INTERNATIONAL MONETARY FUND

Staff Country Reports

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April 2003
IMF Country Report No. 03/97

Uganda: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, Insurance Regulation, Corporate Governance, and Payment Systems

This Financial System Stability Assessment on **Uganda** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **January 27, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Uganda** or the Executive Board of the IMF.

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International Monetary Fund
Washington, D.C.

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UGANDA

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and African Departments

Approved by Stefan Ingves and Abdoulaye Bio-Tchané

January 27, 2003

The Financial System Stability Assessment (FSSA) is based on the work of the joint IMF-World Bank Financial Sector Assessment Program (FSAP) missions to Uganda in January and April 2001. The missions met with senior government officials, with officials and staff of institutions and agencies involved in the supervision and regulation, commercial banks, and other market participants. Follow-up discussions were held with the authorities during November 12–21, 2002 in the context of the 2002 Article IV consultation.

The FSAP team was led by Messrs. Abdessatar Ouanes (IMF, FSAP Mission Chief) and Paul Murgatroyd (World Bank, Deputy Mission Chief), and included: Messrs. Michael Andrews, Cem Karacadag, Obert Nyawata; Ms. Judit Vadasz and, as mission assistant, Ms. Charmane Ahmed (all IMF/MAE); Messrs. Abayomi Alawode, Juan Costain, Peter Kyle, Don McIsaac, and Antony Thompson (all World Bank); Messrs. Bekele Tamirat (central banking auditing and accounting expert), Michael Robotham (payment system expert), Carlisle C. Procter (Reserve Bank of Australia, retired), and C.R. Muralidharan (Reserve Bank of India). Mr. Zia Ebrahim-zadeh, the then IMF Resident Representative in Kampala, assisted the mission.

The banking system in Uganda, which dominates the financial system is fundamentally sound, more resilient than in the past, and currently poses no threat to macroeconomic stability. This is mainly because of the preventive actions taken by the Bank of Uganda in closing four banks in the aftermath of the 1998/99 banking crisis, the swift and decisive actions taken in response to the FSAP recommendations, and the fact that the system is now dominated by large reputable foreign banks that appear to be well capitalized and resilient. A major disruption in donor flows could, however, challenge macroeconomic stability and threaten the financial system.

Despite the progress made in implementing the recommendations of the FSAP, a great deal still remains to be done to further strengthen and support the development of the financial system. This includes the need to: (i) fully address the problem caused by the small banks and the risks they potentially pose to market integrity; (ii) move expeditiously on the stalled passage of the Financial Institutions Bill; (iii) enact anti-money laundering legislation and put in place a credible framework for monitoring and enforcing it; (iv) reform the National Social Security Fund (NSSF); (v) address the problems of the Uganda Development Bank; (vi) phase out direct government involvement in microfinance; and (vii) continue to reform the legal framework, improve banking supervision, and strengthen the payment system.

This report is divided into two parts. The first part provides a staff report on financial sector issues. The second part presents summary assessments of observance of standards and codes relating to banking supervision, securities regulation, payment system, and transparency in monetary and financial policies.

The main authors of this report are Abdessatar Ouanes, Obert Nyawata, and Cem Karacadag.

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Glossary

AML	Anti-Money Laundering
BCP	Basel Core Principles for Effective Banking Supervision
BOU	Bank of Uganda
CMA	Capital Markets Authority
CPSS	Core Principles for Systemically Important Payment Systems
DFCU	Development Finance Company of Uganda
DFD	Development Finance Department
DNS	Deferred Net Settlement
DPF	Deposit Protection Fund
EADB	East Africa Development Bank
EASRA	East African Member States Securities Regulatory Authorities
ESAAMLG	East Africa Anti-Money Laundering Group
FATF	Financial Action Task Force
FIB	Financial Institutions Bill
FIS	Financial Institutions Statute
FMOC	Financial Market Operation Committee
GTZ	German Technical Cooperation Agency
HFCU	Housing Finance Company of Uganda
HIPC	Heavily Indebted Poor Countries
ICB	International Credit Bank
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
MCPC	Monetary and Credit Policy Committee
MFI	Microfinance Institutions
MOF	Ministry of Finance
NBFI	Nonbank Financial Institutions
NSE	Nairobi Stock Exchange
NPA	Nonperforming Advances
NPART	Nonperforming Assets Recovery Trust
NPL	Nonperforming Loans
NPS	National Payments System
NPSC	National Payments System Council
NSSF	National Social Security Fund
NST	Uganda National Strategy Team
RTGS	Real-Time-Gross Settlement
SACCO	Savings and Credit Cooperative Organization
UCA	Uganda Cooperative Alliance
UCBL	Uganda Commercial Bank Limited
UCC	Uganda Communications Commission
UCSCA	Uganda Cooperative Savings and Credit Association
UDB	Uganda Development Bank
UIC	Uganda Insurance Commission
ULS	Uganda Law Society
UMA	Uganda Manufacturers Association
USE	Uganda Stock Exchange

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PART I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. SUMMARY

The banking system in Uganda, which dominates the financial system, is fundamentally sound, more resilient than in the past, and currently poses no threat to macroeconomic stability. This is mainly because of the preventive actions taken by the Bank of Uganda (BOU) in closing four banks in 1998/99, the swift and decisive actions taken in response to the FSAP recommendations, and the fact that the system is now dominated by large reputable foreign banks that appear to be well capitalized and resilient. Nevertheless, a major disruption in donor flows could challenge macroeconomic stability and threaten the financial system.

Despite the progress made in implementing the recommendations of the FSAP, a great deal still remains to be done to further strengthen and support the development of the financial system. This includes the need to: (i) fully address the problem caused by the small banks and the risk they potentially pose to market integrity; (ii) move expeditiously on the stalled passage of the Financial Institutions Bill; (iii) enact anti-money laundering legislation and put in place a credible framework for monitoring and enforcing it; (iv) reform the National Social Security Fund (NSSF); (v) address the problems of the Uganda Development Bank; (vi) phase out direct government involvement in microfinance; and (vii) continue to reform the legal framework, improve banking supervision, and strengthen the payment system.

The macroeconomic environment in Uganda is exposed to a number of potential vulnerabilities, which also need to be addressed if the health of the financial sector is to be safeguarded. These include: (i) the economy's dependence on agriculture, which leaves Uganda vulnerable to external shocks; (ii) the country's heavy dependence on politically sensitive foreign donor flows; and (iii) the still unsettled security situation in part of the country, as well as some uncertainties about the political succession. There is also a need for sustaining the reform process.

II. MACROECONOMIC ENVIRONMENT AND SHORT-TERM VULNERABILITIES

A. Macroeconomic Background and Risks

1. **After several decades of civil war and economic mismanagement, Uganda began to rehabilitate its economic infrastructure and restore macroeconomic stability in 1987.** The reform process was bold and comprehensive. It included a substantial reduction of the government's involvement in commercial activities, and the elimination of official controls on prices, interest rates, and bank credit. The liberalization of trade and exchange arrangements, which started with current account convertibility in 1993, culminated with the opening of the capital account in 1997. Economic liberalization and prudent macroeconomic policies resulted in a sustained high rate of growth (averaging about 7 percent during the past decade) and low inflation. These achievements, together with Uganda's resolve to alleviate poverty, have earned it strong support from the international community in the form of debt relief and large donor inflows (Table 1).

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Table 1. Uganda: Selected Macroeconomic Indicators
(1997/98–2001/02)1/

	1997/98	1998/99	1999/00	2000/01	Est. 2001/02
	(Annual percentage changes unless otherwise indicated)				
Total population (end-2001): 24.7 million					
GDP per capita (2002): US$237					
Real sector					
GDP at constant prices (percent change)	4.7	7.9	5.3	5.5	6.6
GDP (at market prices in billions of U Shillings)	7513	8126	8904	10005	10292
CPI (e.o.p. percentage change)	-0.9	5.3	1.9	6.4	-2.5
Private savings ratio (in percent of GDP)	5.4	10.9	11.5	10.1	14.7
Monetary and credit data (change in annual averages)					
Monetary base	5.1	5.8	0.9	8.0	5.1
Money and quasi-money (M3)	26.1	13.8	16.1	17.5	21.6
Broad money (M2 - percent change)	23.7	9.1	8.8	15.2	24.9
Domestic credit	2.7	17.2	46.9	7.0	1.9
Central government	-8.3	0.1	46.7	3.4	1.4
Credit to the private sector	11.0	12.3	2.9	4.0	0.7
Treasury bill rate	10.6	7.1	7.7	19.3	6.1
Rediscount rate	12.2	10.1	9.7	25.3	8.1
Bank rate	14.1	14.6	11.2	26.9	9.2
Public finances (in percent of GDP)					
Revenue	10.7	11.7	11.3	10.8	12.2
Grants	5.3	5.0	5.8	7.6	7.0
Government budget balance (excluding grants)	-6.4	-7.7	-15.5	-10.6	-12.7
Government balance (including grants)	-1.1	-2.7	-9.7	-3.0	-5.7
Net donor inflows	8.2	7.1	8.0	10.6	11.6
External sector (in percent of GDP, unless otherwise indicated)					
Average exchange rate (U Sh/US$)	1149.7	1362.0	1511.4	1762.9	1755.0
Real effective exchange rate (percent change)	2.2	-13.0	-0.2	-6.5	-0.8
External current account balance					
(including official grants)	-6.7	-6.2	-6.9	-6.0	-6.0
(excluding official grants)	-12.5	-10.8	-13.0	-14.1	-13.4
Terms of trade (deterioration = "-")	10.6	-10.7	-17.3	-10.7	-3.1
Gross official reserves (millions of US$)	750.5	748.1	719.4	738.8	866.4
Reserve cover (months of imports)	-6.2	-6.4	-5.9	-5.4	-6.1
External debt (including the IMF)	-12.5	-10.8	-13.0	-14.1	-13.4
Debt service/government revenue (in percent)	24.0	25.6	15.2	13.3	10.1
Debt-service ratio in percent of exports of goods and nonfactor services 2/	27.1	24.3	20.2	9.7	8.0
External interest payments to exports of goods and nonfactor services (in percent)	7.1	6.1	7.4	6.3	5.6

Sources: Bank of Uganda and IMF staff estimates.

1/ The fiscal year begins in July.
2/ The debt service ratio incorporates the effects of rescheduling and estimated HIPC assistance from non-Paris Club bilateral creditors with whom bilateral agreements have not yet been reached.

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2. **The macroeconomic environment in Uganda, while stable, is exposed to a number of potential vulnerabilities, which would need to be managed**. Specifically, the economy's dependence on agriculture leaves Uganda vulnerable to external shocks, especially to falling world commodity prices.[1] Second, the country's heavy dependence on politically sensitive foreign donor flows is another source of vulnerability. While aid flows provide much-needed resources to reduce poverty, major delays in their disbursement or a drop in their level could unveil the country's large internal and external imbalances. This would challenge macroeconomic stability and pose a threat to the financial system.[2] Finally, the still unsettled security situation in part of the country, as well as some uncertainties about the political succession, continue to weigh negatively on the country's medium-term prospects.[3]

B. Structure of the Financial System

3. **The financial system in Uganda is small, underdeveloped, and dominated by commercial banks.** The financial sector is relatively small, with total assets equivalent to 29.5 percent of GDP in June 2002. It is underdeveloped, with indicators of financial depth being low both in absolute terms and relative to most African comparators.[4] For example, broad money's share in GDP is only 13 percent; bank branch penetration is low at one branch per 130,000 Ugandans and most of these branches are urban-based, despite the fact that 90 percent of the population lives in rural areas; and financial markets are embryonic. In terms of its structure, commercial banks dominate the financial system, accounting for over 82 percent of financial assets, and traditional bank deposits represent the major form of financial savings. Other financial intermediaries are limited in number, small in size, and relatively ineffective. These include pension funds, insurance companies, microfinance institutions, and other nonbank financial intermediaries (Table 2).

---

[1]The authorities' efforts to diversify the economic base and expected gains in productivity should over time help enhance the economy's resilience to the vicissitudes of primary commodity prices.

[2]It should be noted that the current high level of international reserves would provide an important cushion and would afford the authorities some time to adjust their policies.

[3]If the security situation in neighboring countries deteriorates, it could also adversely affect the Ugandan economy.

[4]In case of Uganda, selected indicators of financial depth such as M2/GDP and private sector credit/GDP are significantly lower than neighboring Kenya, Zambia, and Zimbabwe, while the ratio of currency/M2 is one of the highest in Africa.

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Table 2. Uganda: Financial System Structure

	Number of Institutions 1/					
	Dec. 1997	Dec. 1998	Dec. 1999	Dec. 2000	Dec. 2001	Jun. 2002
Type of institution						
Depository institutions						
Commercial banks	20	19	17	17	17	15
Savings and loan institutions	7	5	5	6	6	7
Microfinance institutions	80	...	...	102	102	101
Non-depository intermediaries 2/						
Securities firms 3/	8	8	8	8	8	8
Finance companies	1	1	1	1	1	1
Life insurance companies	3	3	3	3	4	4
Pension funds 4/	1	1	1	1	1	1
Memorandum items:						
State-owned banks 5/	1	1	1	1	1	0
Foreign-owned banks	11	11	11	11	11	11
Financial system assets as of June 30, 2002						
	Assets (U Sh billions)	% of Assets	% of GDP			
Commercial banks	2,450	81.8	24.1			
NBFI	200	6.7	2.0			
Pension	254	8.5	2.5			
Insurance	60	2.0	0.6			
Microfinance	30	1.0	0.3			
Total assets of the financial system	2,994	100.0	29.5			

Sources: Bank of Uganda and IMF staff estimates.

1/ With the merger of UCBL and Stanbic and the closure of TransAfrica, the number of commercial banks fell to 15 in 2002.
2/ Including Housing Finance, two development banks and one leasing company.
3/ Of which only three are reported to be operating.
4/ The National Social Security Fund.
5/ With the privatization of UCBL, there are no state-owned commercial banks in Uganda (defined in terms of majority ownership).

4. **The financial system is not interconnected.** Reflecting the underdevelopment of the financial system, the banking sector's equity investments in, and lending to, nonbank financial institutions is negligible. However, Uganda's banking sector lending to foreign banks is very high and has almost doubled since March 2001 to over 100 percent of bank capital in June 2002, reflecting the propensity of large foreign bank to place their foreign currency assets abroad. It also reflects the large foreign currency-denominated flows (from

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donors and NGOs) they mobilize compared to their ability to lend them domestically, while safeguarding credit quality, avoiding exchange rate risks, and meeting prudential regulations. While in principle these flows could represent a source of vulnerability, prudential requirements in this area, and the fact that most of these resources are placed with the foreign banks' parent institutions, significantly mitigate risks in this area. This does, however, underscore the need to enhance the economy's absorptive capacity in order to redirect foreign resources to finance bankable domestic investments. In contrast, interbank lending domestically, which amounted to about 16 percent of system capital, fell precipitously over the past two years and currently represents only a third of its level two years ago (Table 3).

Table 3. Uganda: Measures of Financial System Interconnectedness

	Mar.-2001	Dec.-2001	Jun.-2002
	(In percent of financial system capital)		
Banking system lending (exposure) to shareholders			
On-balance sheet	3.7	6.3	4.2
Off-balance sheet	0.3	0.1	0.1
Banking system equity investments in:			
Financial Institutions	0.2	0.2	0.1
Non-financial institutions	0.2	0.2	0.1
Banking system lending (exposure) to:			
Finance companies	0.7	0.0	0.0
Securities firms	0.0	0.0	0.0
Gross (overnight) interbank lending (exposure) to:			
Domestic banks	16.2	11.5	4.6
Foreign banks	58.8	120.6	110.0
Banking system exposure to insurance sector:			
Credit	0.0	0.0	0.0
Equity and others	0.2	0.0	0.0
	(In percent of system deposits)		
Insurance sector deposits in banking system	2.8	0.4	0.4
National Social Security Fund (NSSF) deposits	5.1	3.9	4.8

Source: Bank of Uganda.

