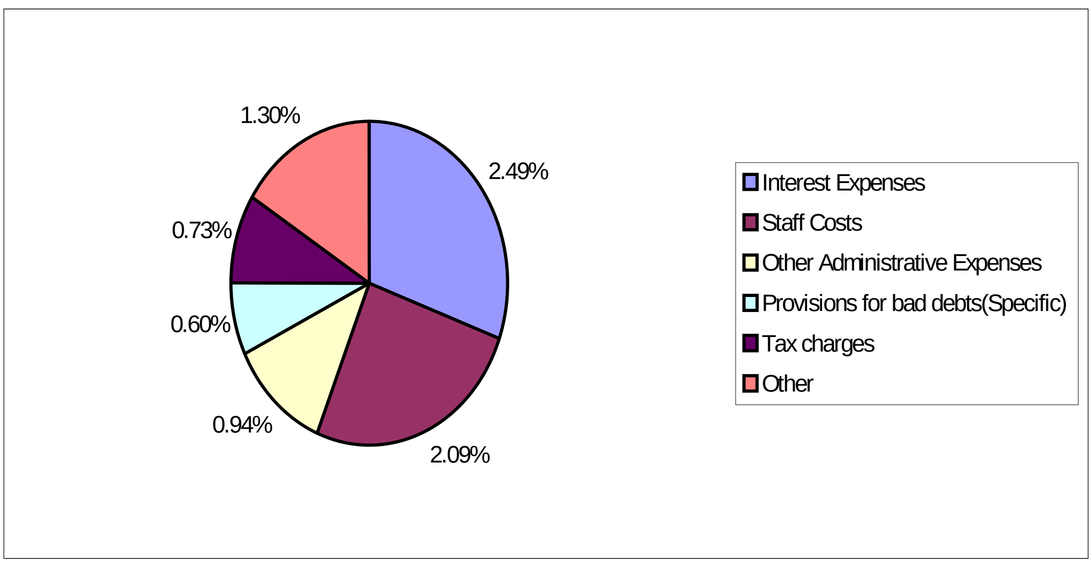


FIGURE 3.7D: EXPENSES AS A PERCENTAGE OF TOTAL ASSETS-1999

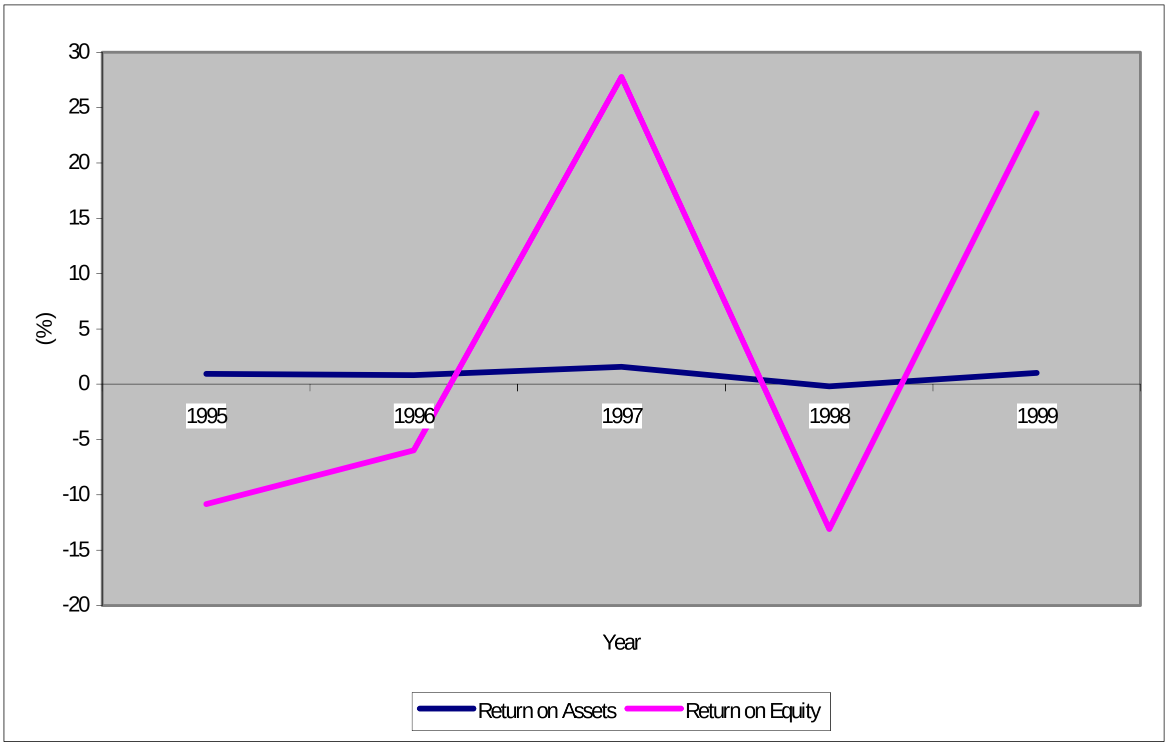


Specific provisions for loans and advances charged to the income statement amounted to shs.8,148, which was 0.60% of the total assets. Specific provisions for 1999 reduced by

70.2% relative to the specific provisions of 1998. This is in view of the relative decline in the level on NPAs to total advances as shown in figure 3.4b above

The banking sector achieved a before tax return of approximately 1.9% of total assets (1998: –0.18%) and after-tax return of approximately 1.02% of total assets during the year. The average return on equity for the year was 24.5% (1998: -13.1). Figure 3.7e shows the trends in ROA and ROE for period between 1995 and 1999. From figure 3.7e, a return on assets of –0.65% was record for in 1998, 1.67% in 1997, 0.92% in 1996 and 1.11% in 1995.

FIGURE 3.7E: EARNING RATIOS



The significant change in return on equity (ROE) in 1997, as shown in Figure 3.7e, was mainly due to income earned from the bonds that were used to re-capitalize the largest state owned bank. In December 1998, special audits were carried out in four banks where high provisions were recommended and this eroded the overall capital and earning position of the banking industry.

The earnings of most banks are still low largely due to the need for high provisioning for bad assets as well as the high intermediation costs. Consequently, although inflation rates have come down to single digit levels, lending rates continue to be high because banks have to cover their high operating costs brought about by losses on bad debts.

ii. Interest Rates

Due to the increased competition in the banking sector, many banks are beginning to offer competitive interest rates on fixed deposits in order to attract more deposits. This has had the effect of making their lending also expensive. Rates offered range from 8-20% for long-term deposits. For the very strong banks rates offered range from 3-8 percent for similar deposits. Such high interest rates make the cost of funds high, and in order to cover such costs, the banks have to charge high rates on lending, which has a bearing on the prompt repayment of such loans in most cases.

