

FINANCIAL REPRESSION AND FINANCIAL REFORM IN UGANDA

Martin Brownbridge

Summary

The banking system in Uganda is among the weakest in Sub-Saharan Africa. Its liabilities comprise less than 10 per cent of GDP, it is highly oligopolistic and inefficient in performing many basic banking functions, and the largest bank and several smaller banks are insolvent.

The financial policies of the pre-reform period aimed to control banking markets, ostensibly for developmental and other non commercial objectives. These policies had very damaging effects on the banking system. Financial repression deterred the public from holding bank deposits. A large government owned bank was operated with very little regard for commercial principals and accumulated a massive portfolio of bad debts as a result. The role of the foreign banks, which at least provided a basic, if limited, range of banking services, was sharply curtailed when they sold most of their branches to the public sector banks. The neglect of prudential regulation allowed mismanagement to become widespread, not just in the government banks but also among some of the newer banks established in the late 1980s by the private sector.

The financial sector reforms of the 1990s are intended to remedy the consequences of the previous two decades of misguided financial policies. The second contention of this paper is that these objectives are likely to prove very difficult to attain because of the scale of the problems which the banking sector inherited from the pre-reform era, and especially because of the dominant market position of the public sector banks.

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1 INTRODUCTION

The banking system in Uganda is among the weakest in Sub-Saharan Africa. Its liabilities comprise less than 10 per cent of GDP, it is highly oligopolistic and inefficient in performing many basic banking functions, and the largest bank and several smaller banks are insolvent. The problems of the banking system are attributable to the financial policies pursued by successive governments between the mid 1960s and the late 1980s, combined with the severe economic crisis, civil conflicts and acute political instability, which afflicted Uganda during this period. Since 1991 the government has begun implementing financial sector reforms with the objective of redressing these weaknesses. The reforms include the liberalisation of financial markets, restructuring distressed banks and strengthening prudential regulation.

The financial policies of the pre-reform period aimed to control banking markets, ostensibly for developmental and other non commercial objectives. One of the contentions of this paper is that these policies had very damaging effects on the banking system. Financial repression deterred the public from holding bank deposits. A large government owned bank was operated with very little regard for commercial principals and accumulated a massive portfolio of bad debts as a result. The role of the foreign banks, which at least provided a basic, if limited, range of banking services, was sharply curtailed when they sold most of their branches to the public sector banks. The neglect of prudential regulation allowed mismanagement to become widespread, not just in the government banks but also among some of the newer banks established in the late 1980s by the private sector.

The financial sector reforms of the 1990s are intended to remedy the consequences of the previous two decades of misguided financial policies; in particular to boost deposit mobilisation, stimulate competition and enhance efficiency in financial markets, tackle financial distress and ensure prudent management of banks. The second contention of this paper is that these objectives are likely to prove very difficult to attain because of the scale of the problems which the banking sector inherited from the pre-reform era, and especially because of the dominant market position of the public sector banks.

¹ The author thanks Charles Harvey, IDS, for invaluable comments on the first draft of this paper but takes responsibility for all remaining errors.

The main part of this paper is organised in two sections, the first discusses the pre-reform financial policies and their impact on the banking industry and the second evaluates the financial reforms of the 1990s. The paper focuses mainly on the problems of the public sector banks and the measures now underway to restructure them, prudential regulation and its reform, the effects of interest rate controls on banking and the efficacy of interest rate liberalisation. It also discusses the role in the banking industry played by the foreign banks and the new local private sector banks. The rest of this introduction provides a very brief background to economic developments and policies in Uganda during the post independence period in order to place the discussion in the subsequent sections in perspective.

Uganda suffered a prolonged economic decline from around 1970 until 1986 as a result of mismanagement and intermittent civil war. Real GDP per capita fell by 38 per cent over this period. The economy was subject to extensive administrative controls over foreign exchange, imports, financial markets and agricultural prices, etc., which led to acute distortions and the shrinkage of the formal and monetised economy. The collapse of the public revenue base led to large public deficits, the financing of which by the Central Bank caused very high rates of inflation. The country was also denuded of skilled personnel as a result of war, the expulsion in the early 1970s of Ugandan Asians, and more recently AIDs.

