SADRN
SOUTHERN AFRICAN DEVELOPMENT RESEARCH NETWORK

POLICY BRIEF 3

# Services sector development in Uganda: The role of financial services

## INTRODUCTION

The objectives of financial sector reform in Uganda were interest liberalisation, reducing directed credit, improving prudential regulation, privatisating financial intermediaries, reducing reserve requirements, liberalisation of securities markets and pro-competition measures.

Interest rate liberalisation focused on positive interest rates, with rates linked to the weighted average of an auction-based treasury bill, followed by full liberalisation in 1994. To increase competition, entry barriers were lowered in 1991 but this was followed by a moratorium on new banks that was lifted only in 2005. Reserve requirements for commercial banks were raised in 2000 following collapses in the 1990s and in 2004. Directed credit and credit ceilings were gradually removed but re-introduced using European Union funding in the late 1990s to support selected sectors, emphasising export production. Other reforms included privatisation with government divesting its stake in commercial banks in the 1990s and early 2000s.

In 1991, penalties were introduced for non-compliant banks and supervision was aligned with Basel 1. Legal and regulatory reforms to enhance the Bank of Uganda's authority started in 1993. Legislation governing microfinance institutions was introduced in 2003 followed by the Financial Institutions Act in 2004 with new regulations. In 1996 the Capital Markets Authority was established followed by the licensing of the Uganda Securities Exchange. Treasury bonds were introduced in 2004.

Liberalising the exchange rate began in 1986 with a dual rate replacing the fixed rate, followed by a parallel foreign exchange market in 1992 marking the transition to a market-based system. This was followed by an inter-bank foreign exchange market, liberalisation of the current account and then capital account in 1997.

### Banking sector level developments

Financial development can be assessed using the ratios of M2 money supply to Gross Domestic Product (GDP), M3 to GDP and domestic credit to GDP. From 1983-2008, M2 and M3 to GDP showed an initial sharp upwards trend followed by a decline and then a steady increase. Domestic credit to the private sector has not matched growth in the M2 and M3 shares of GDP. For instance from 1983-2008 M2 and M3 grew by 13% and 15% respectively while private sector credit grew by 11%.

Deposit and lending rates rose from 9% and 15% in 1983 to 32% and 40% in 1989, with the spread widening to 15% in 1987. They then dipped, rose again and fell to about 8% and 20% in 1995, remaining at about those levels until the present.

The inflation rate reflected these movements rising from about 25% in 1984 to a peak of 190% in 1998, driven by excess money supply, and then declining to single digit levels from 1994.

### Bank level developments

In December 2008 there were 20 banks, matching the 1999 number after falling to 15 in 1993. However, by 2008 the size and The composition had changed, with more foreign-owned banks (16) and fewer locally-owned banks (4), after a number

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closed or amalgamated, and foreign-owned Stanbic acquired the state-owned bank. Branch numbers have increased and the banking system is more competitive with several distressed banks closing, improved supervision, the introduction of a risk-based approach and a regulatory system that meets international standards.

Total commercial banks assets increased from an average USh668 billion in 1993-1996 to USh7 555 billion in 2008, while liabilities in the form of deposits increased from an average USh356 billion in 1993-1996 to USh4 696 billion in 2008. Profitability has improved with interest on advances rising from an average UHs37 billion in 1993-6 to USh494 billion in 2008 and increasing as a share of total income from 42% to 46%. Despite the increase in profitability, expenses increased from an average USh113 billion in 1993-1996 to USh745 billion in 2008, largely due to investments in modern banking facilities, and new branches and ATMs.

The rate of return on assets increased from 1% in 1999 to 4% in 2008. Capital adequacy indicators improved with the ratio of core capital to risk weighted assets rising from an average of -41% in 1993-1996 to 19% in 2008. The high ratio of non-performing assets to total advances of about 38% in 1993-1999 was mainly due to political interference in the state-owned bank and insider lending in private banks. This declined to 10%, the international standard, in 2000 and to about 2% in 2008.

The sector maintained high liquidity in the 1990s peaking at 80% in 2001, and then declining to 48% in 2008 due to increased credit extension and the government switching project aid funding to the central bank. However, it remains well above the ideal 17.5%, indicating low intermediation and a high appetite for investment in short-term government securities as opposed to extension of credit services to the private sector. Nevertheless intermediation has improved from 1990s levels.

## RESEARCH FINDINGS

Analysis of the effect of liberalisation on growth shows that physical capital had a positive effect on output and was significant at a 5% level. Human capital had a negative effect, also significant at a 5% level. This was counter intuitive but could be due partly to the low skills levels and productivity of most of the labour force. Net foreign assets of banks had no significant effect on output. However, opening the capital account and promoting foreign bank entry had significant negative effects on output. This could be because these banks found investing in government securities and a few large customers more lucrative than servicing the credit-constrained private sector. To better understand the effects indicated by the macro-level analysis, additional micro-level analysis was done.

Analysis of bank performance for intermediation margins, quality of bank assets and non-financial costs, which all have a bearing on profitability, show that entry of foreign banks and capital account liberalisation contributed to increased intermediation spreads.

Increasing capital flows did not have a significant effect on intermediation spreads. Other variables suggest that increasing non-financial costs led to improved efficiency making it possible to lower intermediation spreads. However, falling non-performing loans had a positive effect on intermediation spreads, implying that banks reduced non-performing loans by deterring some borrowers through higher interest rates. This is confirmed by the positive effect of lending rates on intermediation spreads, suggesting that deposit rates were not adjusted upwards as interest rates increased. Increasing market share contributed to higher intermediation rates suggesting oligopolistic tendencies in the sector. Foreign banks contributed to higher intermediation spreads implying they charged higher interest rates or offered lower deposit rates. Despite this they appear to have attracted depositors because they were better capitalised and therefore seen as less risky.

## RECOMMENDATIONS

The results suggest that liberalisation led to improved efficiency and increased profitability among banks but not to a corresponding reduction in intermediation spreads. This could partly explain why financial liberalisation failed to show a positive effect on per capita GDP growth and poverty reduction. Possible polices to remedy this could focus on lowering intermediation spreads by increasing competition in the credit market, reducing the number of government securities issued to limit crowding out effects, and increasing entry into the sector. In addition the credit reference bureau could be promoted to limit credit risk. Policies to improve loan recovery procedures from defaulting debtors may also increase credit provision.

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