5. **Lending to the private sector is limited in size and short in tenure.** Overall credit to the private sector has hovered around 6 percent of GDP and has remained constrained by the underdevelopment of the market, as well as by structural factors. These include inadequate credit discipline, widespread contract enforcement problems, the scarcity of creditworthy borrowers and projects, the lack of interest rate transmission from treasury bill rates to lending rates, and the narrow range of assets acceptable as collateral. High transaction costs and information asymmetries also raise the perceived risk of lending, especially in rural areas. In the past, financial institutions often found it difficult to realize

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collateral value. The recent strengthening of the commercial courts and appointment of judges to adjudicate the cases have helped considerably in the recovery of bad debts and contributed to the reported decline in non-performing assets.

C. Banking Sector Structure and Performance

6. **The banking sector is characterized by a large share of foreign ownership and high concentration.** Following the privatization of Uganda Commercial Bank Limited (UCBL), four foreign-owned banks dominate the banking sector in Uganda and account for 73 percent of total sector assets, 68 percent of sector loans and 75 percent of deposits (Box 1 and Table 4). In addition to the large foreign-owned banks, there are three medium-size banks representing some 14 percent of assets, and eight very small banks. The presence of foreign commercial banks and the recent repositioning of Stanbic as the lead player should strengthen the stability of the system, contribute to improvements in financial markets, and enhance competition. While it is too early to judge, there are already some signs of new competitive forces at play.

7. **The structure of banks' balance sheets reflects their preference for liquid, low-risk assets.** Loans constitute only 23 percent of total assets, given the constraints to credit demand and supply, including the sluggish pace of new investment. As a result, funds invested in government securities (33 percent) and placed abroad (30 percent) comprise 63 percent of total assets, well above the share of loans.

Box 1. Uganda Commercial Bank Limited (UCBL)

The state-owned UCBL has traditionally been Uganda's largest bank, accounting for as much as 50 percent of the banking system deposits and loans in the mid-1990s. It also has the most extensive nationwide branch network (189 branches in 1990 but reduced to 68 at the time of its privatization). A sale agreement was concluded in October 1997 with a Malaysian industrial conglomerate, Westmont Land Asia Bhd, which bought a 49 percent shareholding in UCBL. The transaction was later nullified following discovery by the BOU of irregularities, but the government reiterated its intention to reprivatize the bank.

The FSAP mission identified the failure to privatize UCBL as the highest risk facing Uganda's financial sector at that time. UCBL was then under statutory management by BOU. Under this arrangement, UCBL, with a few exceptions was not extending loans and the bulk of its mobilized resources were invested in government securities.

UCBL's continued statutory management by BOU posed serious challenges to the development of the financial system in Uganda given:

- the distortions it introduced in the money and treasury bill markets;
- the impact of UCBL's non-lending mode on the economy; and
- the risk of political interference in its lending decisions.

Under these circumstances, the FSAP mission urged the authorities to privatize expeditiously UCBL while retaining essential branches, since they perform a key role in rural development and in the country's payment system.[1]

The Bank of Uganda, in its capacity as statutory manager, appropriately pushed for the speedy resolution of UCBL. Standard Bank of South Africa offered to purchase, through its local subsidiary in Uganda–Stanbic, 80 percent of government's equity in UCBL. A sales agreement was reached in November 2001, and ratified in February 2002. The merger of Stanbic and UCBL was announced on September 18, 2002. In terms of ownership, the government retained a share of 10 percent in the enlarged Stanbic. The government is committed to float its 10 percent share in the merged bank within two years. Stanbic is also expected to float a matching 10 percent. As a result, Stanbic will retain 80 percent control and 20 percent will be eventually held by the public.

1/ Essential branches represent most of the 34 branches located in areas where there are no other commercial banks and tend to have a key potential role in rural development. These branches collectively represent almost the entire commercial bank branch network outside Kampala and major secondary cities.

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Table 4. Uganda: Banking Sector Structure and Soundness
(As of December 31, 2001, and June 30, 2002) 1/
(In percent unless otherwise indicated)

	As of December 31, 2001				As of June 30, 2002			
	Big Banks	Medium Banks	Small Banks	Sector Total	Big Banks	Medium Banks	Small Banks	Sector Total
				(In percent of assets)				
Balance sheet structure								
Government securities	29.7	30.8	25.7	29.7	33.5	32.4	24.5	32.8
Foreign currency assets	27.6	24.6	33.3	27.3	30.6	25.3	34.0	29.7
of which: deposits abroad	22.6	17.6	17.2	21.6	22.6	17.6	23.1	21.6
Loans	24.3	30.6	39.0	26.3	21.9	25.9	28.5	23.1
Loans (incl. letters of credit and loan commitments)	30.0	40.8	46.3	33.1	33.0	36.5	35.0	33.8
				(In percent of total loans)				
Foreign currency loans	26.6	25.0	35.7	26.9	29.6	25.3	30.7	28.6
Demand deposits	73.3	36.6	50.7	64.6	74.9	37.4	54.9	66.1
Foreign currency deposits	27.3	26.1	36.7	27.5	29.1	26.3	42.1	29.2
Deposit and loan concentration								
Top 5 loans share in total loans	25.6	7.6	3.8	37.0	28.8	7.3	3.8	39.9
Top 20 loans share in total loans	39.6	12.6	5.4	57.7	45.4	12.9	5.5	63.9
Top 5 deposits share in total deposits	10.1	4.4	1.4	15.9	14.0	5.0	2.0	20.9
Top 20 deposits share in total deposits	15.9	6.6	2.1	24.5	23.3	7.1	2.5	32.9
				(In percent of assets)				
Profitability and cost of funds								
Interest cost of funds	2.1	3.5	2.8	2.4	0.9	2.4	1.4	1.2
Non-interest cost of funds	7.1	11.6	17.4	8.5	5.6	9.5	14.7	6.9
Total cost of funds	9.1	15.2	20.2	10.9	6.5	11.9	16.1	8.2
Interest margin	7.8	9.6	8.6	8.2	5.5	7.8	6.2	6.1
Non-interest income	3.9	6.4	4.9	4.5	3.0	5.5	4.2	3.6
Non-interest cost	7.1	11.6	17.4	8.5	5.6	9.5	14.7	6.9
Net Income	4.7	4.3	-4.0	4.2	2.9	3.9	-4.3	2.7
T-bill income total interest income	46.3	35.3	29.5	42.6	46.4	34.2	28.1	41.7
Non-interest income to total income	28.4	32.9	30.0	29.7	32.1	35.2	35.1	33.2
Asset quality								
NPLs to total advances	4.2	6.2	28.5	6.5	2.9	4.5	8.2	3.6
Adjusted NPLs to total advances	2.0	1.7	2.3	2.0	0.6	0.2	-0.3	0.5
Provisions to NPLs	1.9	3.2	25.4	4.0	1.8	2.6	5.8	2.3
Insider loans to capital	2.0	3.4	27.9	4.5	1.7	6.2	9.5	3.9
Capital adequacy								
Capital to risk weighted assets	20.5	28.9	33.7	23.1	20.0	28.6	46.2	23.7
Capital to assets	8.9	13.6	17.0	10.2	7.9	12.9	21.7	9.7
Adjusted capital to risk weighted assets	19.3	27.8	31.9	21.9	19.7	28.5	46.4	23.4
Liquidity								
Loans to deposits	32.6	40.8	53.9	35.3	28.4	35.0	40.5	30.4
Liquid assets to total assets	66.6	62.2	58.8	65.3	68.3	65.6	63.8	67.5
Short term assets gap to total assets	-27.4	-12.8	3.4	-22.8	-25.4	-10.5	-2.7	-20.9
				(In percent of capital)				
Foreign exchange and off balance sheet exposure								
Foreign exchange exposure	3.9	5.0	7.9	4.5	27.4	5.0	5.5	18.1
Off balance sheet items	64.6	74.9	42.9	65.6	140.2	81.7	29.8	109.8

Source: Bank of Uganda.

1/ Deposit and advances figures exclude UCBL, TransAfrica Bank, and one other bank.

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8. **The distribution of credit is lopsided.** Agriculture accounts for almost 40 percent of GDP but receives only 10 percent of total private sector lending. There is also a chronic shortage of long-term finance as shown in Table 5. In June 2002, 88 percent of bank loans were short-term in tenure, while only 7 percent of loans outstanding were above three years in maturity. The pace of liability dollarization somewhat decelerated, as reflected by the decline in the share of foreign currency deposits to 29 percent of total deposits at end-June 2002, from 33 percent at end-June 2000 (Table 6).

Table 5. Uganda: Maturity Structure of Bank Loans and Advances (1995-2002)

	1995	1996	1997	1998	1999	2000	2001	June 2002
1 year and less	72.2	74.1	79.4	83.1	86.4	88.2	87.3	88.4
1-3 yrs	26.1	19.7	15.2	11.7	7.7	4.2	3.6	4.4
Above 3 years	1.6	6.2	5.5	5.2	5.9	7.5	9.1	7.2
Overdrafts/ total loans	44.8	46.0	60.0	57.3	58.3	51.8	45.2	45.5

Source: Bank of Uganda.

Table 6. Uganda: Balance Sheet Trends of Commercial Banks (1999-2002)

	1999	2000	2001	Jun. 30 2002
	(In billions of Uganda Shillings)			
Foreign currency assets	356.1	585.2	539.7	687.4
of which: FC funds placed abroad	263.0	426.5	386.4	487.6
FC deposits	311.9	433.5	405.8	514.6
FC loans	71.2	114.1	140.1	153.5
Total loans	445.0	525.1	521.3	536.2
Treasury bills	211.7	331.7	514.2	672.2
Total deposits	1,033.9	1,314.8	1,475.4	1,764.1
	(In percent)			
FC loans to total loans	16.0	21.7	26.9	28.6
FC deposits to total deposits	30.2	33.0	27.5	29.2
Loans to deposits	43.0	39.9	35.3	30.4

Source: Bank of Uganda.

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9. **A key feature of the Ugandan banking sector is the high degree of concentration on both the loan and deposit sides.** When loans to the top five borrowers for each bank are aggregated together, they represent about 40 percent of all loans. While on the deposit side the concentration is smaller, it is still very high, with the top five depositors for each bank on the aggregate accounting for about 21 percent of deposits in the system. Banking sector's exposure to a small number of large borrowers and depositors means that a cyclical downturn or a terms of trade shock affecting these borrowers could translate quickly into asset quality problems for banks.

10. **Interest rate spreads have been exceptionally high, reflecting high levels of perceived credit risk, low competition among banks, and inefficiency in the system.** Interest rate spreads have ranged between 15 to 20 percent since 1994, while real lending rates have varied from 10 to 25 percent since 1996. Non-interest expense is high at 5.8 percent of assets and is passed on to borrowers in the form of high spreads, suggesting inadequate competitive pressures in the market. However, there are signs of more competitive forces at play following the privatization of UCBL and its subsequent merger with Stanbic.

11. **Asset quality has substantially improved following the closure of four banks in 1998/99 and the privatization of UCBL (Table 7).**[5] Reported nonperforming loans (NPLs) system–wide have fallen remarkable fast, reflecting the major improvement in the quality of the risk portfolio of banks. NPLs fell from 29 percent of the portfolio in 1998 to 12 percent in 1999, and further to 3.4 percent at end-September 2002 (Figure 1). The closure of four relatively large banks in 1998/99, recovery efforts, and the cleaning up of the portfolio of UCBL are key factors in explaining the improvement.[6] Half of the improvement in NPLs since 1999 has been on account of UCBL and the recent closure of TransAfrica. Nevertheless, some smaller banks are still riddled with high levels of NPLs (over 30 percent).

12. **High interest rates spreads and a marked reduction in NPLs helped keep banks highly profitable.** Notwithstanding the recent decline in profitability, the financial sector as a whole has been profitable, thanks to high spreads and relatively high rates on treasury bills, whose share in bank assets has grown steadily since 1995. Interest receipts from treasury bills investments, which accounted for 7.8 percent of interest income in 1995 reached

[5]Starting in October 2001, the BOU aligned its loan classification criteria to international standards, and issued circulars in April and July 2002, to adequately capture NPLs in the system. It has now been more than 15 months since the loan classification standards were strengthened, providing further comfort with respect to loan quality.

[6]The level of provisions for most banks increased initially due to the more stringent loan classification criteria introduced in 2001, and subsequently declined as a result of some write-offs.

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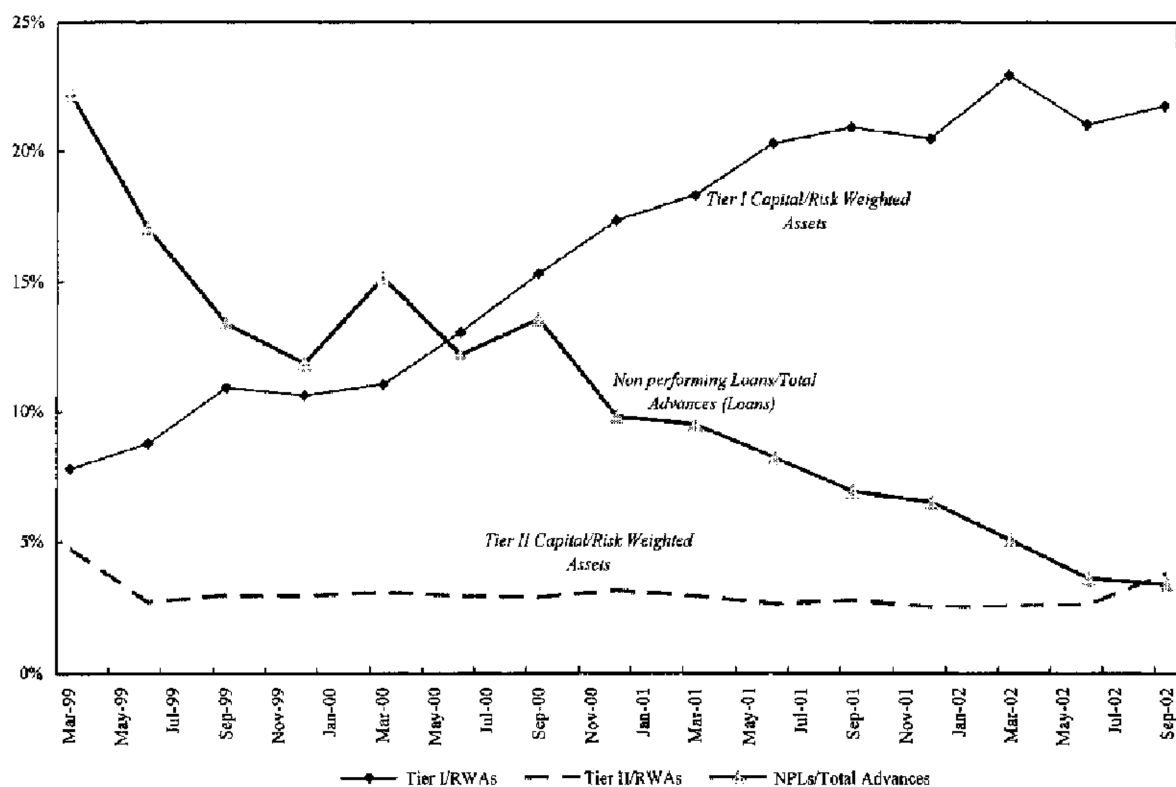
42 percent in June 2002. The high interest rates prevailing in Uganda have provided a windfall profit for banks and masked a number of inefficiencies, and in the case of some smaller banks, underlying financial weakness.