In 1986 the National Resistance Movement (NRM) seized power, restored security to most of the country and set about reviving the economy, with much success. Real GDP growth has since averaged 6 per cent per annum. A stabilisation programme was adopted in 1987 supported by the IMF, World Bank and donors, with the initial emphasis on devaluation, increased producer prices for farmers, and fiscal and monetary restraint. Many of the administrative controls on the economy were subsequently liberalised, including those on foreign exchange markets, and in 1991 the government adopted a financial sector adjustment programme which entailed financial liberalisation and institutional reforms.

2 FINANCIAL POLICIES IN THE PRE-REFORM PERIOD

The commercial banks operating in Uganda at independence - Barclays, Standard, ANZ Grindlays and Bank of Baroda - were foreign owned. As in many other newly independent African countries, there was discontent over the lending policies of these banks and a belief that government intervention was necessary to ensure that the banking system played a more supportive role in the development of the economy. Consequently successive governments adopted interventionist policies towards the banking sector after the country gained independence. Interest rates were controlled, public sector banks were set up, the government purchased shares in the foreign banks, and a variety of administered lending programmes were established.

This section examines the impact of these policies on banking markets. Sub-section 2.1 discusses interest rate policy and its effect on financial depth (i.e. the holding of financial assets). The role and performance of the public sector banks is assessed in Sub-section 2.2. Sub-section 2.3 deals with foreign banks and the following sub-section with the growth, since the mid 1980s, of local private sector banks. Prudential regulation is discussed in Sub-section 2.5 and this is followed by a brief summary of the conclusions of the section.

2.1 INTEREST RATES

The level and structure of interest rates were determined by the Central Bank, the Bank of Uganda (BOU) until 1992. Nominal interest rates were held well below the rate of inflation for most of the 1970s and 1980s. Annual consumer price inflation was high during the 1970s and 1980s, fuelled by monetary financing of large government deficits. Inflation averaged 103 per cent during 1981-90, while nominal lending rates for commerce averaged 31 per cent and time deposit rates 24 per cent (see Table 1).² Consequently real interest rates were substantially negative on average, although there were wide annual fluctuations because, while adjustments to the administered nominal interest rates were generally small, the inflation rate displayed considerable instability.³

Negative real returns on monetary assets contributed to the steep decline in the financial depth of the Ugandan Economy. Between 1970 and 1990 the M2/GDP ratio fell from 18 per cent to 7 per cent while the share of bank deposits in M2 fell from 65 per cent to 59 per cent (see Table 2). The attractiveness of bank deposits for the Ugandan public was further eroded because the banks operated a very inefficient payments system, hence cash was needed to effect most transactions (Harvey 1993: 1). Unsurprisingly in view of the chronic instability in real returns, the holding of long term financial assets by the public was negligible. Although the severe financial shallowing in Uganda was partly attributable to developments exogenous to the banking system - the share of monetised output in GDP declined as a result of acute security problems and unattractive producer prices paid to farmers - it is clear that sustained financial repression had very damaging consequences for the banking system. Public confidence in the holding of financial assets is also likely to have been undermined by the demonetisation exercise in 1987, which imposed a tax of 30 per cent on holdings of currency and bank deposits as well as some other financial assets in an attempt to reduce

² Data on inflation rates in the 1970s are not readily available.

³ Although fiscal deficits were the principal cause of the inflation, monetary policy does not appear to have been particularly restrictive until the SAP was introduced in 1987 and credit ceilings were imposed on the banks as part of the stabilisation measures. Apart from interest rate controls (which were clearly useless as a macroeconomic tool given that they were set at levels far too low to clear the market), the main instrument of monetary policy was the cash reserve requirement (set at 10 per cent of deposit liabilities until 1993), but the effectiveness of this was undermined because banks had automatic access to BOU lending facilities whenever they faced liquidity constraints (Musinguzi 1995: 37).

liquidity in the economy, although most of the damage in terms of the reduction in financial depth of the economy had already occurred by this point.