Liquidity Risk

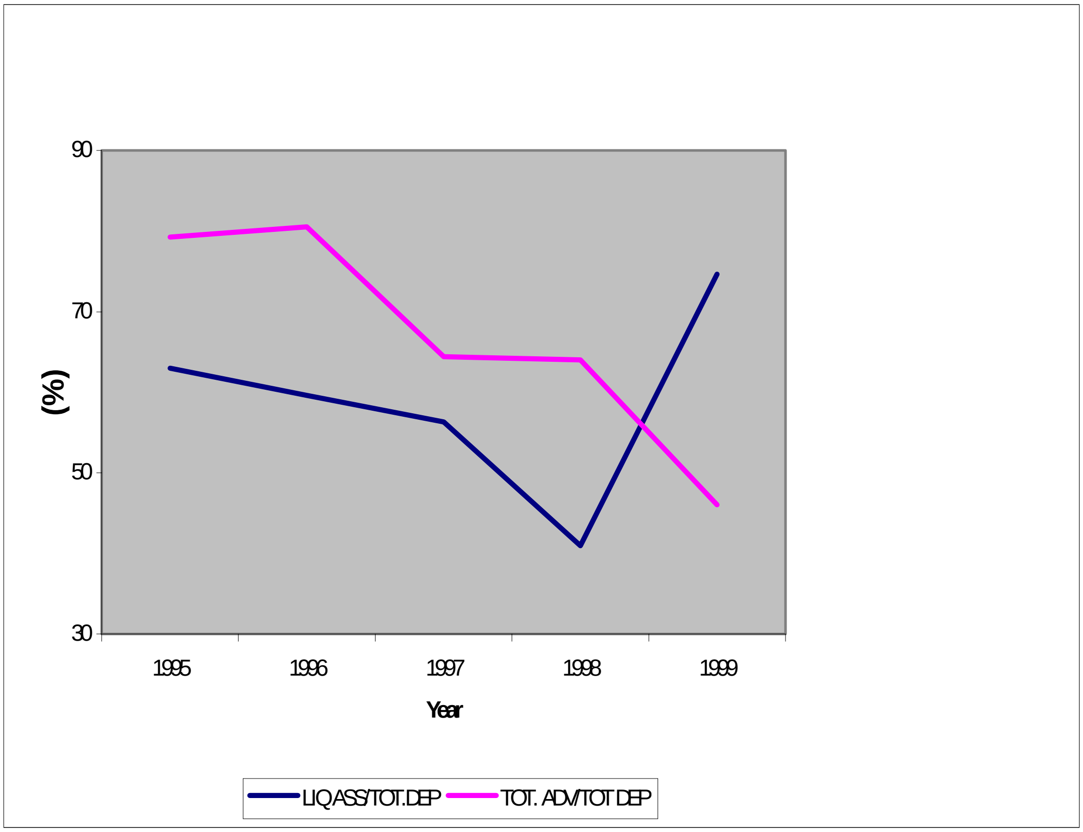
An evaluation of the liquidity risk management involves an assessment of the level of compliance with the statutory liquid asset requirements and cash reserve requirements for all the institutions in the financial sector.

Most commercial banks maintained sufficient liquidity over the period between 1995 and 1999. All banks recorded an overall liquid assets to deposits ratio of 62.99% as at end of 1995, 59.63% for 1996, 56.36% for 1997, 41% for 1998, and 73.62% for 1999, compared to an ideal ratio of 17.5% (see figure 3.8 below).

The overall credit to deposit ratio stood at 41.46% as at 31/12/99. The banking industry maintained positive clearing balance with BOU except for one bank. However such high levels of reserves may be symptomatic of a reduced role of banks in inter-mediating resources either for lack of bankable projects or risk averse behaviour to avoid losses associated with credit extension.

Credit institutions maintained a liquid assets/deposit ratio of 69.5% compared to the prescribed ratio of 15%.

FIGURE 3.8: LIQUIDITY INDICATORS



Market Share.

Commercial banks market share is dominated by one recently partially privatized state bank, holding 21% of total assets of the banking industry. Four biggest foreign controlled banks held 38% and the rest of domestic banks held 40%. The largest bank enjoys 24% of total deposits in the industry while the four foreign biggest banks control 35%, the rest hold 41% of the total deposits.

CHAPTER 4

4.0 CURRENT ISSUES IN BANKING SUPERVISION:

4.1 Introduction:

The purpose of this chapter is briefly to discuss the most important regulatory and supervisory developments and trends both locally and internationally. These include corporate governance, consolidated supervision, money laundering, micro finance, and core principles of effective supervision.

4.2 Corporate Governance:

Corporate governance in banks is a key tenet of the regulatory and supervisory approach. In its broadest sense corporate governance is a system by which companies (in this case financial institutions/banks) are directed and controlled. It involves inter-relationship among shareholders, board of directors, executive management, regulators, auditors and other stakeholders with accountability, transparency and protection of their interest in the institution as the main goals. The Board of directors and top management of financial institutions constitutes major components of corporate governance.