Figure 1. Uganda: Capital and Nonperforming Assets
(March 1999 to September 2002)



Source: Bank of Uganda.

13. **Sector liquidity is high, with the majority of assets in liquid form.** Liquid assets' share in total assets stood at 66 percent at end-June 2002. However, a substantial portion of liquid asset is accounted for by government securities, which, especially in a period of distress, would be impossible to liquidate in large amounts given the absence of secondary markets (Figures 2 and 3).

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Table 7. Uganda: Financial Soundness Indicators for the Banking Sector (1999–2002)
(In percent unless otherwise indicated)

		Dec. 1999	Dec. 2000	Dec. 2001	Jun. 2002
I. Camels Indicators					
Capital adequacy					
Tier-I capital/ risk-weighted assets (RWAs)		10.6	17.4	20.5	21.0
Total (regulatory) capital /RWAs		13.6	20.5	23.1	23.7
Total (regulatory) capital/total assets		7.0	9.8	10.0	9.5
Assets					
Share of assets (exposures)	RW=0	31.9	31.5	40.7	42.5
per risk weight (RW) category	RW=20	24.2	27.4	22.7	23.6
	RW=50	3.4	4.9	0.0	0.0
	RW=100	40.5	36.3	36.6	33.9
Total exposures/total assets		48.9	47.9	41.1	38.6
Loan (or exposure) concentration					
Large exposure /total capital		217.5	225.6	169.1	145.0
Connected lending /total capital		14.0	7.2	4.5	3.9
Sectoral concentration					
Government		0.4	0.5	0.3	0.3
Agriculture		12.8	9.9	9.9	11.8
Mining and quarrying		0.4	0.3	0.8	0.6
Manufacturing		38.6	40.0	36.5	31.4
Trade and commerce		22.2	20.4	23.1	26.1
Transport, communication, electricity, and water		9.1	6.4	5.6	5.2%
Building and construction		5.4	4.2	3.7	3.5
Other services		11.0	18.2	20.2	21.2
Total		**100.0**	**100.0**	**100.0**	**100.0**
Foreign currency lending					
Foreign currency exchange loans/total loans		15.9	21.7	26.9	28.6
Nonperforming loans (or exposures)					
NPLs/ total gross loans (or exposures)		11.9	9.8	6.5	3.6
NPLs net of provisions/total capital		22.7	11.9	16.8	8.6
II. Management					
Expenses/revenues		73.4	70.1	72.4	63.7
III. Earnings					
Return on (average) assets		3.7	4.4	4.4	3.3
Return on (average) equity		56.5	53.1	45.8	33.5
Interest margin /gross income		42.5	51.6	54.5	55.2
Non-interest expenses /gross income		66.5	55.2	52.4	52.3
IV. Liquidity					
Liquid assets/total assets		56.0	60.1	63.4	66.1
Liquid assets/short-term liabilities		69.4	77.1	81.8	86.7
Demand deposits/total liabilities		51.1	52.5	54.6	56.9
Net forex position/total capital		18.4	13.5	4.5	16.0
Duration (or average repricing period) of assets (in months)		3.9	3.9	...	...
Duration (or average repricing period) of liabilities (in months)		2.8	2.6	...	...

Source: Bank of Uganda.

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Figure 2. Uganda: Indicators of Liquidity (1999–2002)

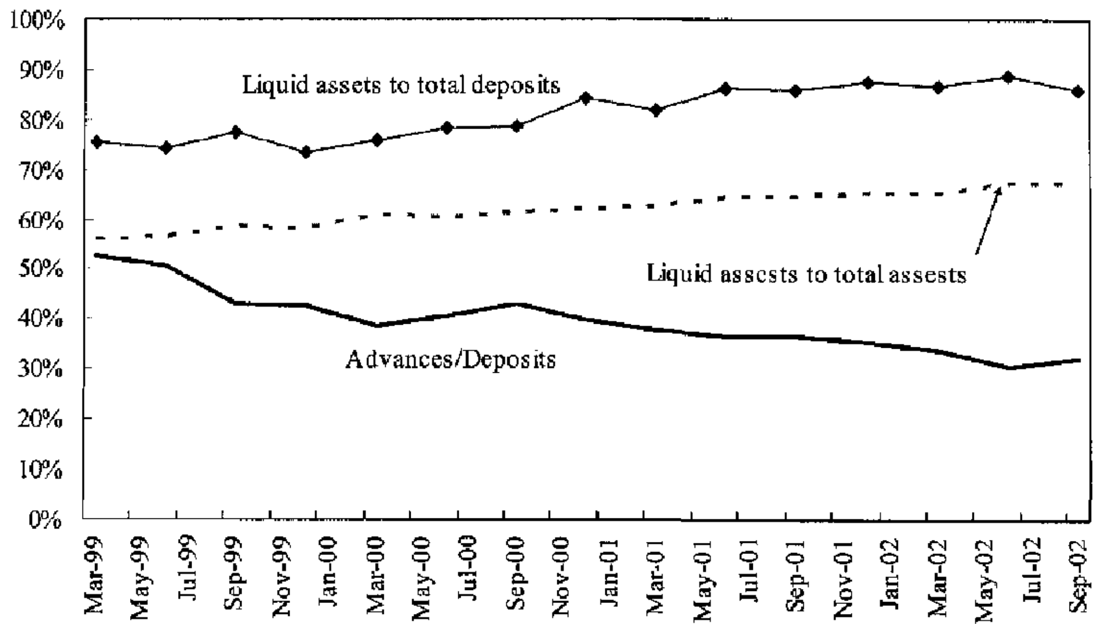
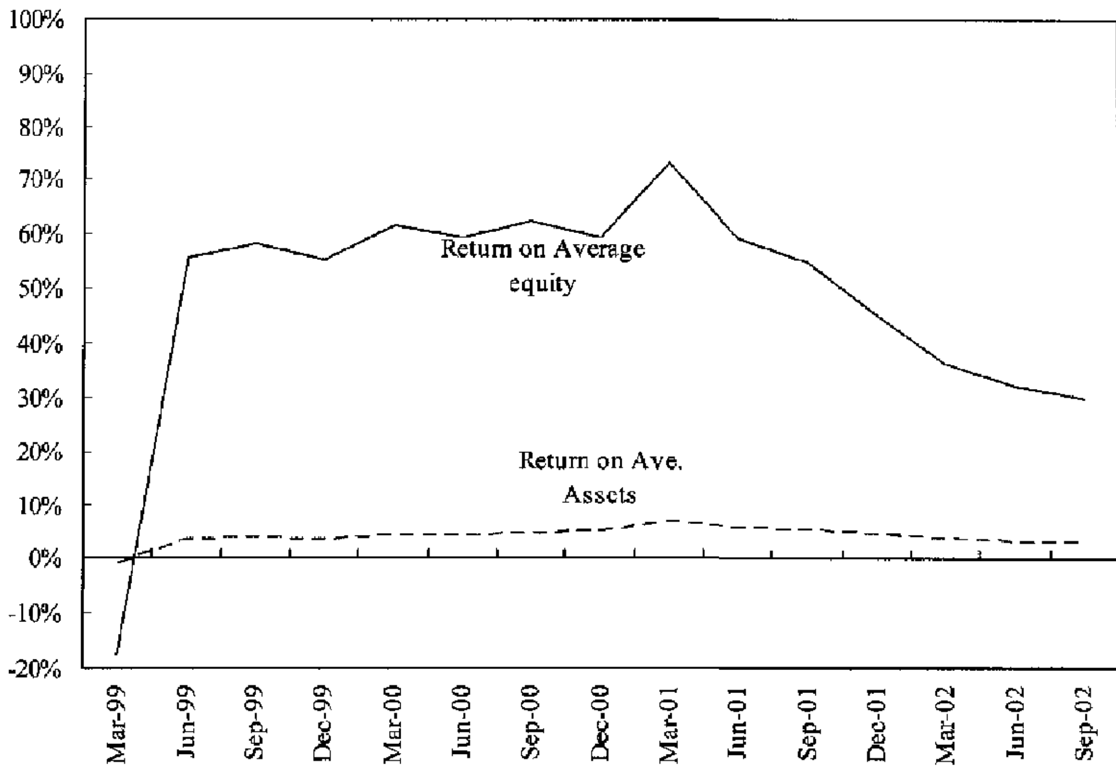


Figure 3. Uganda: Indicators of Profitability (1999-2002)



Source: Bank of Uganda.

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D. Short-Term Vulnerabilities

14. **The banking system in Uganda, which dominates the financial system, is fundamentally sound, more resilient than in the past, and currently poses no threat to macroeconomic stability.** This is mainly because of: (i) the preventive actions taken by Bank of Uganda in closing four banks in 1998/99, which helped weed out the weak and nonviable large banks in the system; (ii) the swift and decisive actions taken in response to the FSAP recommendations, including the privatization of UCBL, one of the key stability risks that faced the system at the time of the FSAP mission in 2001, and the substantial improvements introduced in liquidity management in order to reduce the high level of volatility in interest rates, which, at the time, posed a threat to the soundness of the system (Box 2); and (iii) the fact that the system is now dominated by large reputable foreign banks that appear to be well capitalized, profitable, and resilient. Stress testing results show that while the banking system is highly exposed to interest rate risks, the system is relatively robust and can weather plausible changes in key macroeconomic parameters. A major disruption in donors flows could, however, pose a threat to the system.

15. **Despite the substantial progress made, a great deal still remains to be done to further strengthen and support the development of the financial system.** To address the immediate stability concerns, there is a need to: (i) build on the recent supervisory focus on the small banks and fully address the potential risks they pose to market integrity; (ii) move expeditiously on the stalled passage of the Financial Institutions Bill; (iii) enact an anti-money laundering legislation and put in place a credible framework for monitoring and enforcing it.[7] On the developmental front, the agenda for reform should focus on: (i) strengthening the management of domestic debt; (ii) reforming the National Social Security Fund (NSSF); (iii) addressing the problems of the Uganda Development Bank (UDB); (iv) phasing out direct government involvement in microfinance; and (v) continuing the reform of the legal framework.

16. **Overall, the banking system, as expected, is most exposed to interest rate risks.** The FSAP team conducted a number of stress tests on the banking system, which were updated on the basis of the balance sheets as of end-June 2002. Despite some weaknesses in the data, a number of scenarios were explored to assess the robustness of the banking system to shocks in interest rate, exchange rate, and credit risks.[8] Overall, the banking system, as expected, was most exposed to interest rate risks. Exposure to exchange rate risk, which was

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[7]This will involve, in addition to the enactment of the AML and related legislation, the drafting of enabling regulations, the assignment of responsibilities for AML issues to the appropriate organization, and the establishment, as expected, of the Financial Intelligence Authority.

[8]The data exhibited some anomalies, in part as a result of the recent merger of UCBL with Stanbic, and were incomplete, particularly with respect to the off-balance sheet information on banks.

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found to be high at the time of the FSAP missions in 2001, seems to have been reduced considerably, in part because of the imposition by the Bank of Uganda of strict limits on the net open foreign exchange position of banks and its alignment of the definition to accepted international standards in this area. The recent reduction in the level of dollarization in the system has also helped. On the credit side, the low level of the risk portfolio of banks, the short term tenure of the portfolio, and the current low level of reported nonperforming loans, have mitigated the overall credit risk exposure (Box 3).

Box 2. Summary of Key FSAP Recommendations

Bank of Uganda
- Ensure that there is no inadvertent provision of liquidity to an insolvent bank;
- Avoid potentially large risk exposure by phasing out BOU's, directed lending;
- Develop well-founded "failure to settle" rules as a matter of the highest priority;
- Enhance the audit function by establishing an audit committee; and
- Improve internal controls and accounting activity.

Systemic liquidity management
- Assign some role for fiscal policy in sterilizing the impact of the Poverty Alleviation Fund expenditure financed by donor flows;
- Continue to improve the new monetary policy framework and avoid emitting confusing policy signals; and
- Introduce a system of benchmark issues and longer-term bonds in order to foster the development of the secondary market.

Prudential regulation and supervision
- Address the problem of small banks, avoid forbearance and foster consolidation of the financial sector;
- Introduce risk-based approach to supervision and promulgate guidelines for banks as to minimum requirements for policies, procedures and controls related to credit risk, asset quality, insider lending, country risk, market risks, operational risk, internal audit and control; and
- Maintain regular formal and informal contact with home country supervisors.

Non-bank financial institutions
- Reconsider proposals to restructure Uganda Development Bank and initiate a housing study; and
- Tighten BOU licensing requirements for NBFIs.

Microfinance
- Dismantle any remaining government schemes that provide microfinance services.

Legal issues
- Adopt expeditiously the new Financial Institutions Bill.
- Introduce an anti- money laundering law and related legislation, and strengthen AML monitoring and enforcement;
- Introduce a new Insolvency Act; and
- Further strengthen the court administration system to improve loan contract enforcement.

Pension schemes
- Reform the NSSF, improve its investment policies and performance, and ensure proper oversight of NSSF.

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Box 3. Stress Testing Results

Interest rate risk. Based on the repricing model,[1] the FSAP team simulated interest rate shocks equivalent to a reduction in interest of 5 percentage points and 10 percentage points. While these appear to be large by international standards, they have occurred frequently in the past, and in light of the volatility of interest rates, are not that unlikely in the future. A reduction of 10 percentage points in interest rates, with a parallel shift in the yield curve, could potentially reduce the capital of banks system-wide by 20 percent. The largest foreign-owned banks, as a group, are the most vulnerable to this shock, given their large portfolio of government securities. Some banks in this group would lose as much as 40 percent of capital as a result of this shock. It should be pointed out, however, that there are two major recent positive developments that would likely mitigate the risk for stability. First, banks in Uganda are well-capitalized, thereby providing a significant cushion to absorb such losses. Moreover, the recent increase in the minimum capital of banks would further strengthen the capital base of the system. Second, the reforms undertaken by the BOU in improving the monetary framework and in strengthening liquidity management have already helped in reducing the volatility of interest rates, thereby sheltering the banking system from unnecessary amplification of policy-induced interest rate changes.

Exchange rate risk. The long foreign exchange position of most banks, while shielding them from the direct impact of a currency depreciation, exposes them to the risk of an appreciation of the exchange rate. A 20 percent appreciation of the currency would result in total losses of about 5 percent of capital for the system as a whole. The largest banks in the system—which tend to have the largest open positions—are most exposed, with losses in some banks as high as 20 percent of capital. However, the stress test has also shown that, while the impact on the system as a whole is relatively small, the impact of an exchange rate appreciation, even of this magnitude, would be quite serious on some banks, including some large banks with significant long positions.

Credit risk. Given the relatively small size of the risk portfolio in banks the credit risk facing banks is not very significant at present. The stress test performed for capturing credit risk is straightforward, given the limitation of the available statistics.[2] The results show that if 5 percent of the risk portfolio of banks became nonperforming, the system would lose some 7 percent of its capital. The large foreign-owned banks would be the most affected, losing as much as 7.6 percent of their total capital as a group.