2.2 PUBLIC SECTOR BANKS

Two public sector banks were established in the period following independence: The Uganda Commercial Bank (UCB) was set up in 1965 as the successor to the Savings and Credit Bank and this was followed in 1972 by the Cooperative Bank. Both were expected to fulfil developmental objectives, ignored basic commercial principles, and incurred huge losses from bad debts.

The objectives of the UCB were to provide credit for indigenous businesses and to facilitate government development programmes, although the emphasis of its operations changed with the priorities of different governments. Its lending policies were heavily influenced by the government and some of its programmes - onlending government and donor funds with medium term maturities - were more suitable for a development bank than a commercial bank. From the mid 1960s the government established a variety of administered agricultural and rural lending schemes; one of the latest being the UCB rural farmers scheme of 1987-93. As the UCB and Cooperative banks were the only banks with branches in the rural areas after the early 1970s they were the obvious vehicles for operating these schemes.

In 1971/72 the parastatal sector was expanded when many of the Asian and other foreign owned businesses were nationalised: UCB became the banker to this sector. Its branch network expanded rapidly in the early 1970s as result of it taking over most of the branches of the foreign owned banks. The acquisition of these branches left UCB, along with the much smaller Cooperative Bank, with a monopoly in banking markets virtually everywhere outside of Kampala. The removal of Amin in 1979 brought a revival of foreign development assistance to Uganda, some of which was channelled through UCB, which led to an increase in the share of medium term financing in its loan portfolio. It was also used to perform a variety of functions for the government in the rural areas: for example, taxes and school fees were paid into its branches.

During the late 1980s the UCB undertook a major rural expansion programme, opening 130 new branches and further extending its financing of agricultural investment. Given the acute shortages of professional skills in Uganda this rapid expansion must have even further undermined the bank's managerial efficiency and internal controls. By the early 1990s the UCB held around 50 per cent of commercial bank deposits and had 190 of the 237 bank branches in the country (see Table 3).

The Cooperative Bank, which had the second largest branch network with 24 branches, was owned by the cooperative societies which were themselves major borrowers of the bank. It would have been difficult for the bank to refuse to extend credit to the cooperatives, even though many were badly managed and not creditworthy.

The availability of automatic liquidity support from the BOU and the lack of proper accounting procedures allowed the imprudent management of UCB and the Cooperative Bank, and the consequent losses incurred, to continue unchecked until the early 1990s. Both banks were by then insolvent. The UCB's non performing loans accounted for around 75 per cent of its total loan portfolio. The accumulation of such a huge volume of non performing loans was attributable mainly to the political influence on its lending policies, exacerbated by very poor loan procedures and corruption. Loan recovery rates on the administered lending schemes were below 50 per cent. Because of the political nature of these schemes, the UCB failed to adequately appraise or monitor these loans or to pursue their recovery. Repayment discipline on the part of borrowers was low because they often regarded such loans as reparations for war damage or rewards for political support, while in some instances politicians told their constituents that loans from government banks need not be repaid (Nsereko 1995: 28-29). UCB also appears to have suffered from widespread corruption, although the evidence is largely anecdotal: politicians and politically connected borrowers appear to have been able to access loans, to have failed to repay them and then to have successfully lobbied against the bank taking action to recover the loans.

Although the protracted economic crisis, disruption from war and the weak legal system made the lending climate for the banks in Uganda very difficult and undoubtedly made some contribution to the bad debts of UCB and the Cooperative Bank, the scale of this problem indicates that the primary cause was their lending practises rather than exogenous factors. The foreign banks also faced a difficult lending climate and did accumulate some bad debts, but these were nowhere near the level of those of the UCB and the Cooperative Bank.⁴

Sustained operating losses also contributed to UCB's financial problems: until 1995 it had not made an operating profit for seven years. The large size of its branch network, high staffing levels, the provision of non banking services for the government referred to above, the deficiencies of the rural infrastructure, and inefficient management boosted its operating costs. The UCB's wage bill alone exceeded its income in the early 1990s (The New Vision 1995: 11 (8): 31).

⁴ See Sub-section 2.3 below.