- *Role of Directors.*

The prime responsibility for managing the risks inherent in banking lies with banks' management, which accounts to the board of directors. The board of directors, in turn are responsible for setting the limits for the bank's risk appetite and its oversight. The detailed design, implementation, reporting and operation of adequate internal controls will normally be delegated to management by the board of directors. Directors, however, have to judge whether or not the system of internal control is adequate and whether the right balance between cost and benefit is being maintained.

To serve as a director of a banking institution evidently carries substantial responsibilities that may well have major personal financial repercussions. In view thereof, it is advisable that the decision to become a director of a bank be reached only after it has been duly determined whether the proposed directors are fit and proper persons.

- *Role of internal auditors:*

The internal audit function is an important part of corporate governance and one of the mechanisms of the system of checks and balances in an institution. Internal audit has been recognized as an increasingly important player in the risk management process of the bank. It is concerned with monitoring the risk to which a bank is exposed and reporting whether risk is adequately controlled. The internal audit function should therefore be an independent function within an organization and its effectiveness will depend on:

- The independence of the internal audit function's reporting lines.
- The technical capacity of the internal audit team.
- Unrestricted access to all activities, records, property and personnel of a bank by the internal auditors.

The following can be cited as some of the reasons for Bank Supervisors' increased interest in the work of banks' internal auditors.

- Internal audit is an integral component of a bank's control procedures.
- The external auditors of banks can place greater reliance on the work of internal auditors.
- The internal audit function enables the board audit committee to assess whether the risk- management process is effective.
- The internal audit function is considered to be an integral part of the overall system of prudential supervision.

- *Role of external auditors:*

External auditors provide an opinion on the structure of checks and controls within a financial institution. They report on the ensure quality of information produced by bank management, adequacy of management disclosure truth and fairness of the banks' financial position, reliability of the banks' internal control system as well as accounting and management information systems.

4.3 Consolidated Supervision:

From a bank supervisor's perspective, consolidated supervision of banking operations entails two important aspects:

- Ongoing risk assessment of the overall structure of a banking group and business. This is intended to quantify the potential impact that risks arising in any non-banking entity within such a group may have on the bank or banks in that group.
- Supervision of a domestic bank's local and cross-boarder operations by a home country, and supervision of a foreign bank's operations which are within the supervisor's jurisdiction by a host country.

The process involved in consolidated supervision includes, inter alia:

- Analysis of statutory information and other financial and non-financial information to ensure regulatory compliance on a group basis;
- Liaison and interaction with other regulatory and supervisory authorities, both locally as in the case of a banking group with non-banking entities, and internationally; and
- Regular interaction and discussions with the key players directly involved in the risk-management process of bank's directors, management, audit committees including internal audit, external auditors both locally and abroad.

It thus becomes evident that consolidated supervision is complex and demanding in terms of time, human and infra-structural resources.

4.4 Money Laundering

Money laundering is the process by which criminals attempt to hide and disguise the true origin and ownership of the proceeds of their criminal activities, thereby avoiding prosecution, conviction and confiscation of criminal funds. Failure to prevent the laundering permits criminals to retain the funds or recycle them to fund further crimes.

In recent years, there has been increasing recognition of the need to attack money laundering in order to fight serious crime effectively. The ability to launder the proceeds of criminal activity through world financial systems is vital to the success of criminal operations. Strengthening the prudential supervision and reputation of the financial system through effective anti-money laundering measures is an essential pre-requisite of achieving and maintaining the potential benefits of domestic and foreign financial liberalisation.

Uganda has joined the rest of the world to fight money laundering. As a member of East and Southern Africa Anti – Money Laundering Group (ESAAMLG), Uganda has set up a national Anti-Money Laundering Committee (AMLC) to work towards attainment of the highest international standards in the fight against money laundering.

An enabling clause has been included in the draft Financial Institutions Bill (FIB) 2000 to enable Bank of Uganda regulate and control money laundering in Uganda. And a fully fledged law to criminalise money laundering is in the process of being drafted.