	Losses as a Result of the Shock (In percent of capital)			
	Total Banking System	Large Banks	Medium Banks	Small Banks
Impact of an appreciation in exchange rate of:				
10%	-2.6	-3.6	-0.6	-1.6
20%	-5.2	-7.1	-1.2	-3.1
30%	-7.8	-10.7	-1.8	-4.7
Impact of a reduction in interest rate by: 1/				
500 basis points	-9.4	-13.1	-3.1	-4.6
1000 basic points	-18.9	-26.2	-6.2	-9.2
Impact of credit risk 2/				
5% of the performing loans become NPLs	-7.0	-7.6	-6.9	-5.6
10% of the performing loans become NPLs	-12.0	-13.3	-11.7	-9.0

1/ Sustained over a year period. The test assumes an instantaneous repricing of deposit liabilities.
2/ Assuming on average a 40 % provisioning is required for the new NPL and 100 % for the old.

1/ The repricing model measures the effect of a change in interest rates on the future net interest income of banks (i.e., the cash flow gains/losses of a bank over a given period).
2/ It assumes that a percentage (5 percent and 10 percent tests were run) of the performing loans become nonperforming and hence require provisioning (at an average of 40 percent), and all that old NPLs become a loss, requiring 100 percent provisioning.

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17. **While the overall health and soundness of the financial sector has been considerably improved by BOU's actions over the past year, there are some areas where further actions are needed.**

- **Dealing with the small banks.** At the time of the FSAP missions in 2001, there were many signs of weakness among the smaller banks. These banks typically have higher loan-to-deposit ratios than their large counterparts, and a higher propensity to be in violation of insider lending limits (Table 5). The frequent violations of prudential requirements raise serious questions about their financial performance, governance, and solvency. While they do not pose a systemic risk, small banks are periodically (and in some cases consistently) a burden on supervisors. Further, in light of the governance issues and potential market integrity risks some of the smaller banks pose, there is a need to closely monitor these banks, and for the Bank of Uganda to avoid providing supervisory forbearance. While some of the weaknesses have persisted over the past year, the Bank of Uganda has redoubled its efforts in addressing the problem of the smaller banks and has followed a two-pronged approach. It has undertaken full-scope examinations of several small banks to ensure their soundness and the adequacy of their risk management and internal controls. At the same time, it has proactively requested the concerned banks to submit their capitalization plans ahead of the deadline of January 2003. This was important to ensure that banks were either in a position to increase their minimum unimpaired capital, as mandated by the supervisor, to no less than U Sh 4 billion or consolidate through mergers and acquisitions. BOU reports that the deadline was met and that all banks are now compliant with the capital requirements. BOU also closed TransAfrica, a small ailing bank, and later facilitated its takeover by Orient Bank. These are important steps in the right direction, and the authorities are encouraged to continue their vigilance, especially regarding corporate governance and market integrity issues.

- **Adopt the new Financial Institutions Bill (FIB).** The FIB has been undergoing revisions for several years. The Fund has provided comments on the legislation at different stages, and urged the authorities to move expeditiously on Parliamentary approval while ensuring that the key provisions relating to the concentration of ownership of banks and the powers of the BOU in issuing regulations are upheld. These provisions are essential for fostering good corporate governance, avoiding the problems that led to the previous episode of bank distress, and for providing BOU with the needed flexibility to respond to changes in the financial sector in a timely manner and with no undue political interference.

- **Anti-money laundering.** Uganda does not have in place an AML legislation nor is the system set up for reporting, monitoring, or enforcing AML violations. Putting in place a legal framework, as well as monitoring and enforcement mechanisms for AML, was a major recommendation of the FSAP team and was reiterated in the

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assessment of the Basel Core Principle for Effective Banking Supervision (BCP).[9] In a liberal and open financial system, such as that of Uganda, and in the context of weak corporate governance in a number of smaller banks, the risks are not negligible. Since the FSAP, the authorities have made significant progress in this direction, but a great deal remains to be done to safeguard against reputation and legal risks. Some of the actions already initiated by the authorities include (i) building on the initial AML work undertaken in the context of the East African Community and in the context of the East and Southern Africa Anti-Money Laundering Group (ESAAMLG), which is affiliated with the Financial Action Task Force (FATF) and to which Uganda is a signatory;[10] (ii) drafting an AML law, which should be soon tabled in parliament; and (iii) issuing AML guidelines to commercial banks.

III. Financial Market Environment and Infrastructure

A. Banking Supervision and Prudential Regulations

18. **Considerable progress has been made by the BOU in strengthening supervision**. Improvements include the intensification of on-site examinations of problem banks, the close monitoring of banks through the off-site system, and the generally more vigilant follow-up of banks' operations. This vigilant approach to banking supervision has resulted in the closure of a small bank and its subsequent merger with another healthier bank. Box 4 summarizes a number of initiatives since the time of the FSAP report.

19. **Further strengthening of banking supervision is needed to safeguard the gains made.** In particular, it is important that BOU continue to take prompt appropriate supervisory corrective actions against non-compliant, under-capitalized or non-viable financial institutions and avoid regulatory forbearance. Also, the BOU should refrain from providing liberal exemptions from the single borrower limits to banks, as this will exacerbate the already high loan concentration in the system and undermine the development of much needed financial instruments in the rest of the financial market (e.g., commercial papers and syndicated loans).

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[9]The FSAP did not conduct a formal detailed assessment of Anti-Money Laundering/Combating Financing of Terrorism (AML/CFT) activities in Uganda.

[10]As a member of the ESAAMLG, Uganda agreed in 1999 to adopt and implement the 40 FATF Recommendations, and also implement any other measure contained in multilateral agreements and initiatives for the prevention and control of laundering of the proceeds of all serious crimes. Following this regional commitment, the government issued a Uganda AML policy paper, and the Uganda Anti-Money Laundering Committee (UAMLC) was created in August 2000. The UAMLC is mandated to promote greater cooperation among various agencies, institution building, and awareness raising on the dangers of money laundering.

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Box 4. Supervisory Actions Undertaken since the FSAP Report

Since the preparation of the FSAP report and its presentation to the Ugandan authorities, a number of developments have occurred, especially with respect to the strengthening of the supervisory framework of the financial sector. Included among the developments and initiatives are:

- Preparation of anti-money laundering legislation and guidelines;
- Preparation of comprehensive risk management guidelines for financial institutions;
- Completion of a policy paper on Risk-Based Approach to Supervision;
- Issuance of a Circular on Foreign Currency Position Limit using the shorthand method;
- Issuance of a Circular on Revised Classification Criteria for Overdraft Facilities;
- Pilot-testing of a new quarterly off-site surveillance system;
- Preparation of a Deposit Protection Fund (DPF) policy paper;
- Revision of the format for balance sheet statistics;
- Drafting regulations to implement new FIB; and
- The closure of TransAfrica Bank on September 2, 2002.

20. **While the adoption and effective implementation of the new FIB will significantly enhance Uganda's compliance with the BCP, additional desirable measures include**: (i) developing guidelines for banks as to the minimum requirements for internal policies, procedures, and controls; (ii) enacting an anti-money laundering legislation; (iii) ensuring that the accounting standards for banks meet the minimum requirements; (iv) introducing consolidated supervision; (v) moving to a risk-based supervision; and (vi) initiating a regular and formal process for exchange of information with home country supervisors.

B. Financial Safety Nets and Crisis Management

21. **Past supervisory response to insolvent banks has been slow and weak.** The requirement to consult with the minister regarding the closure of a financial institution is problematic. However, the new FIB will provide the BOU with full legal independence to deal with problem institutions. Long delays between the discovery of insolvency and the final closure of three banks (ICB, Greenland, and Coop) resulted in significant increases in the

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ultimate losses. Aside from the issue of timeliness of closure, the experience with closure and liquidations has highlighted the need to minimize disruption through prompt depositor payout, improved application of creditor rights and remedies to enhance recoveries.

22. **Market discipline was undermined by the payment of uninsured deposits in the earlier bank closures.** In the closure of the three banks in 1998–99, the government committed to pay depositors in excess of the U Sh 3 million limit. However, the observance of the limit in the more recent Trust Bank purchase and assumption agreement is encouraging.[11] The FSAP expressed concern that no clear accounting trail existed for the payments made to the depositors by Deposit Protection Fund (DPF) and recommended the development of procedures to govern future payments. The BOU responded by reviewing the role of the DPF and, in a recent policy paper, has explored expanding the role of the DPF to include an agency role in resolving problem/closed banks and serving as a receiver or liquidator of failed institutions.

C. Systemic Liquidity Management

23. **Systemic liquidity management suffers from a weak market infrastructure.** The BOU conducts monetary policy in a difficult setting, characterized by large and unpredictable flows of donor assistance, a high propensity to hold and transact in cash, uncertainties about government injections of funds, and shallow financial markets. Cash constitutes a high share (24 percent) of broad money, and money and securities markets are underdeveloped and illiquid.

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[11]On this issue, the government stated in the Budget Speech of 2001/02 that no payment of uninsured deposit of closed banks will be made and the latest bank failure has been resolved at no cost to the DPF.

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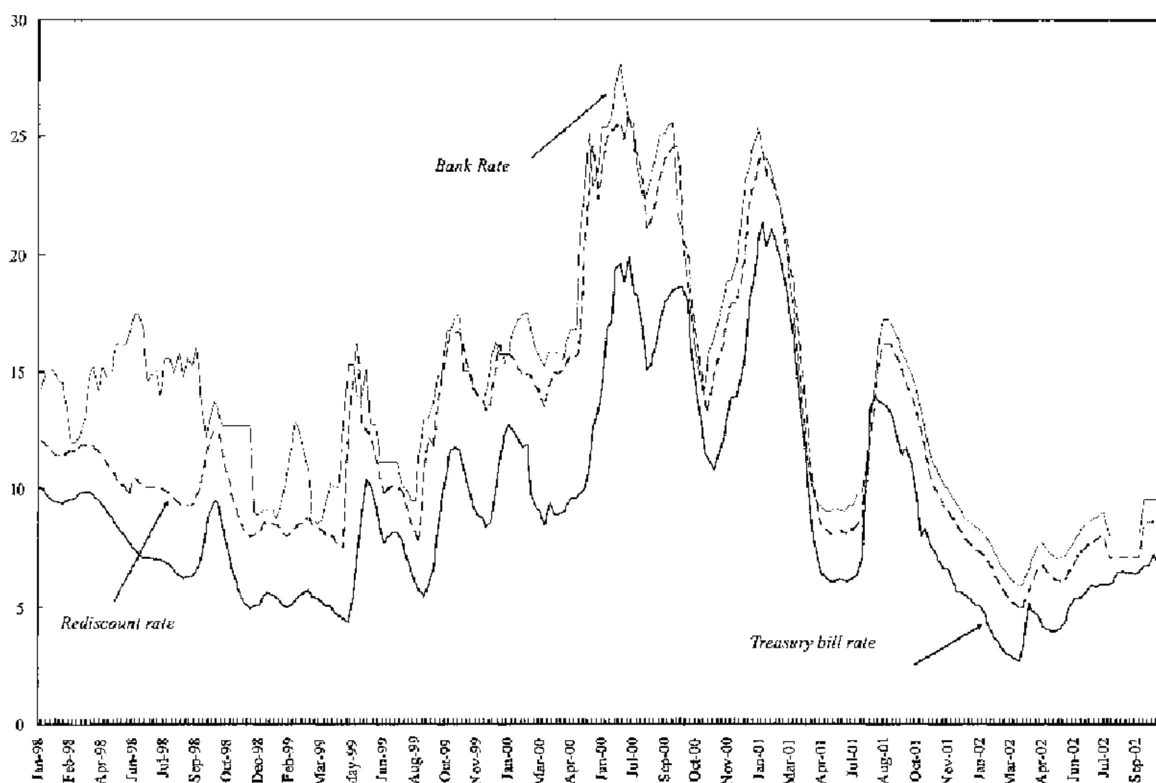
24. **The conduct of monetary policy has been impaired in the past by weaknesses in the liquidity management framework and the absence of adequate instruments (Box 5).** At the time of the FSAP mission, interest rates were extremely volatile. For instance, the volatility of the 91-day treasury bill rate, as measured by the standard deviation around the mean, increased from 0.9 in 1996 to 3.7 in 2000, and rose further to nearly five in 2001. It was not unusual for the rate to move by as much as 600 basis points between auctions. The high degree of volatility of interest rates in the market increased uncertainties, reduced the signaling effects of interest rates, and raised the cost of liquidity management, with spikes in interest rates contaminating the whole spectrum of rates (Figure 4).

Figure 4. Uganda: Key Interest Rates, 1999-2002



Source: Bank of Uganda.

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Box 5. Monetary Policy Instruments

The BOU administers a number of monetary policy instruments for prudential and liquidity management purposes; these are summarized below.

Reserve requirements. The BOU subjects commercial banks to a 10 percent reserve requirement on demand deposits and a 9 percent requirement on term and saving deposits. Reserve requirements applied only to shilling deposits until September 2000, when the central bank expanded the requirement to include foreign currency deposits, subject to the same rates. Reserves for both shilling and foreign currency deposits are held in shillings, which are not remunerated by the BOU. Eligible reserve assets include banks' funds held in their clearing accounts at the central bank and 30 percent of vault cash. Banks that maintain more than 10 branches outside Kampala—presently only the Uganda Commercial Bank Limited and the Centenary Rural Development Bank—are permitted to count 50 percent of vault cash as reserves, given the need to maintain sizable amounts of cash in vault to service branches. Operationally, reserve averaging is permitted, with reserves allowed to fall below the required minimum to a maximum of 50 percent of required reserves so long as the average over the two-week maintenance period meets the requirement. The four-week moving average of deposits and vault cash (eligible to serve as reserve assets) is used to calculate required reserves, which are maintained with a two-week lag. The penalty for noncompliance is a daily interest charge of 0.1 percent on the shortfall in reserves.

Standing facilities. Following the increased reliance on the repo for fine-tuning of temporary liquidity variations, there was a move to variable repo rates to enhance price discovery in September 2002. As a result the re-discount rate became the policy rate and since then BOU has de-linked its determination from the reference rate (four week moving yield on the 91-day T-bill rate plus a margin). This is now fixed by BOU to signal to the market its desired monetary policy stance.

The second standing facility is the ***Lombard facility***, which serves as the last-resort loan window of the central bank. The facility is not actually called the Lombard facility, but effectively functions like one. The facility is accessible at the discretion of banks and is limited to 5 percent of required reserves. Borrowings beyond the limit require the approval of the head of the Monetary Operations Department, whose discretion is not subject to any statutory ceiling. Borrower banks are required to post treasury bills with a remaining maturity of 91 days or less as collateral, which are returned upon the maturation of the loan. Loan maturities are determined by borrower banks, but cannot exceed the maturity of securities serving as collateral. The facility carries an interest rate computed by adding a 1 percent margin to the rediscount rate. As such, it effectively sets the ceiling on interest rates in the money market.

Liquidity management instruments. The central bank has used treasury bills, foreign exchange market intervention and the repo operations to manage systemic liquidity. In this policy mix, treasury bills followed by foreign exchange intervention were the most actively used. Treasury bills are issued solely for monetary policy purposes and the costs are accounted for in the government's annual budget. Treasury bill auctions in maturities of 91, 182, 273, and 364 days are conducted weekly.