2.3 FOREIGN BANKS

The dominance of the foreign banks was sharply reduced in the 1970s. The Amin regime compulsorily purchased 49 per cent equity stakes in three of the banks in the early 1970s (Standard Bank was the exception). It also closed all but one of Standard's 15 branches: these were later taken over by the Cooperative Bank. Most of the branches of Barclays Bank and Grindlays were sold to UCB later in the 1970s (Harvey 1993: 5-6). As a result the foreign banks no longer have a nation-wide branch network: Standard and Stanbic (a South African bank which bought out Grindlays' shares in 1992) now have only a single branch each and Barclays three.⁵ The foreign banks' operations are mainly confined to Kampala and their share of commercial bank deposits has fallen to 30 per cent.⁶ Their asset management has remained conservative: their liquidity ratios have been high and their lending has generally been concentrated on the larger companies, on trade finance and syndicated loans to the crop marketing boards to finance crop purchasing.

The loans to crop marketing boards, principally the Coffee Marketing Board (CMB), comprised a major share of bank lending to the non government sector by the foreign banks and the UCB: in the late 1980s the overdrafts of the CMB comprised over 20 per cent of all commercial bank lending. From the banks' point of view this lending was safe, as it was secured by the CMB's holdings of coffee stocks.⁷ The foreign banks also lent to some of the better managed cooperative unions in the late 1980s.

Not surprisingly in view of the economic problems in the country, the foreign banks have made only modest profits. Recorded profits would probably have been lower had stricter accounting standards been applied in respect of the treatment of non performing loans. Barclays suffered a heavy loss in 1994 as a result of having to make extensive provisions for non performing loans to comply with the requirements of the newly enacted Financial Institutions Statute.⁸ However the foreign banks have made sufficient profits to avoid serious distress with the exception of the Tropical Africa Bank. Apart from Stanbic, the foreign

⁵ Stanbic purchased ANZ Grindlays' subsidiaries in several African countries. The main reason for its investment in Uganda is to provide corporate finance, especially to South African companies investing in, or trading with, Uganda.

⁶ A fifth foreign bank - the Libyan Arab Bank for Trade and Development - was established in 1972 as a joint venture with the government but its share of the banking market is negligible. Since 1994 it has been called the Tropical Africa Bank.

⁷ The CMB was itself acting as a financial intermediary, onlending between 25 per cent and 50 per cent of its commercial bank loans to cooperatives, private processors and other marketing boards. The CMB did not have the expertise to allocate credit efficiently and it is likely that much of the funds that it on lent were wasted. Some of the loans extended to cooperatives for the purpose of buying coffee were diverted into investments which were commercially unsuccessful.

⁸ Barclays had made provisions for 25 per cent of its lending portfolio in 1994. Standard and Stanbic had made lower levels of provisions.

banks have shown little inclination to reinvest in Uganda, to re-establish rural branches or to introduce any innovative services since the country began liberalising its economy in 1987.

2.4 LOCAL PRIVATE SECTOR BANKS

During the second half of the 1980s and the early 1990s nine banks were established by local private sector investors, mainly business people with interests in trading, manufacturing, agriculture and real estate. Some of the locally owned private sector banks (henceforth local banks) originated as credit institutions before later converting to banks. Most of the local banks are still relatively small, although the largest, Nile Bank, had captured 8.3 per cent of commercial bank deposits by 1993. The local banks' lending is mainly short term and focused on traders and manufacturers. Most have only two or three branches located in the main cities.

The poor standard of services offered by the established public sector and foreign banks created an opportunity for the new banks to win customers by, for example, offering longer opening hours and a greater willingness to serve the credit needs of small scale businesses. Given the abundance of low denomination notes in circulation, some of the local banks were able to speed up transactions with customers, and therefore cut the time customers spent waiting in queues in banking halls, by installing note counting machines and by accepting cash deposits at the customers' valuation, with the notes counted and discrepancies reconciled later.

The local banks have faced a number of difficulties in establishing their presence in the banking market. Liquidity is tight because of the shallow depth of the financial system in Uganda and because the interbank market is not developed. There is a shortage of suitable collateral other than real estate in Kampala. Loan recovery is hard because of weaknesses and delays in the courts and because the property market is depressed. There are severe scarcities of qualified and experienced staff.