4.5 Micro Finance:

The micro finance sector in Uganda has grown rapidly in recent years. Non-bank institutions that offer small loans to individuals for a variety of purposes have mushroomed and stand at over 64 in number. International recognition has been given to the fact that micro lenders constitute effective credit providers to people with limited or no access to credit sources other than informal moneylenders. By creating another tier in addition to the formal financial system, these micro financiers fulfill a valuable role in the intermediation process of a developing economy.

Bank of Uganda in consultation with interested parties in the micro finance sector, is currently considering options. It is envisaged that the introduction of appropriate legal framework would set standards for the industry and enforce compliance. The micro finance sector therefore would be afforded the opportunity to operate and grow in a manner that is safe, sound and sustainable.

4.6 Core Principles of Effective Banking Supervision

Background

In 1997, the Basel Committee on Banking Supervision circulated a set of 25 core principles for effective banking supervision with a view to assessing the status of implementation by member countries. Central Bank Governors of the G-10 countries formed the committee whose secretariat is based at the Bank of International Settlements, Basle, Switzerland in 1975. It now encompasses non G-10 countries divided into sub-regional groupings. Uganda belongs to the Eastern and Southern Africa Sub-Group (ESAF) whose secretariat is currently based at the Bank of Zambia.

The Basle core principle are the minimum guidelines for effective banking supervision and supervisory authorities are therefore required to adopt them to suit local environment.

Evaluation of the progress made in implementation of the relevant core principles in Uganda is satisfactory. However, there are a few outstanding areas, which will be addressed after the proposed amendments to the legal framework are put in place.

Below is a summarized statement of the 25 Core Principles:

Preconditions for Effective Banking Supervision:

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in supervision, ensuring legal protection and operational independence and adequate resources for the supervisors; and information sharing and confidentiality of the same *among examiners.*

Licensing Structure

2. Clearly defined permissible activities of licensed bank/financial institutions and control of the word bank in names.

3. Licensing authority must have the right to set criteria and reject applications that do not meet the standards. The licensing process should at least consist of and assessment of the bank's ownership structure, directors, and senior management, operating plan and internal controls, projected financial condition, prior consent of the bank's home country supervisor.

4. Banking supervision must have the authority to review and reject any proposals to transfer significant ownership.

5. Banking supervision must have the authority to establish criteria for reviewing major acquisitions or investments by a bank/financial institution and ensuring that corporate affiliations do not expose the bank to undue risks or hinder effective supervision.

Prudential regulations and requirements

6. Banking supervision must set minimum capital requirements that reflect risks that banks undertake.

7. There must be an independent evaluation of banks' policies, practices and procedures related to the granting of loans and making of investments and the on-going management of the loan and investment portfolios

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provision and reserves.

9. Banking supervision must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrower or group of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control the risks.

11. Banking supervision must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international and investing activities and for maintaining adequate reserves against such risks.

12. Banking supervision must be satisfied that banks do accurately measure, monitor and control market risk exposure. Banking Supervision should have powers to impose limits on market risk exposures.

13. Supervisors must be satisfied that banks have comprehensive risk management process to identify, measure, monitor and control all other risks and where appropriate, to hold capital against these risks.

14. Supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of business.

15. Banking supervisors must ensure that banks have adequate policies including strict 'know your customer rules' that promote ethical and professional standards and prevent the bank being used by criminal elements.

Methods of On-going Banking Supervision

16. An effective banking supervisory system should consist of both on-site and off-site supervision.

17. Banking supervisors must have regular contacts with bank management and thorough understanding of bank management.

18. Banking supervisors must have means of collecting, reviewing and analyzing reports and statistical returns from banks in a solo and consolidated basis.

19. Banking supervisors must have a means of validating of supervisory information through on-site examinations or use external auditors.

20. An essential element of banking supervision is the ability to supervise the banking organization on a consolidated basis.

Information Requirements

21. Banking supervisors must make sure that banks have adequate records drawn in accordance with consistent accounting policies that enable supervisors to obtain a true and fair view of the position and the performance of the bank.