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25. **Major progress has already been achieved, with FSAP follow-up technical assistance, in improving liquidity management and reducing the volatility of interest rates**. While the large government injections of liquidity is a complicating factor, the main weaknesses in the framework are the lack of short-term, flexible instruments for managing liquidity and the overburdening of treasury bill auctions with multiple and often contradictory objectives. There is now a clear recognition of the duality of BOU's role in managing liquidity, namely managing short-term "temporary" liquidity and sterilizing "structural liquidity" resulting from government domestic spending financed through foreign donor inflows. The BOU has as a result adopted a new monetary policy framework. It now sets a sterilization plan based on an appropriate mix of foreign exchange sales and net treasury bills issuance, while ensuring that the mix (i) minimizes distortions in the foreign exchange and the money markets; (ii) is sufficient to absorb the bulk of the "structural liquidity;" and (iii) is consistent with the overall macroeconomic framework. Improvements were also introduced to the foreign exchange transactions procedures, which now clearly separate, in the mind of market participants, between intervention and sterilization actions, thereby avoiding confusing the market and triggering an overshooting in the rates. The BOU also increased its reliance on repos for fine-tuning "temporary" liquidity variations and moved to variable rate repos in order to enhance price discovery. Progress is also continuing in better gauging the Ministry of Finance's injection of liquidity on a timely basis, while fine-tuning the liquidity forecasting mechanisms. Overall, these actions have already resulted in a significant reduction in the volatility of interest rates and have helped anchor market expectations. However, there is still a need to fine-tune this approach and further enhance the effectiveness of the new monetary framework. Special care should be taken in setting the level of key policy instruments such as the discount rate and access to the discount window to ensure that the BOU does not unintentionally complicate liquidity management. There is also a need to strengthen the statistical base on exchange rate developments, introduce benchmark issues of treasury bills, and improve debt management.

D. Liquidity Access and Lender-of-Last Resort

26. **Commercial banks can access liquidity at their own discretion in the interbank market or from the central bank's standing facilities**. The interbank market, however, is segmented and very thin. Measured in terms of commercial banks' total deposit liabilities, annual turnover in the market was only 0.1–0.2 from 1997 to 2000, a remarkably low level, and as noted above, interbank lending has declined noticeably over the past two years. While this is in large part attributable to the excess liquidity in the system, there are structural factors, which need to be analyzed. Currently, the majority of transactions in the interbank market are among large foreign banks, and the few that involve domestic banks are done on a collateralized basis. The scarcity of counterparties that are perceived as creditworthy in the system is the chief impediment to developing the interbank market, and will take considerable time to overcome. Banks can also access liquidity from the BOU through two standing facilities.

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27. **Historically, BOU has provided liquidity support for extended periods and adequate security has not always been obtained, leading to significant losses during bank failures.** The current policy is to limit liquidity to solvent banks that are able to provide adequate security.

E. Auditing and Accounting

28. **Some enhancement to BOU's audit system is necessary to ensure good governance, improved performance, and to bring it in line with best practice.** BOU's internal audit system has been operating reasonably well but should be further enhanced by: (i) establishing an audit committee to oversee audit activities and ensure timely implementation of needed action; (ii) introducing a written charter for the audit department, as well as a written policy guideline for the internal audit function; (iii) widening the scope of the internal audit service beyond financial transactions; and (iv) improving the internal controls and accounting activity, including timely reconciliation and maintenance of records. In line with these recommendations, BOU has made substantive progress in these areas. With IMF support, it has completed an Accounting Manual, updated its charts of accounts, and strengthened internal controls. It has also made some progress in enhancing internal audit.

F. Payment System

29. **The payment clearance and settlement system in Uganda is comparatively limited.** Cash is the preferred payment medium. Noncash payments are predominantly checks. Although volumes and values are not large, there are significant flows through the system, and a failure could quickly have serious systemic effects on the Ugandan financial sector and the wider economy.

30. **The payment system's ability to withstand stress is very limited.** In its present context and as a practical matter, the payment system works tolerably well day to day. However, the operations of the system—which involve mainly the manual processing of paper—are slow and imprecise, while inadequacies in infrastructure, telecommunications and power—together with a lack of understanding of alternatives—have hampered the development of more sophisticated options. The legal underpinnings are opaque or lacking. There has been an absence of representative bodies charged with running the system. Some of the direct participants in the system are less than robust, and there is a lack of substantive checks on the legitimacy or otherwise of the transactions passing through the system.

31. **There are numerous weaknesses to be addressed before the Ugandan payment system conforms with CPSS principles.** The lack of comprehensive risk controls is particularly worrisome. In the past, some failing banks have had their settlement obligations met by the central bank. While the system has been tightened, the lack of any proper "failure to settle" arrangements in the present system leave participants—including the central bank—exposed to significant uncertainty and risk. The authorities recognize these shortcomings, and have started the implementation of a reform of the payment system. They are introducing the automated check clearing system, and clearing house rules and

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procedures which spell out the "failure to settle" rules have been made public, and a detailed study of the legal framework has been completed. These changes, if implemented, with appropriate accompanying regulations, should produce a stronger basis for the operations of the payment system.

IV. Developmental Agenda

32. **Uganda has made excellent strides since the FSAP in strengthening its financial sector and in significantly reducing the vulnerability of the financial system.** It has also begun addressing the longer-term issues facing the development of the financial sector. As the authorities proceed with the reform agenda, priority should be given to improving domestic debt management, reforming the National Social Security (NSSF), moving expeditiously to address the problem Uganda Development Bank, phase out government direct intervention in microfinance, and build on the progress made in reforming the legal framework.

A. Issues in Domestic Debt

33. **Since budget deficits in Uganda are mainly financed with donors' funds, the government has not had to issue treasury bills to fund itself.** Nevertheless, treasury bills are issued for liquidity management purposes. Specifically, large sterilization operations have been required to absorb the injection of liquidity created by foreign-financed government domestic operations. As a result, domestic debt has been increasing steadily since 1997 and its growth accelerated dramatically in recent years (Table 8). It has increased to U Sh 929 billion, equivalent to 8.7 percent of GDP in June 2002, from U Sh 108 billion, equivalent to 1.4 percent of GDP in 1997, a growth of more than 800 percent in five years. At about 9 percent of GDP in 2002, the debt is relatively low. However, its dynamics and the associated high interest cost raise a number of concerns regarding fiscal and financial stability including: (i) the unsustainable current path of the domestic debt growth; (ii) the impact of the interest cost on the budget; (iii) the crowding out of the private sector, as banks continue to increase their holding of zero-risk-weighted government debt; (iv) the lack of absorptive capacity of the domestic market, which can distort interest levels and structure, especially in the absence of a well-designed domestic debt management strategy; (v) the increased sovereign risk facing the banking system (with exposure in excess of 35 percent); and (vi) the high roll-over risk given the short-term nature of the debt.

34. **Notwithstanding the low level of domestic debt at present, it is important for the authorities to formulate expeditiously a domestic debt management strategy and improve the monitoring of debt, including by strengthening debt statistics.** Motivated by the desire to establish a longer-yield curve and a benchmark for zero-risk paper to lay a basis for capital market development and to address the issue of structural liquidity problems, the Ugandan authorities are at an advanced stage of launching longer-term government bonds, as was done recently in neighboring Tanzania.

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Table 8. Uganda: Domestic Debt Stock
(In billions of Uganda shillings)

	1997	1998	1999	2000	2001	2002 1/
Total domestic debt	108	140	292	482	698	929
In percent GDP	*1.4*	*1.7*	*3.3*	*4.8*	*6.8*	*8.7*
Interest cost	5.3	5.0	13.2	64.9	83.4	70.6
In percent of GDP	*0.1*	*0.1*	*0.1*	*0.6*	*0.8*	*0.7*
Weighted average interest rate	4.9	5.0	4.5	13.5	12.0	7.5
Commercial bank holdings	93	110	213	379	561	721
In percent of total debt	*86*	*79*	*73*	*79*	*80*	*78*

Source: Bank of Uganda.

1/ The figure for 2002 refers to stocks as of June 30.

B. Pension System

35. **Uganda's private pension systems generally, and the National Social Security Fund (NSSF) in particular, are ineffectual.**[12] They fail to protect Ugandan employees' post-retirement futures and do not adequately preserve the long-term nature of their funds, which are critically important to development in Uganda. The combined pension-related funding aggregates add to roughly 2 percent of GDP, far less than in most developing countries. These potentially valuable accumulations of long-term capital are small, despite high required payments (15 percent of gross salary). Several factors account for this, including low participation (250,000 active members out of an estimated labor force of 6 million), past mismanagement, and poor financial performance.

36. **NSSF's performance over the past 10 years in protecting its contributors has been dismal.** NSSF, which is a provident fund subject only to a requirement that it pays a dividend each year (with no minimum specified), has declared dividends substantially higher than its income during most of the last 10 years. Nevertheless, total dividends represent a return of only 4.9 percent per annum to participants, a return of about negative 8 percent per annum in real terms, and substantially (12 percent points) less than the return on treasury

[12]The NSSF is a Provident Fund (Defined Contribution) type scheme, established to cover all employees in the formal sector, except government and other government-related enterprises. Participation in the scheme is mandatory, with contributions of 15 percent (10 percent by the employer and 5 percent by the employee) of total cash compensation.

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bills. As a result, large deficits emerged and peaked in 1996/97 at U Sh 8.3 billion, equivalent to 15 percent of the value of the fund.[13]

37. **NSSF's poor financial performance can be attributed primarily to administrative inefficiency, poor investment practices, and performance**. Over much of its history, NSSF had high administrative expenses relative to assets. However, while the situation has now improved significantly, NSSF still has annual operating costs equivalent to 11 percent of contributions and 3 percent of assets.[14] At the same time, past investment performance has not served the interests of members, with negative real rate of returns and with an investment portfolio that is overvalued, illiquid, and highly concentrated in real estate. This is likely to affect the pace of recovery for NSSF, as it will inevitably continue to be a drain on its financial performance (Box 6).

38. **From a developmental perspective, the NSSF, one of the few non-donor sources of long-term investment capital in Uganda, has a highly suboptimal investment strategy.** Although most of its liabilities are long term, it has not aggressively transformed developmentally valuable long-term funds. About 52 percent of its funds are in short-term bank deposits and treasury bills, 40 percent in real estate, 8 percent in long-term bonds, loans and equities, and no funds are invested in mortgages. The high level of investment in short-term bank deposits and treasury bills has not only led to exacerbating the concentration of deposits in banks but has further complicated liquidity management and led to a negative maturity transformation.

39. **Avoiding negative maturity transformation by NSSF, while highly desirable, would require a number of pre-requisites.** These include: (i) that NSSF adopt a consortium approach to major investment, which will allow for pooling of financial resources and reduce risks for all participants and the financial sector at large; (ii) that the government issue long-term government bonds to serve as both an additional investment instrument for NSSF and as a benchmark for stimulating the development of the market; (iii) that the Bank of Uganda avoid providing commercial banks with exemptions from the single borrower limits, thereby fostering appropriate incentives for banks for pooling resources with institutional investors.

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[13]It is not surprising that NSSF participation is widely viewed as a tax and not a benefit, and under these circumstances enforcing required participation and collecting contributions has been challenging. This is why the NSSF has begun a public relations campaign to improve its image.

[14]A moderately well-run provident fund in a developing country the size of Uganda might expect to incur operating expenses of 1 to 2 percent of contributions and 0.1 percent of assets.

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Box 6. Developments in NSSF since the FSAP Mission

The FSAP mission recommendations included (i)strengthening NSSF's Board of Directors; (ii) improving financial controls; (iii) ensuring a professional management of NSSF investment; (iv) significantly strengthening the fund's ability to track and monitor clients; and (v) formulating a national pension strategy. Since the FSAP mission, the authorities reacted swiftly and, while a great deal of progress has already been achieved, more is still needed to ensure that the NSSF plays its appropriate role in support of the financial system and its members. To be sure, major developments have already taken place and there was a significant improvement in NSSF's financial position.

Recent developments

- A new interim board of directors has been appointed to serve the remainder of the five-year term of the dismissed former board (until the spring of 2003).
- An external audit has been conducted and completed. The main findings of the external audit include the need to (i) streamline the organizational structure, which tends to be top-heavy and ineffective; (ii) improve financial control, including putting in place a comprehensive financial manual to guide the staff and reduce abuse in all aspects of NSSF dealings, especially in investment and treasury functions; and (iii) significantly upgrade the IT system to enable NSSF to better identify clients and monitor and track them.

Improvements in NSSF's financial position

Over the past two years, there was also a major improvement in the financial position of NSSF. First, the overall assets of the NSSF grew rapidly, reaching U Sh 254 billion as of end-June 2002, mainly as a result of a significant improvement in the collection of funds. The improved financial position of NSSF helped to virtually eliminate its accumulated deficit.

Notwithstanding this major turnaround in the NSSF's financial position, a number of challenges still remain. These include (i) the urgent need to reorganize the fund and implement the recommendations of the external audit, especially with respect to the strengthening of financial controls; (ii) the need for a professional board that is capable of setting broad policies, exercising effective control, and safeguarding the interests of members without involvement in the day-to-day operations and while avoiding any politically-motivated interference; (iii) the need for professional management staff that is accountable; and (iv) the need for an action plan aimed at enhancing contributions, improving internal efficiency and corporate governance, substantially improving investment performance, and improving the oversight of the fund.

NSSF Data (billions of U Sh)	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Members' fund	37	58	83	113	149	196	254
Accumulated deficits	6	8.3	6.9	6.7	5.8	0.6	0.1
Contributions collected				31.6	43.2	46.5	58
Benefits paid				4.1	4.5	5.5	8.1
Income	2.3	2.3	4.5	5.9	8.4	16.4	15.8
Operating expenses	2.7	3.5	3.0	3.4	4.1	5.5	7.8
Ratios of operating expenses:							
to income	--	--	--	*58%*	*49%*	*34%*	*49%*
to contributions	--	--	--	*11%*	*10%*	*12%*	*14%*
to assets	*7%*	*6%*	*4%*	*3%*	*3%*	*3%*	*3%*

Sources: National Social Security Fund and IMF staff estimates.

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C. Uganda Development Bank

40. **Following the restructuring of the bank in 1997, the authorities began the divestiture process under the Public Enterprise Reform and Divestiture Statute.** The idea is to convert UDB into a sound institution that can provide financing to the small and medium enterprises. The divestiture process, which was expected to be completed within two years, has so far taken close to six years. This has raised concerns that the earlier problems of governance may reemerge if the bank is not privatized.[15] Since UDB is not a deposit-taking institution, it is not supervised by the BOU. It is currently operating under the management of the restructuring team and de facto supervision is exercised by the privatization unit, a government agency in charge of public enterprises. Although UDB appears well on the way to becoming privatized, the delays raise concerns, as UDB still represents the biggest NBFI-related risk. If an appropriate buyer cannot be found, UDB should be liquidated.

D. Microfinance

41. **Uganda has a fairly well-developed and diversified microfinance industry involving 2 commercial banks, 2 NBFIs, up to 100 NGO-type organizations, and numerous financial cooperatives (SACCOs).** However, the industry is very small relative to the needs of the rural and microfinance subsectors, which represent the bulk of Uganda's population and more than 50 percent of its GDP. These institutions together have relatively few branch locations, a small deposit base, and a small loan portfolio. Every significant microfinance institution (MFI) has received substantial donor support and private investors are becoming increasingly interested in those that give promise of becoming commercially viable. However, staffing and administrative logistics constrain growth and the industry cannot sharply increase its rural activity quickly.

42. **The government's willingness to accept the necessarily high interest rates charged by MFIs has been key to the development of the sector.** The government Poverty Eradication Action Plan (PEAP) has put emphasis on the role of microfinance as an instrument for poverty alleviation, especially in light of the fact that over 43 percent of the population do not have access to financial services. Given this emphasis, microfinance has grown over the past five years both in volume, outreach, and effectiveness, and the government is currently formulating a comprehensive policy framework to encourage further growth.

43. **However, the industry is now entering a period of transformation and consolidation where there will be "winners and losers."** Those MFIs that have reached financial self-sustainability will be able to access commercial funding and private investment, and are well placed to reap economies of scale benefits by expanding their

[15]Governance problems and directed credit have led in the past to about 90 percent of UDB's portfolio to become nonperforming.