Four of the local private sector banks have run into financial distress during the last few years. The BOU, using its newly acquired powers under the 1993 Financial Institutions Statute, closed down the Tieffe Bank in 1994, and in April 1995 it took over the Nile and Sembule Banks, suspending their boards of directors and management and appointing new chief executives to implement restructuring plans. These banks were insolvent and required large overdrafts from the BOU to remain liquid. A fourth local bank, the Centenary Rural Trust Bank, is being restructured with foreign assistance. The measures being implemented to restructure these banks are discussed further in Section 3.2 below: the remainder of this section concentrates on the causes of their financial distress.

The financial fragility of the local banks was largely the result of bad debts arising from imprudent credit practices, especially insider lending (mainly to the other businesses owned by the shareholders), lending without proper security, and very weak internal controls. Non performing loans accounted for two thirds of the loan book of one of the banks currently being restructured, while insider lending accounted for almost 50 per cent of its total loans. This bank's record keeping was very poor and it had issued around Sh4 billion of contingent liabilities (amounting to more than 50 per cent of its deposits) without any proper records having been kept.

Prudent management in the distressed banks was impeded because managers and boards of directors lacked sufficient banking experience and because there was too little separation between the roles of managers and owners, hence the pressure to extend loans to the businesses of the latter. The banks were also severely undercapitalised, in part because of the acute shortages of capital and absence of capital markets in Uganda.⁹

2.5 PRUDENTIAL REGULATION AND SUPERVISION

Prudential regulation and supervision were not accorded much emphasis by the government and BOU during the pre-reform period. The 1969 Banking Act, which provided the legislative framework for the banking industry, contained numerous deficiencies (these are discussed in more detail in Section 3.2 below which deals with the reforms to prudential regulation). Supervisory capacities in the BOU were too weak for it to effectively discharge many of the functions it was assigned under the Act. The bank returns provided to the BOU were inadequate for off site inspection, and the information they did contain was sometimes not collated and analysed by the BOU, while on site inspections were not conducted regularly. Differences in auditing practises among the banks also complicated the task of supervision. The UCB was able to consistently ignore regulations, such as the liquidity ratios, while the BOU's willingness to accommodate the credit needs of illiquid banks further undermined incentives for bank managers to improve performance.

The consequences of ineffective prudential regulation became even more acute with the growth of the local banks discussed in the preceding section. Legislative weaknesses contributed to the fragility which afflicted some of these banks. Most were severely undercapitalised, having been set up in the late 1980s and early 1990s when minimum capital requirements were worth very little. The minimum capital requirement was only Sh200,000 in 1988 (equivalent to only \$2,000 at the time).¹⁰ It was subsequently raised to Sh20 million

⁹ The paid up capital of the Nile Bank amounted to only \$200,000 in 1993.

¹⁰ The minimum capital requirement had been set at Sh2 million in the 1969 Banking Act. It remained at the same level, despite the huge increase in the price level and in 1987 it was reduced to Sh200,000 in line with the currency reform which removed one of the zeros from the currency.

but, but with further rapid inflation and exchange rate depreciation, this was equivalent to less than \$30,000 in 1991. The local banks were given banking licenses by the Minister of Finance, clearly, in the light of subsequent events, without proper consideration having been given to the expertise of managers and directors. The 1969 Banking Act did not impose clear restrictions on insider lending. Had the BOU undertaken regular bank inspections and possessed the legal authority to force banks to improve management, lending practises and internal controls, some of the losses incurred by these banks may have been prevented.¹¹

2.6 SUMMARY

The impact of government controls on financial markets and participation in banking was disastrous. There was a steep decline in the financial depth of the economy, and a marked deterioration in the institutional strength of the banking system. The banking system was dominated by the UCB which held 50 per cent of the total deposits of all the commercial banks and had a near monopoly everywhere other than in Kampala. This led to a massive misallocation of resources. The UCB was bankrupted, mainly as a result of politically influenced lending, but also because of corruption and excessive operating expenses, and required regular loans from the BOU to remain liquid. By the end of the 1980s financial intermediation was peripheral to large sections of the economy, banking services were very poor outside Kampala, huge losses were being incurred by the public sector banks and effectively being financed through monetary creation, and the legislative and institutional framework for prudential supervision was seriously deficient.