Formal Powers of Supervision

22. Banking supervisors must have at their disposal, supervisory measures to bring about corrective actions when banks fail to meet prudential requirements.

Cross-border banking

23. Banking supervisors must practice global consolidated supervision applying prudential norms to all aspects of business conducted by banking organization worldwide, primarily at their foreign branches and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved primarily host country supervisory authorities.

25. Banking supervision must require the local operations of foreign banks to be conducted to the same high standards as domestic banks and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

APPENDIX:

REGISTERED COMMERCIAL BANKS AS AT 31.12.99.

	Name of Bank	*Ownership*	*No. of Branches*	*No. of Agencies*	*No. of Sub-branches*
1	Uganda Commercial Bank Ltd	Government	65	2	
2	Cooperative Bank Ltd. *	Coop. Movts, USAID & staff	24	6	
3	Gold Trust Bank Ltd.	Local	5		
4	Nile Bank Ltd.	Foreign	3		
5	Greenland Bank ltd. **	Local	5		
6	Allied Bank International	Foreign	3		
7	Centenary Rural Devt. Bank	Local	9	1	
8	National Bank of Commerce	Foreign	2		
9	Orient Bank Ltd.	Local	2		
10	Barclays Bank (U) Ltd.	Foreign	2		
11	Bank of Baroda (U) Ltd.	Foreign	7		
12	Stanbic Bank (U) Ltd.	Foreign	1		
13	Standard Chartered Bank (U) Ltd.	Foreign	1		
14	Tropical Bank	Foreign	3		
15	Crane Bank Ltd.	Local	2		
16	Cairo International Bank	Foreign	1		
17	Diamond Trust Bank	Foreign	1		
18	International Credit Bank Ltd. ***	Local	2		1
19	Transafrica Bank ****	Local	4		
20	Trust Bank *****	Foreign	1		
	TOTAL		143	9	1

Note:

* Co-operative Bank Ltd. was seized and closed on 20th May 1999 by Bank of Uganda.

** Greenland Bank ltd was seized and closed on 1st April 1999 by Bank of Uganda.

*** International Credit Bank ltd was seized by Bank of Uganda on 18th September, 1998. Its operations were discontinued, license had earlier expired.

**** Transafrica bank's operations were suspended on 22nd September, 1998, and then re-opened on 26th January, 1999.

***** Trust bank's operations were suspended on 21st September 1998, and re-opened on 7th December 1998 and later closed on 24.11.99.

REGISTERED CREDIT INSTITUTIONS AS AT 31.12.99

	Name of Credit Institution	*Ownership*	*No. of Branches*
1	Housing Finance Company (U) Ltd.	Local	2
2	Stanbic Bank International (U) Ltd *	Foreign	1
3	Mercantile Finance Co. Ltd	Local	1
4	Capital Finance Corporation Ltd	Local	1
5	Interstate Finance Co. ltd	Local	1
6	Stanhope Finance Co. ltd.	Local	1
7	Imperial Investments Finance Co. ltd.	Local	1
	TOTAL		**8**

Note: * Stanbic Bank International has now closed down.

(Figures in Billions) except where percentages have been used

COMPOSITION OF ASSETS	1995	1996	1997	1998	1999
Cash and Bal.with BOU	84	115	110	137	129
Treasury Bills	41	61	106	113	212
Fixed Assets	71	84	86	95	92
Loans to DMBs	150	167	220	279	290
Loans and Advances to customers	303	387	376	443	439
Securities	0	3	82	91	89
Other Assets	74	52	73	120	101
TOTAL	724	868	1,053	1,279	1,352

CREDIT DISTRIBUTION	1995	1996	1997	1998	1999
Real Estate	0	2	2	5	4
Export	10	10	4	5	6
Tourism	-	-	-	-	-
Commodities	230	304	272	307	319
Government	3	2	2	3	2
Non Traded	60	69	96	124	108