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operations. Most MFIs that have not reached the break-even point will probably lose their donor support and close or be taken over, although there will always be a number of NGOs operating on a very local basis.

44. **Most of the estimated 700 SACCOs in the country are dysfunctional.** Two cooperative umbrella organizations are operating, with external support, pilots attempting to bring a total of 30 rural SACCOs up to internationally recognized standards for credit unions.[16] If the SACCO sector can be revitalized, it is most likely to come through the organic growth of these pilots, but it will take time to inculcate the culture and transfer the knowledge and operational systems beyond the initial pilot SACCOs.

45. **Despite a vibrant private microfinance industry, the government continues to be involved.** The government currently operates a number of microfinance schemes, most notably "Entandikwa," which introduces inefficient and unnecessary distortions into the sector and acts as an impediment to the development of a sustainable microfinance industry. While the government should continue to create the appropriate incentives and foster an enabling environment, including the appropriate legal and supervisory structure, its direct involvement in MFIs should be phased out.

E. Legal Reform

46. **The authorities would need to build on the progress made in reforming the legal framework to support the development of the financial sector**. The presentation of the FIB and of the Microfinance Bill to parliament is a welcome development. However, most of Uganda's commercial laws remain outdated, creating administrative difficulties and excessive costs for financial institutions, particularly in the area of debt contract enforcement. A new Insolvency Act is needed since bankruptcy is virtually unknown, and insolvent companies either carry on indefinitely or fade away, leaving creditors with no recourse. Also, a new Land Act amendment makes extending credit to homeowners difficult because of its requirement to prove consent of spouses and children. Moreover, the functioning of the courts requires further improvement. The court system, because of inefficient administration, inadequate skills and corruption, does not contribute to the effective enforcement of loan contracts, and strengthening it is a high priority. The recently established Commercial Court is a promising development but is not yet fully effective and is largely irrelevant for loans made outside the Kampala area. The government has recognized these deficiencies in the legal area and has launched a Commercial Justice Reform Program to create an enabling legal environment. Since the FSAP, there have been a number of positive developments, including the relocation of the High Court to Kampala, the establishment of a commercial court registry, the reduction of case backlogs, and the finalization of a new draft Insolvency Act.

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[16] The two umbrella organizations are UCA and UCSCA.

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F. Capital Market

47. **Uganda has a professionally capable Capital Market Authority (CMA) and well-designed capital market legislation but should address deficiencies in the Companies Act relating to inadequate provisions on transparency, protection of minority shareholders, and flexible capital structures**. Unfortunately, this relatively sophisticated infrastructure is very costly relative to the small capital market, which has an insignificant market capitalization (US$149 million relating to three issues), negligible turnover, and a modest pipeline of potential supply generated by the privatization process. Market development is inhibited by the often high real interest rates and relative lack of participation by contractual savings institutions.

48. **In its current form, the stock exchange is not economically viable**. Both investors and borrowers of equity capital in Uganda should have access to more developed markets, which offer superior infrastructure, liquidity, and depth. While other options are available, the investment already made toward regional integration and the advanced stage of negotiation on the establishment of the East Africa Regional Stock Exchange argues for pursuing this option while working with partner governments to enhance the efficiency and liquidity of the regional market. It should be recognized that the combined East African markets would still be modest, illiquid, and may not satisfy the long-term needs of the country. Nevertheless, working within the regional stock exchange would present many advantages to Uganda, including benefiting from a larger and deeper market than its own and strengthening its regional integration. This should, however, be viewed as a stepping stone since the regional market itself would still be inherently small and would need to look toward further integration into larger and more global securities markets.

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PART II—OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains summaries of the detailed assessments of the observance of financial sector standards and codes, carried out as part of the joint Fund-Bank Financial Sector Assessment Program (FSAP) in Uganda. They reflect Ugandan authorities' practices in financial sectors' regulation and supervision at the time of assessment.

The detailed assessments of the financial sector standards and codes were conducted under the supervision of Mr. Abdessatar Ouanes (Mission Chief) by the following teams of assessors:

- Basel Core Principles for Effective Banking Supervision (BCP)—Messrs. Michael Andrews (IMF) and C.R. Muralidharan (IMF expert, Reserve Bank of India).
- Core Principles for Systemically Important Payment Systems (CPSS)—Messrs. Carlisle Procter (IMF expert, formerly Reserve Bank of Australia); and Michael Robotham (IMF regional payment systems expert).
- Transparency in Monetary and Financial Policies
    - Monetary Policy Module—Ms. Judit Vadasz (IMF).
    - Banking Supervision Module—Ms. Judit Vadasz and Mr. Michael Andrews (IMF).
    - Payment Systems Oversight Module—Ms. Judit Vadasz (IMF), Messrs. Carlisle C. Procter, (IMF expert, formerly Reserve Bank of Australia), and Michael Robotham (IMF regional payment systems expert).

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I. Basel Core Principles for Effective Banking Supervision

A. General

49. This assessment of compliance with the Basel Core Principles for Effective Banking Supervision was undertaken as part of a Financial Sector Assessment Program (FSAP) undertaken jointly by the World Bank and the International Monetary Fund. The assessment team reviewed legislation, regulations, and various Bank of Uganda (BOU) documents, and held extensive discussions with the staff of the BOU and participants in the financial markets. While the assessment is based on supervision practices, legislation, and regulations in effect at end-April 2001, the assessment team also reviewed the draft of the new Financial Institutions Bill (FIB 2002), which is being discussed in parliament. The assessment team had access to all required information, and expresses its deep appreciation and thanks to the staff of the BOU for their full cooperation.

B. Institutional and Macroprudential Setting, Market Structure—Overview

50. The financial sector in Uganda is dominated by 15 commercial banks. Although there are a number of nonbank institutions, most of these are very small compared to the banks. The banking sector itself is segmented with interbank activity generally limited to the five large foreign-owned banks that collectively account for about 82 percent of the banking sector's assets.[17] There are 10 other banks, most of which are quite small, that collectively comprise about one-quarter of the banking sector's assets.[18]

51. Most banks are liquid as they perceive a lack of bankable projects. There is intense competition for the top tier of customers, but borrowers without a long established track record are likely to have difficulty in accessing financing. The reported financial condition of the banking sector has improved considerably since the closure of four banks in 1998 and 1999. On-site examinations regularly require additional provisions, suggesting that capital levels are overstated and the off-site data cannot be wholly relied upon. A number of smaller banks have been in frequent violation of prudential requirements since their inception in the 1990–95 period. The authorities have agreed with the FSAP mission's recommendations to close nonviable banks and enforce capital adequacy requirements. Since the assessment, the level of nonperforming loans has declined substantially and, as of September 30, 2002, it stood at 3.4 percent. All banks are currently in compliance with the extant capital requirement.

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[17]The formerly state-owned Uganda Commercial Bank Limited was acquired by the Stanbic group in a privatization arrangement in February 2002 and subsequently merged in September 2002.

[18]Following the recommendations of a full-scale bank inspection, the BOU closed one of the small banks on September 2, 2002 and facilitated its merger with another bank.

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C. General Preconditions for Effective Banking Supervision

52. There is a generally appropriate framework of commercial law, although the Bankruptcy Act is outdated and in need of revision. Efforts of the Nonperforming Asset Recovery Trust (NPART) to collect nonperforming assets removed from Uganda Commercial Bank Limited as part of the first attempt at privatization has had the beneficial effect of establishing the legal precedents for enforcing security. This has encouraged banks to legally pursue debtors, which is helping to cultivate a culture of repayment. Uganda adopted International Accounting Standards (IAS) with effect from January 1, 1999, but professional standards and the application of IAS remain uneven.

53. Greater disclosure of specific bank information is required to enhance market discipline. The government's decision to fully compensate all depositors following the closure of International Commercial Bank (ICB), Greenland Bank, and Cooperative Bank (Coop) undermined market discipline, as it created the expectation that the deposit insurance limit would not be enforced. The subsequent handling of Trust Bank was an improvement, as uninsured depositors incurred losses, providing much needed credibility for the joint BOU–government intervention policy and the deposit insurance limit of U Sh 3 million. The recent resolution of TransAfrica bank and the vigorous enforcement of prudential requirements are positive developments.

54. The Financial Institutions Statute (FIS) provides a broad range of remedial measures to deal with problem banks; but, as documented in a judicial inquiry (the Ogoola report) into the closure of ICB, Greenland and Coop, response to developing problems, in practice, was weak and slow. The FIB 2002 provides for prompt corrective action measures, requiring the supervisor to take specific minimum steps in response to deteriorating capital position in banks. However, as with the current FIS, the key issue is effective implementation rather than legal powers.

55. The BOU's lender-of-last-resort facility has historically been available for extended periods without adequate security. To avoid a repetition of the losses incurred by the BOU in the closure of Greenland Bank and ICB, the BOU has committed as part of its IMF program to provide liquidity support only to solvent banks, upon provision of liquid security.

Main findings

56. Significant improvements have been made in banking supervision in Uganda since the 1993 introduction of a modern banking statute, and the draft FIB 2002 addresses a number of the weaknesses identified in the Core Principles assessment. The bill, having been introduced in parliament, is now under review by the Parliamentary Committee on Finance, Planning and Economic Development. While further delays appear likely, the BOU is preparing regulations and guidelines in anticipation of enactment of the law. If implemented effectively, these measures can improve Uganda's compliance with the Basel Core Principles significantly.

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57. **Objectives, autonomy, powers, and resources—CP 1**. The current legislation and regulations provide a generally appropriate and adequate legal foundation for effective supervision. One exception is the requirement in the current statute for the BOU to consult with the minister of finance in matters of license revocation and closure, and for an aggrieved applicant to appeal to the minister of finance in the event the BOU denies a license application. These provisions increase the possibility of political influence in key prudential decisions. The draft of the new FIB 2002 would remove the minister formally from prudential decision-making. In addition, the assessment team noted that the banking regulations have not been published in the Uganda Gazette. The gazetting of regulations would enhance both transparency and the legal foundation for supervision. The BOU intends to gazette all new regulations implementing FIB 2002.

58. The BOU significantly increased its capacity through the recruitment of 15 new supervision staff in 1999. Training and development presents a challenge; however, the BOU has been able to examine all banks once a year since the fiscal year ended June 30, 2001. Supervisory resources appear adequate, but this will have to be reassessed after the introduction of the new FIB 2002 and microfinance act, which will give the BOU oversight responsibilities for microfinance.

59. **Licensing and structure—CPs 2-5.** The principal shortcoming in the case of CPs 3 and 4 is the lack of a detailed policy to review the fitness and probity of shareholders, and their ability to provide additional financial support, if required; and in the case of a new license, a detailed review of the proposed operating policies, procedures, and controls for the new bank. Under the new FIB, licensing criteria will be strengthened.

60. **Prudential regulations and requirements—CPs 6–15.** The major weakness with this group of core principles relates to the lack of guidance provided to banks as to the minimum prudential requirements for internal policies, procedures, and controls. These issues are generally addressed during on-site examinations, but in the absence of clear minimum prudential requirements, determination of the adequacy of banks' policies and systems is largely dependent on the professional judgment of examiners. Transparency and effectiveness would be improved by the development of suitable guidelines, which can be modeled on similar work done in other countries. Subsequent to the assessment, comprehensive risk-management guidelines covering credit, liquidity, foreign exchange, interest rate, and operational risks were issued after consultation with the industry. The new FIB 2002 will introduce 'know-your-customer' requirements, which will partially meet the requirements of CP 15. The authorities are working on a draft anti-money laundering law and have prepared anti-money laundering guidelines to be issued in 2003.

61. The minimum capital requirement for banks is to increase in 2003 from USh 2 billion increased to U Sh 4 billion. The capital adequacy requirement incorporates Basel risk-weightings. Minimum risk-weighted capital requirements are 8 percent core capital (Basel Tier 1), and 12 percent core plus supplementary capital (Basel Tier 1 plus Tier 2). The

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adoption of a 12 percent minimum requirement in 1999 was a very positive step and properly reflects the higher risks that exist in a country where the preconditions for effective supervision have not been fully developed.

62. **Methods of ongoing supervision—CPs16–20.** The supervisory mechanism is well conceived and has both the onsite and offsite elements. The supervisor has adequate powers to take a range of remedial actions. The assessment team has concerns about the current provisions for the BOU to approve exemptions from the established prudential limits on credit exposure, and supports the approach in the new FIB 2002, which would remove this mechanism. A new quarterly offsite monitoring report that reflects trend analysis and additional measures of financial performance is being pilot-tested and will be introduced in 2003. On-site examinations are transactions-based, compliance-oriented, and are not yet conducted on a consolidated basis. A concerted effort is needed to improve risk management practices by banks. The BOU has formally adopted a risk-based supervision approach and now uses a shorthand method for monitoring foreign exchange net open positions.

63. The major concern in supervision is less with the processes currently in place to identify problems and monitor ongoing progress, and more with the laxity in moving decisively and making full use of the available remedial powers. The Judicial Commission of Inquiry into Closure of Banks (Justice James Ogoola—2000) concluded that "a strong, but secondary cause of bank failures was the consistently weak supervision by Bank of Uganda." Despite the strengthened resolve of the central bank, the continuance of MOU arrangements, even when the problem bank has not made substantive progress, is a cause for concern. The recent closure of one small bank that was solvent, but had weak corporate governance, is a step in the right direction.

64. **Information requirements—CP 21.** The systems of maintenance of records and accounts do not meet the minimum requirements of the core principles. The adoption of International Accounting Standards effective from 1999, and prescription of a common format in the new FIB 2002 are steps in the right direction. The local accounting profession is nascent and the levels of disclosures by banks vary significantly. There are concerns on the accuracy of data provided to the supervisor in the offsite returns.

65. **Formal powers of supervisors—CP 22.** Cease-and-desist orders or removal of management have been rarely used, and delays in supervisory intervention have resulted in significant costs to the deposit insurance fund and government. The new FIB 2002 includes mandatory prompt corrective actions, but as with the current FIS, the key to effective supervision lies more with prompt and firm decisions by the supervisor than with the legal framework.

66. **Cross-border banking—CPs 23–25.** CPs 23 and 24 are not applicable because no Ugandan bank has international branches, subsidiaries, or representative offices. Reaching full compliance with CP 25 requires the establishment of a regular and formal process for the exchange of information with home country supervisors.

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D. Recommended Actions and Authorities' Response

Recommendations

67. The new FIB 2002 will address weaknesses in a number of areas, but there will still be a need for more detail in regulations and/or standards of sound business practice, particularly with regard to banks' internal approach to risk management. Compliance with Core Principles 8 to 14 could be greatly improved by the introduction of prudential guidelines for banks regarding the minimum standards for policies, procedures, and internal controls. The comprehensive Risk Management Guidelines, which address most of these concerns have been finalized and issued formally.

68. The principal challenge to improve supervision is the effective implementation of the powers provided both in the current FIS and the expected new legislation. Decisive supervisory action to deal with identified problems has not always been in evidence. The BOU needs to avoid providing prolonged periods of forbearance and should enforce all prudential requirements in a consistent and equitable manner. Banks unable to comply with undertakings or memoranda of understanding need to be subject to more stringent sanctions, and ultimately intervention. It is important to maintain the hard-won credibility of the BOU that banks are not permitted to operate for extended periods while in violation of prudential requirements (Table 1).