3 FINANCIAL REFORMS

The financial sector reform programme was begun in 1991 with the support of a World Bank financial sector adjustment credit. It has three major elements: institutional reforms to the BOU and the public sector banks, legislative changes to the banking laws and the BOU Act, and financial liberalisation. As with financial reform programmes elsewhere in Africa, it has several interrelated objectives including strengthening techniques of monetary control, boosting deposit mobilisation, stimulating competition in financial markets, enhancing the efficiency with which financial services are provided and financial resources allocated, restructuring insolvent banks, improving prudential regulation and supervision and promoting the diversification of financial markets. In this paper we are concerned with those aspects of the reforms which most directly relate to the banking sector, in particular those aimed at restructuring insolvent banks, strengthening the prudential framework and enhancing the efficiency of banking markets. Sub-section 3.1 examines the restructuring and the future role

¹¹ Many of the problems in Sembule Bank were uncovered in 1993 when the bank was inspected by the BOU, but the recommendations contained in the inspector's report were never carried out by Sembule's management.

of the public sector banks, Sub-section 3.2 details the reforms to prudential regulation and the Central Bank's response to the financial distress which has emerged in some of the local banks, and Sub-section 3.3 addresses the question of whether financial liberalisation will enhance allocative efficiency in banking markets.

3.1 RESTRUCTURING PUBLIC SECTOR BANKS

A major restructuring programme for the UCB was initiated in 1992, financed by a \$100 million World Bank loan, with the objective of restoring the bank to commercial viability. The main requirements of this exercise are fourfold: first, restructuring the UCB's balance sheet to restore the bank to solvency; second, reducing operating costs to prevent further operating losses; third, re-organising lending procedures and internal controls to ensure that bad debts incurred from new lending are kept to acceptable levels; and fourth, insulating the bank from political pressure to compromise commercial principles.

Restructuring the UCB's balance sheet is relatively straightforward but expensive. A Non Performing Assets Recovery Trust (NPART) was established in 1995 to which UCB's non performing loans will be transferred.¹² NPART has been given extensive legal powers to pursue recovery of these bad debts, although it must be doubtful if most will ever be recovered. In return for the transfer of the non performing loans, UCB will receive government bonds with a face value equivalent to the loans transferred.¹³ The government also injected almost Sh10 billion (approximately \$10 million) of additional equity capital into UCB. Hence the cost of restructuring UCB's balance sheet - not taking into account any loans which might be recovered by NPART - will amount to approximately Sh90 billion (around Sh80 billion of non performing loans plus the capital injection): this is equivalent to about \$100 million or about 2 per cent of GDP.

Substantial progress has been made in reducing the UCB's operating costs since 1993. By mid 1995 staffing levels had been reduced by 48 per cent, while the branch network, which had totalled 190 branches, has been cut to 85 branches plus 53 agencies. As a consequence UCB was able to reduce operating expenses by about 25 per cent in nominal terms and generated an operating profit in 1994/95.¹⁴ The management of UCB has been reorganised with the appointment of a new board of directors and foreign technical advisors to the senior management.

¹² The non performing loans were due to be transferred in November 1995.

¹³ The precise value of the loans to be transferred to UCB was not known in August 1995 because it had not been decided whether non performing loans for which provisions had been made would be transferred or not.

¹⁴ The operating profit did not take account of depreciation or provisions for non performing loans: data from The New Vision (11/8/95).

Ensuring that the bad debt problem does not recur in the future may prove more problematic. The reorganisation of UCB includes measures to rationalise its loan appraisal and monitoring procedures, while accounting practices have been revised in line with the requirements of the new banking law. But even if political pressure to extend loans on non commercial criteria can be avoided, building up a portfolio of sound loans will be difficult. The number of creditworthy borrowers in the economy is not large, and many of them borrow from the foreign banks rather than UCB. Loan appraisal and monitoring are impeded by shortages of qualified staff, by high transactions costs in the rural areas, and by the lack of adequate accounting standards among prospective borrowers. Foreclosing on defaulters is difficult because of the deficiencies of the legal system. Preventing future bad debt problems will almost certainly mean that UCB's loan portfolio will be much smaller than in the past.