LIABILITIES	1995	1996	1997	1998	1999
Due to DMBs	131	147	191	247	9
Deposits and Bonds	383	480	584	691	1,040
Capital(Owners funds)	(40)	(43)	74	88	72
Provisions	91	107	58	86	53
Other Liabilities	153	169	131	166	149
Profit For Current Year	6	9	14	1	26

ANALYSIS OF DEPOSITS	1995	1996	1997	1998	1999
DEMAND AND CALL	226	255	296	342	612
SAVINGS	86	98	115	145	167
TIME	72	127	173	204	260

STRUCTURE OF P&L					
INCOME	1995	1996	1997	1998	1999
Interest on Advances	35	51	63	87	74
Trading and Foreign Exchange Results	4	10	12	14	19
Commission(net)	4	10	11	15	17
Other Operating Income	3	6	9	13	10
Net Interest Income	11	33	42	51	68
Net Income	7	5	13	(8)	30

STRUCTURE OF P&L					
EXPENSES	1995	1996	1997	1998	1999
Interest Expenses	8	18	21	34	34
Staff Costs	8	21	22	26	28
Other Administrative Expenses	3	8	11	12	13
Provisions for bad debts(Specific)	5	8	8	27	8
Tax charges	1	3	3	6	10
Other	5	16	15	21	18

INCOME AND EXPENDITURE AS A PERCENTAGE OF TOTAL ASSETS
INCOME

	1998	1999
Interest on Advances	6.77%	5.50%
Trading and Foreign Exchange Results	1.12%	1.38%
Commisions(net)	1.21%	1.26%
Other Operating Income	0.98%	0.71%
Net Interest Income	4.01%	5.02%
Net Income	-0.62%	2.21%

INCOME AND EXPENDITURE AS A PERCENTAGE OF TOTAL ASSETS
INCOME

	1,999
Interest on Advances	5.50%
Trading and Foreign Exchange Results	1.38%
Commisions(net)	1.26%
Other Operating Income	0.71%
Net Interest Income	5.02%
Net Income	2.21%

INCOME AND EXPENDITURE AS A PERCENTAGE OF TOTAL ASSETS
EXPENSES

	1998	1999
Interest Expenses	2.69%	2.49%
Staff Costs	2.04%	2.09%
Other Administrative Expenses	0.96%	0.94%
Provisions for bad debts(Specific)	2.14%	0.60%
Tax charges	0.44%	0.73%
Other	1.67%	1.30%

INCOME AND EXPENDITURE AS A PERCENTAGE OF TOTAL ASSETS
EXPENSES

	1999
Interest Expenses	2.49%
Staff Costs	2.09%
Other Administrative Expenses	0.94%
Provisions for bad debts(Specific)	0.60%
Tax charges	0.73%
Other	1.30%

CAPITAL ADEQUACY INDICATORS

	1995	1996	1997	1998	1999
CORE K/RWA	-15.5	-17.2	5.5	7.7	10.6
	1995	1996	1997	1998	1999
OWNERS' FUNDS	(39,788)	(42,959)	73,636	87,693	72,317

EARNINGS RATIOS	1995	1996	1997	1998	1999
ROA	0.97	0.83	1.58	-0.18	1.02
ROE	-10.8	-5.95	27.78	-13.1	24.5

LIQUIDITY	1995	1996	1997	1998	1999
LIQ ASS/TOT.DEP	62.99	59.63	56.36	40.98	73.62
TOT. ADV/TOT DEP	79.24	80.49	64.4	64.01	41.46
LIQUID ASSETS	241	286	329	392	783

ASSET QUALITY	1995	1996	1997	1998	1999
Loans and Advances to customers(LA)	303	387	376	443	439
Non Performing Loans(NPL)	120	148	98	251	266
Prov.for Non Performing Loans	84	92	44	69	56

Ratios	1995	1996	1997	1998	1999
NPL/Total LA	39.00	38.00	26.00	30.00	26.00
Specific Prov./NPA	69.00	61.00	42.00	48.00	36.00