Table 1. Recommended Actions to Improve Compliance with the Basel Core Principles

Subject	Action
Objectives, Autonomy, Powers, and Resources (CP 1)	• Gazette regulations. • Remove consultation with minister on closure. • Information-sharing agreements. • Introduce formal review of supervisory performance.
Licensing and Structure (CPs 2-5)	• Regulation or policy for a more detailed review of license and ownership transfer application.
Prudential Regulations and Requirements (CPs 6-15)	• BOU to promulgate prudential guidelines for banks as to minimum requirements for polices, procedures and controls related to credit risk, assets quality, insider lending, country risk, market risks, operational risk, internal audit and control. • Introduce money laundering law—new FIS has know-your-customer provision, but further measures required, including the development of detailed guidelines.
Methods of Ongoing Supervision (CPs 16-20)	• Introduce risk-based approach to supervision. • Collection of offsite monitoring data in standardized electronic format. • Require banks to report on loans 30, 60, 90,120, and 150 days in arrears even if provisions are not required. • Introduce consolidated supervision.
Accounting Standards (CP 21)	• Require minimum disclosures.
Remedial Measures (CP 22)	• Decisive supervisory actions to address emerging problem situations.
Cross-border Banking (CPs 23-25)	• Regular formal and informal contact with home country supervisors.

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69. **Response of the Bank of Uganda.** Bank of Uganda appreciated the comments made by the FSAP mission and undertook to correct the deficiencies noted in the core principles graded as materially compliant and noncompliant, and to close the gaps identified in the principles graded largely compliant. The proposed FIB 2002 will address a number of identified weaknesses and the BOU is drafting prudential regulations in preparation for the enactment of the FIB 2002. With effect from end-September 2001, the BOU made the classification of nonperforming assets consistent with international norms. With technical assistance from the IMF, risk-based supervision is being introduced.

II. CPSS Core Principles for Payment Systems

A. General

70. This assessment of Uganda's payment and settlement systems was undertaken in the context of a Financial Sector Assessment Program (FSAP). It is based on information provided by the BOU in the form of the Stocktaking and Situational Analysis Report, the Vision and Strategic Framework for the Development and Modernization of Uganda's Payment System, the National Check Standards of Uganda, and responses to the IMF questionnaire with regard to payment and securities issues. This information was supplemented by discussions with officers of the BOU; commercial banks participating in the payment system, nonfinancial institutions; ministry of finance in the form of the Uganda Computer Services; and the Uganda Securities Exchange. Discussions were also held with the German Technical Cooperation Agency (GTZ), which is actively involved with the BOU in the National Payments System (NPS) reform and modernization program.

B. Institutional and Market Structure

71. The National Payment Systems Council (NPSC) is the overall policymaking body on the payment systems. Its membership is drawn from the major stakeholders, including the BOU, commercial banks, Post Bank, Capital Markets Authority (CMA), the government, Uganda Manufacturers' Association (UMA), Uganda Law Society (ULS), and Uganda Communications Commission (UCC). The statutes supporting the payments system include the Evidence Act, Bills of Exchange Act, Bankruptcy Act, Companies Act, Bank of Uganda Statute, and the Contract Act. A number of these laws and regulations, including a proposed law on the National Payments System in support of the reform of the NPS, and the Financial Institutions Bill. It is hoped that this body of legislation, if and when introduced, will provide an appropriate legal framework.

72. Uganda has implemented an institutional framework that is designed to provide effective support and guidance for the NPS. The Uganda National Strategy Team (NST), is a multidisciplinary team comprised of members drawn from the stakeholders. Its mandate is to advise and make recommendations to the NPSC on all aspects relating to the NPS development. Complementing and supporting these bodies is the National Payment Systems Secretariat (NPSS), which was established in February 1998 to create the environment for the

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reform and modernization of Uganda's payment systems, and to manage the process of developing the NPS on a daily basis. The Vision and Strategic Framework for the Development and Modernization of Uganda's Payment System states that the reform and modernization program will be completed by 2010 and will provide a "modern payment system that is effective, efficient, reliable, accessible and need-driven."

73. The document envisions three core systems to be developed as follows:

- **Paper-based transfer system**. This system is to be designed for the processing of paper-based debit and credit instruments using code line clearing (electronic data files). It will be facilitated by the electronic clearing system that was implemented in May 2002.

- **Bulk electronic transfer system**. This system is to be designed for the processing of credit payment instructions received in electronic form that constitute low value/ high-volume payments (the handling of debit instruments may follow).

- **Large value transfer system**. It is envisaged that large value and time-critical payments will be undertaken utilizing a Real-Time-Gross Settlement (RTGS), or Deferred Net Settlement (DNS) system.

74. Additional complementary systems are to be developed that include: payment card processing systems; electronic banking and internet based systems; and foreign currency clearing.

75. These reform moves are desirable and sensible, although a high-value system based on deferred net settlement should be discouraged. However, while the implications of this proposed program have to be taken into account, payment system reforms are not yet in place. There will need to be a substantial build-up of resources and skills in the BOU if the envisaged timetable is to be achieved. The authorities should be encouraged to press ahead with their reforms, which are critical to the development of a modern economy.

76. The financial sector in Uganda is relatively small and unsophisticated. In turn, the payment clearance and settlement system is also comparatively limited, with cash being the most preferred payment medium. Though volumes and values of checks are neither large nor significant, a failure could quickly have very serious systemic effects on the Ugandan financial sector and the wider economy.

77. The payment system's ability to withstand stresses of any significance is extremely limited. The system's operations—which involve mainly the manual processing of paper—are slow and imprecise, while inadequacies in infrastructure—telecommunications and power—together with a lack of understanding of alternatives, have hampered the development of more sophisticated options. The lack of comprehensive risk controls in the system is particularly worrisome. In the past, some failing banks had their settlement obligations met by the central bank. While the system has been tightened, there is still

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ambiguity about how failures might be handled, as a practical matter, in the future. In any event, the lack of any proper "failure to settle" arrangements in the present system leaves participants—including the central bank—exposed to very significant uncertainty and risk.

Main findings

Legal foundation

78. There is an absence of a clear legal structure to support the payments system in Uganda. There are some legal underpinnings for the clearinghouse, but little to support the system more generally. The absence of well-founded "failure to settle" rules is a major omission, which needs to be addressed.

Understanding and management of risks

79. The present debit paper system is inherently risky. Getting participants to focus on this issue is hampered by an implicit belief that the central bank will step in should there be an emergency. Developing the necessary tools to monitor and control risk is hindered by a shortage of technology, systems and skills, not least in the central bank. The central bank urgently needs to upgrade its computing and systems to allow better and timelier information to be provided to participants, and to achieve finality of settlement sooner. Other participants should also be encouraged to upgrade their systems.

Settlement

80. Because of computing and systems inadequacies, final positions are not known until the next day, and then not always with absolute certainty. There are no failure to settle rules. The utmost priority should be given to developing processes, which will, as a minimum, ensure that the system can settle in the face of the failure of the player with the largest position. The settlement cycle also needs to be accelerated.

81. The system settles in central bank money. Settlement balances should be passed electronically, rather than by check.

Security and operational reliability, and contingency arrangements

82. The clearing and settlement system is substantially manual, which makes it operationally unreliable and insecure. There are no specific contingency/backup measures. The clearinghouse is to be automated, with checks standardized and MICR encoded. Backup arrangements should be formulated.

Efficiency and practicality of the system

83. The system works well enough day-to-day, but it would be unable to withstand any significant stresses. It is inefficient, and does not cover the majority of Uganda's people. It

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needs to conform to the core principles. As well as the work going on to enhance the check clearing, an effort should be made to develop a low-value credit giro system, and to spread that through a much larger proportion of the population.

Criteria for participation

84. There are no objective, publicly available criteria for participation in the payment system. These need to be developed. NBFI's such as Post Bank, and the Housing Finance institution, need to be brought into the system.

Governance of the payment system

85. Some regulations for the clearinghouse are published, others are not. A comprehensive, transparent, and accountable set of regulations for the management and control of the system going forward needs to be developed as part of the reform program. The authorities need to be more proactive in explaining the payment system, and the intended changes, to encourage more active public participation.

Central bank responsibilities in applying the CPs

86. To date, the BOU has not clearly defined its payment system objectives. It is working on a comprehensive document, "Vision and Strategic Framework for the Development and Modernization of Uganda's Payment System." There is consultation with stakeholders (but not the public) on reform of the check-clearing system. The BOU needs to do a great deal of work to bring the payments system into conformity with the core principles. This will require a substantial strengthening of its internal systems and human resources.

C. Recommended Actions and Authorities' Response

Recommended actions

87. Attention needs to be given to ensuring, as far as possible, the legitimacy of transactions passing through the payment system. It is understood that new legislation will help mandate account opening procedures, and other measures commensurate with the Financial Action Task Force on Money Laundering (FATF) principles. The introduction of a second clearing session, specifically for the return high-value items, would help reduce the risk of kiting and also provide finality on the day of presentation to the clearinghouse. There is an urgent need to get as much debit paper as possible out of the system, particularly high-value paper. It should be possible to run such payments through a small PC-based RTGS system. It is important that consumers have appropriate access to, and involvement with, the retail payments system. Access to established dispute-resolution procedures on acceptable terms would be an important element. A banking industry ombudsman could be a useful initiative to assist in dispute resolution, together with the involvement of a consumer affairs

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bureau or like body, to ensure the banking industry provides appropriate payment instruments to consumers on reasonably affordable terms. Additional detailed recommendations are summarized in Table 2.

Table 2. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank's Responsibilities in Applying the CPs

Subject	Recommended Actions
Legal foundation (CP 1)	The lack of legal underpinning to the payment clearance and settlement system in Uganda needs to be addressed with the enactment of the comprehensive list of legislation under preparation by the BOU.
Understanding and management of risks (CPs 2–3)	The present debit paper system is inherently risky. The central bank urgently needs to upgrade its computing and systems to allow better, and more timely information to be provided to participants, and to achieve finality of settlement sooner. Other participants should also be encouraged to upgrade their systems.
Settlement (CPs 4–6)	Because of computing and systems inadequacies, final positions are not known until the next day, and then not always with absolute certainty. There are no failure to settle rules. The utmost priority should be given to developing processes, which will, as a minimum, ensure that the system can settle in the face of the failure of the player with the largest position. The settlement cycle also needs to be accelerated. Settlement balances should be passed electronically, rather than by check.
Security and operational reliability, and contingency arrangements (CP 7)	The clearing and settlement system is substantially manual, which makes it operationally unreliable and insecure. There are no specific contingency/ backup measures. The clearing house is to be automated, with checks standardized and MICR encoded. Backup arrangements should be formulated.
Efficiency and practicality of the system (CP 8)	The system works well enough day-to-day, but it would be unable to withstand any significant stresses. It is inefficient, and does not cover the majority of Uganda's people. It needs to conform to the core principles. As well as the work going on to enhance the check clearing, an effort should be made to develop a low value credit giro system, and to spread that through a much larger proportion of the population.
Criteria for participation (CP 9)	There are no objective, publicly available criteria for participation in the payment system. These need to be developed. NBFI's such as Post Bank, and the Housing Finance institution, need to be brought into the system.
Governance of the payment system (CP 10)	Some regulations for the Clearing House are published others are not. There are no regulations for the system as a whole. A comprehensive, transparent and accountable set of regulations for the management and control of the system going forward needs to be developed as part of the reform program. The authorities need to be more proactive in explaining the payment system, and the intended changes, to encourage more active public participation.
Central Bank Responsibilities in applying the CPs	The BOU should clearly define its payment system objectives.

Authorities' response

88. The authorities are in broad agreement with the assessment. They recognize the main weaknesses in the existing payment, clearance, and settlement system. The BOU is driving a major program of legislative reform which, if carried through and supported by appropriate regulations, should lead to a robust payment system. It is important that the BOU has

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unambiguous authority over the payment system, and the power to make and implement regulations as deemed necessary. They are also planning for the automation of the check-clearing system, which is well advanced. This will be preceded by standardized checks with magnetic ink character recognition (MICR) encoding. Subsequently, it is envisaged that credit transfers will be handled electronically and entered through the same clearing system. Direct debits are planned to follow.

89. The authorities recognize that the most pressing issue is to develop proper "failure to settle" rules in the clearinghouse, with appropriate legal underpinnings. In a debit paper system with multilateral netting and deferred settlement, this will involve having committed resources in place to ensure that settlement can be completed on schedule in the event of the failure of the largest participant.

90. The other pressing issue is to improve the BOU's internal technology and reporting systems to substantially enhance its ability to provide timely settlement figures and other data, both for its own use and for other payment-system participants. The central bank should be abreast of, and ideally ahead of, best industry practice in these areas. The availability of requisite skills will be an important element to ensure success of the payments system. In that regard, consideration could be given to the use of technical assistance in the reform and modernization program.

91. It should also be possible to accelerate the clearing cycle with the ultimate objective of achieving a standard three-day cycle. As a first step, automating returns/dishonors can produce significant results in this area.

III. MFP Transparency Code—Monetary and Financial Policies

A. General

92. The assessment of the BOU's observance of good transparency practices in the area of monetary and financial policies was carried out as part of the joint Fund-Bank Financial Assessment Program (FSAP). Its contents are based on answers to the questions laid down in the *Code of Good Practices on Transparency in Monetary and Financial Policies*. The assessment is based on the authorities' response to the questionnaire sent to them before the FSAP mission; on the relevant laws and regulations; consultations with the BOU and several commercial banks; other written information, as given by authorities; information from the BOU's website; and, to a small degree, as explained by market participants. The assessment also took into consideration the findings of an experimental IMF report on the observance of standards and codes carried out in August 1999, although at the time when the 1999 report was completed, no detailed questionnaire or template existed yet.

93. The authorities should be commended for being very open and cooperative in the assessment process, giving the mission their help in completing the questionnaires in a timely manner.

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B. MFP Transparency Code—Monetary Policy

Legal framework, institutions, and market structure

94. The Constitution and the Bank of Uganda Statute constitute the legal framework for monetary policy. The Constitution states that the BOU shall "... promote and maintain the stability of the value of the currency of Uganda," while the Statute formulates the same by stating that the BOU shall maintain monetary stability.

95. The BOU uses a reserve money targeting framework within the context of a Poverty Reduction Growth Facility (PRFG) program to attain its overall inflation objective. This entails an agreement with the Fund on the macroeconomic policies to be pursued and the performance criteria to be attained.

96. Long-term monetary policy decisions are taken by the BOU Board, which—in addition to BOU staff and other members, includes a representative of the Ministry of Finance (Secretary to the Treasury/Permanent Secretary), while day-to-day monetary policy decisions rest with the Monetary and Credit Policy Committee (MCPC), a body composed of central bank staff and meeting weekly. In addition, the Financial Markets Operation Committee (FMOC), consisting of the relevant department heads of the BOU, convenes daily with the aim of reviewing developments on the domestic interbank and foreign exchange markets. The FMOC reviews and informs the MCPC on the implications of developments in these money markets on monetary policy.

Main findings

97. Monetary policy transparency in Uganda compares favorably with the best international practices and fares better than the levels of transparency in other financial subsectors. The authorities make a conscious effort to provide information on monetary policy to banks, as well as the public. The latter group is informed through various channels including BOU's publications and website. Notwithstanding the improvements, three basic areas where improvements are still needed include: (i) the timeliness of publications;[19] (ii) the provision of information to the general public about the main considerations underlying monetary policy and the effects of the evolving macroeconomic situation on the conduct of monetary policy; and (iii) the development and publication of the internal governance and accountability rules of the staff of the BOU.

98. The responsibilities of the BOU in formulating and implementing monetary policy, as well as the other tasks of the central bank, are laid down both in the Constitution and the

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[19]It must be emphasized that problems with the timeliness of publications arise more with hard copies of various reports of the central bank and less with the versions of the publications appearing on the website.

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statutes of the central bank. The relevant legislation is widely available to the public through the official gazette and the BOU's annual report of 1994/95 (containing the BOU statutes as an annex, and also the banking law).