UCB must also be insulated from political pressure if it is to be run on strictly commercial lines. The government's current intentions, following World Bank advice, are to privatise UCB as soon as possible, although the modalities for this have not been decided. Even with its balance sheet restructured, UCB does not appear to be a very attractive investment for the private sector. Its rural network will probably be at best marginally profitable and whoever does buy UCB will have to inject considerable managerial resources into the bank to protect their investment. Most of the major foreign banks operating in Africa are now much less interested in retail banking than in the past: their current focus is on corporate banking, for which UCB's structure would be redundant. If a buyer is found it is likely that they would want to further retrench its branch network and staff, and narrow the scope of its lending. There is likely to be considerable political resistance, if this leads, as seems inevitable, to a marked reduction in access to credit and other banking services in the rural areas. UCB runs the payments system in the rural areas (albeit inefficiently and unreliably), so that a large scale withdrawal from rural areas would necessitate establishing an alternative structure for payments. It may be possible for the Post Office to provide basic savings and money transfer facilities as an alternative to the UCB.

The Cooperative Bank is also being restructured, has retrenched staff and has been divested from the cooperative unions. It is being recapitalised with money generated from sales of US food aid.¹⁵ In addition its liabilities to the government arising from administered loan schemes will be written off.

3.2 STRENGTHENING PRUDENTIAL REGULATION AND SUPERVISION

Strengthening the legislative and institutional framework for the prudential regulation of financial markets has involved enacting new legislation to replace the 1969 Banking Act and

¹⁵ The Cooperative Bank will receive Sh13 billion (about \$13 million) from sales of food aid, provided that certain conditions are fulfilled.

upgrading supervisory capacities in the BOU. The 1969 Banking Act had become outdated and its provisions were deficient in many respects. The authority to license banks lay with the Minister of Finance rather than the BOU. The BOU also required Ministry of Finance permission before taking action related to prudential matters. Minimum capital requirements were too low, having been eroded by inflation. The Act failed to delineate appropriate prudential requirements to be followed by banks: instead it specified a number of allocative requirements. It was also inflexible: the BOU found it difficult to implement without having recourse to the courts, nor was it able to issue prudential guidelines to the banks where appropriate.

The 1993 Financial Institutions Statute rectified most of these legislative defects. In addition to banks, the statute covers credit institutions, building societies and development finance institutions, bringing all these financial institutions under the supervisory authority of the BOU. It gives the BOU more independence from the Minister of Finance in licensing and regulating financial institutions, although rejected applicants have the right of appeal to the Minister who also must be consulted before prudential regulations are issued and before the BOU liquidates insolvent financial institutions. It is also more flexible than the 1969 Act in that it gives the BOU the authority to issue prudential regulations pertaining to capital adequacy, liquidity, data to be supplied for supervisory purposes, etc.

Under the statute the minimum paid up capital required for local investors to start a bank has been set at Sh0.5 billion: this is equivalent to about \$0.5 million, which is relatively low in comparison to other African countries. The statute gives the BOU authority to issue statutory instruments to revise capital requirements, which will enable adjustments to be made to take account of inflation. It also specifies minimum ratios for core capital and total capital to risk adjusted assets of 4 per cent and 8 per cent respectively, along the lines of the Basel Accord on capital adequacy.

The statute imposes restrictions on insider lending, large credit exposures,¹⁶ investment in non bank business and purchase of real estate. It also gives the BOU a range of options for dealing with financial institutions that act imprudently, infringe regulations, or have otherwise become insolvent. The BOU can issue cease and desist orders, impose fines on management, or take over the management of the offending financial institution and re-organise or liquidate it.