Clarity of roles, responsibilities, and objectives of the central bank

99. The Bank of Uganda Statute of 1993 stipulates the main function of the BOU as the formulation and implementation of monetary policy to achieve and maintain economic stability. More specific tasks include the maintenance of monetary stability and external reserves, and the participation (where appropriate) of the central bank in economic growth and development programs. In practice, the BOU's primary monetary policy objective is the maintenance of low, stable, and single-digit inflation. However, the lack of clarity on which of the objectives takes precedence could lead to policy conflicts.

100. There is a discrepancy between the Constitution and the BOU Statute regarding the power of the minister of finance to instruct or influence the central bank in its operations. However, this apparent contradiction between the Constitution and the Statute is resolved by the former, which takes precedence over the latter.

Open process for formulating and reporting monetary policy decisions

101. The BOU's *ex post* presentation of developments in monetary operations is transparent, but the considerations underlying monetary policy decisions and reports to the public on the evolving macroeconomic situation and their effect on monetary policy objectives are either nonexistent or published on an ad hoc basis. There is no pre-specified method or timetable for public consultation before structural changes are made to monetary regulations; nevertheless, these consultations occur first of all with the banking community. Regulations on data requirements from the commercial banks are not disclosed to the general public, but are included in BOU circulars sent directly to the institutions concerned.

Public availability of information on monetary policy

102. The central bank's data releases are only partially compliant with the best practices recommended in the GDDS. Summary BOU balance sheets are published only annually and with a considerable time lag, as the audited financial statements are usually available only after a year or more following the period under consideration. The BOU aims at reducing this time lag significantly, and to adhere to the publication schedule mandated by the Statute (the annual report, including the audited accounts should be published within three months following the financial year). The aggregates of monetary operations are publicly disclosed in various forms, but might be difficult to separate from other items, as the level of aggregation is high. Emergency financial support by the central bank is not disclosed and there are no plans to publish it.

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Accountability and assurances of integrity by the central bank

103. The BOU's internal governance procedures, including the internal auditing arrangements are not publicly disclosed, although such disclosure would help to promote a positive picture of the central bank. The conduct of the personal financial affairs of the senior management is regulated publicly, but there are no rules for junior staff. The details of the audited financial statements are published annually, as are data on expenses and revenues of the central bank, but with a significant delay.

C. Recommended Actions and Authorities' Response

104. There is a discrepancy in the role and independence of the BOU between the Constitution and BOU Statute, which should be reconciled in the near term by aligning the BOU Statute with the Constitution's provision. It is important for the BOU to avoid emitting unclear signals by reducing the volatility of interest rates. The development and publication of the internal governance and accountability rules of the BOU staff is also important (Table 3).

Table 3. Recommended Actions to Improve Observance of MFP Transparency Code—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy	Eliminate the conflict between the Constitution and the BOU statute regarding the independence of the central bank from government instructions. The planned revision of the BOU Statute (1993) will address this. Clearly specify the priorities among monetary policy objectives and thus avoid potential contradictions. Clearly indicate the terms and conditions of government borrowings from the BOU and deposits held at the BOU.
II. Open process for formulating and reporting monetary policy decisions	Present to the public developments in monetary operations, the tools it used, and other numeric information in a timely manner. Publish the considerations underlying monetary policy decisions and reports to the public on the evolving macroeconomic situation, and their effect on monetary policy objectives in a regular and systematic manner.
III. Public availability of information on monetary policy	Reduce the time lag in the production of the annual reports. Present less aggregated monetary data where appropriate to improve access to information on the BOU's monetary operations.
IV. Accountability and assurance of integrity by the	Explicitly provide for modalities of ensuring

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central bank	accountability of the BOU directly to parliament. Build on the leadership Code Act of 2002 and proceed with the inclusion of junior staff in a disclosed code of conduct and other internal governance elements.

Authorities' response and recent developments

105. The authorities were in broad agreement with the assessment. The BOU's work to amend its 1993 Statute to remove the apparent inconsistency is ongoing. However, the timing of this may be subject to some delays as has been the experience with the FIB 2002, which has been stalled in parliament. The BOU and the government plan to finalize the MOU in order to improve the openness of policy formulation. Through MAE technical assistance, the BOU has modified its conduct of monetary and exchange rate policies in a way that is more transparent. Some consultations are ongoing with respect to accountability rules. The authorities mentioned that the lag in the production of quarterly and annual economic reports has been reduced from nine to six months. To strengthen accountability and the assurance of integrity, all BOU staff from the rank of principal banking officers upward will be required to declare their income, assets, and liabilities under the Leadership Code Act of 2002. This becomes effective in the fiscal year 2002/03.

D. MFP Transparency Code—Banking Supervision

Institutional and market structure

106. The Bank of Uganda Statute stipulates that the BOU shall supervise, regulate, control, and discipline all financial institutions, insurance companies, and pension funds institutions. The FIS elaborates on these responsibilities and the modalities for effecting them.

107. The BOU Statute further defines the broad objective of the banking supervisor as: "(a) to promote and maintain adequate and reasonable banking services for the public; (b) to ensure high standards of conduct and management throughout the banking system; (c) to promote such policies not being inconsistent with any provision of this Statute; and (d) to vet Directors of the financial institutions."

Main findings

108. Transparency in banking supervision in Uganda has reached a reasonably high level and thus, from a systemic point of view, this aspect of banking supervision does not pose a problem. The authorities put a conscious emphasis on providing information about banking supervision first of all to the banks, but also to the general public. Nevertheless, there are five areas where improvements need to be made: (i) the timeliness of publications; (ii) the clarity of responsibilities in licensing between the BOU and MOF; (iii) establishment and publication of outlines of information-sharing arrangements between domestic and foreign financial agencies; and (iv) publication of banking regulations. Although there is no code of

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conduct for BOU staff and, thus, public disclosure is not applicable, the adoption and publication of such a code would enhance BOU's transparency.

Clarity of roles, responsibilities, and objectives of the supervisory agency

109. The Bank of Uganda Statute entrusts the task of supervising the financial sector to the BOU. The FIS elaborates these responsibilities and the modalities for making them operational. Some issues of concern include the possibility of appeal against a decision to deny a license by the BOU to the MOF, and the need for the BOU to consult with the MOF regarding license revocations and liquidations. The adoption of the draft Financial Institutions Bill is expected to eliminate these inconsistencies and confer supervisory autonomy to the BOU.

110. The regular publication of the Annual Supervisory and Regulatory Report gives wider access to information on the BOU's supervisory objectives. The reduction in the time lag for the issuance of this publication is a positive development.

Open process for formulating and reporting financial policies

111. Most of the weaknesses identified in banking supervision concerned openness of the process of formulating and reporting financial policies. The laws governing banking supervision are publicly disclosed, but the regulations issued by the BOU are not. The BOU intends to publish all its bank supervisory regulations in the official gazette, but there is no planned date for this change to occur. The reporting requirements prescribed for the banks and the fee structure of the BOU are only generally described in the FIS, as is the requirement for the banks to report to the BOU and to pay an annual licensing fee. The specifics of these requirements are not disclosed to the public, but are sent in a circular to the banks concerned.

112. The BOU's intervention policy regarding the restructuring of banks is widely circulated through newspapers, but there are no systematic explanations of policies in this area until the publication of the annual bank supervisory report, which was subject to considerable time lags in the past. The main principles or the outlines of the information sharing and consultative agreements between domestic financial agencies, or between domestic and international bank supervisors are not disclosed to the public, although the banks concerned are informed through monthly meetings with the Uganda Bankers' Association.

Public availability of information on financial policies

113. The BOU uses various channels to publish information on major developments in the banking sector. However, some of the reports have appeared with considerable lags and without adequate information. Efforts are underway to improve the timeliness of publications and improve their coverage. In particular, the BOU now issues annual reports on banking supervision. Some of the financial data forming part of the GDDS appear with a six to eight

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months time lag (these appear in hard copies and are included in the BOU Quarterly Report); and abbreviated data are published in the Economic and Financial Indicators with a six weeks' lag. Information on BOU emergency support to banks is not disclosed at all, unless it is still outstanding by the time the financial institution audits its accounts, in which case it is included in the audited statement. The FIS prescribes the modalities of the deposit insurance and entrusts this task to the BOU in the form of a Deposit Protection Fund. The legislation specifies the financing of this fund and prescribes that the maximum protected deposit per customer should be published in the official gazette. The modalities of deposit insurance are also explained through press releases and the media. Nevertheless, the operating procedures or the performance of this arrangement have not been publicly disclosed.

114. The BOU has a public relations department, which interacts with the press, the other media, as well as the general public. This department, assisted by other departments, answers all public queries about the central bank's operations, and provides information on the supervisory activities as fast as possible. In addition, the BOU has a website.

Accountability and assurances of integrity by financial agencies

115. There are no internal governance procedures, except for those BOU employees who are senior servants and, thus, must act in accordance with the Uganda Leadership Code, which was published in the official gazette. As banking supervision is part of BOU, the assessment of the principles on the audited statements and their publication was done in the assessment of monetary policy transparency.

E. Recommended Actions and Authorities' Response

116. The main recommendations for improving transparency overlap with recommendations from the Basel Core Principles Assessment and Assessment of Observance of CPSS Draft Core Principles for Payment Systems. There is a need to gazette the bank prudential regulations and the authorities reported progress in this area in readiness for when the FIS is adopted. There is also a need to make the operations of the Deposit Insurance Fund more transparent through publication of information regarding its operating procedures, and an annual report. The publication of the annual reports on supervision is a positive step, and it is hoped that the timeliness of the reports will be maintained at no more than six months after the period being covered (Table 4).

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Table 4. Recommended Actions to Improve Observance of MFP Transparency Code—Banking Supervision

Subject	Main Findings
V. Clarity of roles, responsibilities, and objectives of banking supervisory agencies	Clearly define and strengthen the responsibilities of the BOU in banking supervision, legislation, and practice. Maintain improvements in the timeliness of publications on banking supervision. Establish clear legal responsibility for oversight of the payments system.
VI. Open process for formulating and reporting of banking supervisory policies	Publish all bank supervisory regulations in the official gazette. Publish the reporting requirements of banks and the fee structure of the BOU.
VII. Public availability of information on banking supervisory policies	Continue to improve the timeliness of annual bank supervisory reports.
VIII. Accountability and assurance of integrity by banking supervisory agencies	Improve the coverage of internal governance procedures.

Authorities' response

117. The authorities were in broad agreement with the assessment. They have undertaken a number of actions to address the identified problems.

F. MFP Transparency Code—Payment Systems Oversight

Institutional and market structure-overview

118. The creation of the National Payment System Secretariat (NPSS) in 1998 facilitated an orderly development of the Ugandan payment system. About 70 to 80 percent of Uganda's payments are cash transactions, the second most frequently used instruments are checks, but their wider use is hindered by the lack of trust between those involved in these transactions. The legal background also leaves much to be desired, and the courts do not admit electronic evidence. Banks carry out the great bulk of the payment services, but some of them are weak, introducing risks for the system as a whole.

119. The lack of infrastructure has limited the types of payments instruments, and the speed with which funds can be made available. This has also impeded efforts to reduce the extent of the unbanked sector. Considerable improvements have been made to the infrastructure.

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Main findings

120. The BOU's policies in the payments field are less transparent than in some other areas. In the regulatory field, the BOU is a little more open and the basic rules for the clearinghouse, at least, are published in the official gazette. While perhaps not posing an immediate systemic risk to the operation of the financial system as a whole or to the payment system, lack of transparency can inhibit confidence, hamper efforts to reduce the use of cash, and cause confusion in a crisis. Commendable work is under way to develop the Ugandan (and the East African) payment system. The BOU and the NPSS are making efforts to disseminate knowledge about the payment system and the risks involved therein.

Clarity of roles, responsibilities, and objectives of the supervisory agency

121. As per its statute, the BOU Statute is the clearinghouse for checks and other financial instruments for financial institutions. It may also provide facilities for clearing financial instruments generally and make regulations prescribing the procedure, and other provisions for participation in the clearinghouse. However, the BOU's regulatory authority over the wider payment system is ambiguous. As a practical matter, the BOU is the only institution in a position to exercise oversight of the payments system, but its legal basis for doing so needs clarification.

122. The BOU has laid down procedures for handling risks in the operation of the clearinghouse, but other elements are ambiguous, and "failure to settle" rules are under discussion. Work within the East African Payment System Harmonization Committee is ongoing. Significant parts of the clearinghouse arrangements are included in a memorandum of understanding (MOU) with the banks. The laws on other elements of the payment system are either nonexistent or inadequate.

Open process for formulating and reporting financial policies

123. The law governing the operation of the clearinghouse is published in the official gazette. There is also an MOU with banks, which is circulated among signatories to it. There are weaknesses in the publication of significant policy changes. Only the basic information is published by the newspapers, and other channels for communicating these changes are not used effectively. The periodic publications of the central bank do not adequately cover payment system issues.

Public availability of information on financial policies

124. Although the central bank has an ample number of publications, these do not deal with the payment system in any great detail. The BOU's website is not used to convey information about the payment system and there are no special publications dealing with the issues.

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Accountability and assurances of integrity by financial agencies

125. There are no internal governance procedures, except those for BOU employees who are senior civil servants and, thus, must act in accordance with the Uganda Leadership Code, which is published in the official gazette. As payment system oversight is part of BOU, the assessment of the principles on the audited statements and their publication was done in the assessment of monetary policy transparency.

G. Recommended Actions and Authorities' Response

126. There is a need to proceed urgently with the work to develop the legal foundation for the payment system's overseeing. It will be useful to continuously publish, either in the annual reports of the central bank and/or on its website, changes in the BOU's policies of the oversight of the payment system. The publications should include aggregate data on major developments of the payment system. Internal governance procedures and specific standards for the personal financial conduct of staff are also necessary (Table 5).

Table 5. Recommended Actions to Improve Observance of MFP Transparency Code—Payment Systems Oversight

Reference Practice	Recommended Actions
V. Clarity of roles, responsibilities and objectives of payment systems oversight agencies	Make explicit the BOU's authority over the wider payment system. Publish the clearinghouse arrangements included in a memorandum of understanding with the banks.
VI. Open process for formulating and reporting of payment systems oversight policies	Improve the provision of information on significant policy changes. Improve the coverage of payment system issues in periodic publications BOU.
VII. Public availability of information on payment systems oversight policies	Use existing channels more effectively to disseminate detailed information on payment systems. The publications should include aggregate data on major developments of the payment system.
VIII. Accountability and assurance of integrity by banking supervisory agencies	Improve the coverage of internal governance procedures.

Authorities' response and recent developments

127. The response was that the draft National Payment System law is under review and is expected to be made public once it has had parliamentary approval. The BOU staff indicated that banker-customer relationships are confidential, in accordance with acceptable banking norms. However, the BOU makes periodic press releases on issues that are of public interest. They also pointed to a number of initiatives to improve the openness of the formulation and reporting of the payment system, which include a number of documents that will be posted

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on the BOU's website; the continuation of NPSS in running media programs on the introduction of the national check standard and electronic clearing system, and the inclusion of payment system information in the BOU's annual report. The "Failure to Settle Rules" document is currently under discussion. The planned implementation of the electronic funds transfer system is expected to reduce the use of debit paper significantly. The modalities for the implementation of the RTGS system are under discussion. The authorities also indicated a number of improvements that are underway in the payments system, which include: enhancement of the BOU accounting system to facilitate electronic transmission of settlement data; possible introduction of Giro credits by the Post Bank; and the adoption of clearinghouse rules after consultation with all participants.

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