In addition to the legislative changes supervisory capacities at the BOU have been strengthened. The Bank Supervision Department has been re-organised into two separate

¹⁶ Exposure to a single customer (or group of customers with a common interest), and aggregate lending to a bank's own directors, their families and businesses, are both restricted to a maximum of 25 per cent of core capital.

departments dealing with banks and other financial institutions, with an advisor taken on, staff sent abroad for training and new equipment purchased. The submission of regular information from financial institutions to the BOU has improved and on site inspections are being undertaken.

Developments during 1994 and 1995, when the BOU used its powers under the Financial Institutions Statute to take action against distressed local private sector banks, indicate that the reforms outlined above have enabled the BOU to adopt a more purposeful approach to prudential regulation. Illiquid banks no longer receive automatic overdraft facilities from the BOU. In 1994 the BOU took over and closed down the insolvent Tieffe Bank, reimbursing the depositors.¹⁷ The Nile and Sembule banks were taken over in April 1995, with the BOU suspending their managements and boards of directors and appointing new chief executives. Restructuring programmes for Nile and Sembule are being implemented entailing the revision of loan policies and internal controls, upgrading accounting systems and documentation and measures to recover loans.¹⁸ The banks have been given performance targets to recover loans and raise capital to the minimum levels required under the Financial Institutions Statute. The BOU's take-over of these two banks is indicative of the priority accorded to prudential concerns, as both have close connections with politics and public administration. However it is not yet clear whether public funds will be used to recapitalise any or all of the banks currently being restructured, and if so, what the cost will be. Moreover the support provided by the BOU to depositors of failed banks, either through the restructuring of banks or the reimbursing of deposits when banks are closed, as with Tieffe, does little to encourage depositors to be more circumspect about putting their money in the more risky financial institutions. It therefore creates moral hazard problems which may facilitate badly managed financial institutions to attract funds. There are sound reasons for providing protection to depositors,¹⁹ but the moral hazard involved reinforces the need for effective supervision of financial institutions.

While the reforms have clearly strengthened prudential regulation in Uganda, two problems in particular have the potential to impede the BOU's efforts to ensure that financial institutions are managed prudently. First, there may be little that it can effectively do to ensure that UCB complies with prudential regulations. The BOU cannot realistically take over UCB yet alone liquidate it: it is too big to fail. Second, the greatest threat to the

¹⁷ The Tieffe Bank was small with deposits amounting to only Sh300 million (\$300,000).

¹⁸ The restructuring of Sembule Bank is being assisted by Banque Belgolaise of Belgium, which has subsidiaries in other African countries. It has signed a letter of intent with the BOU to recapitalise Sembule if its solvency is restored.

¹⁹ These include first, enhancing stability in the financial system, by discouraging 'runs' on deposits when financial institutions are thought by the public to be in difficulties and second, the protection of small depositors, many of whom might be regarded as not having sufficient financial expertise to discriminate between sound and unsound financial institutions.

solvency of the local banks will be insider lending, which has already caused substantial distress among local banks. The new banking legislation imposes much stricter limits on insider loans, but if their presence in a bank's portfolio is concealed by fraudulent accounting, bank examiners may not be able to detect them and take action in time to prevent the bank becoming distressed.

3.3 FINANCIAL LIBERALISATION

Financial liberalisation in Uganda has so far been relatively limited in both scope and impact, largely because government intervention in financial markets for allocative purposes was mediated mainly through its ownership of the largest bank rather than through administrative controls over private sector institutions. The latter mainly consisted of interest rate controls, reform of which commenced in 1992 when some rates were decontrolled and others linked to the treasury bill rate. A treasury bill auction was also introduced in 1992, although the market is very thin. Interest rates were further liberalised in 1994 when the formal link with treasury bill rates was removed (Sharer *et al.* 1995: 34-35). Liberalisation has also involved removing some of the restrictions previously imposed on commercial banks' operations and asset holdings such as dealing in foreign exchange and treasury bills.

Unlike in a number of other African countries, interest rate liberalisation took place in the context of a reduction in government domestic borrowing and inflation: the government repaid debt to the banking system in 1992/93 and 1993/94 with consumer price inflation falling from 63 per cent in 1991/92 to 16 per cent in 1993/94 (see Table 4).²⁰ Consequently liberalisation has enabled positive real lending rates to be achieved without a sharp rise in nominal interest rates: lending rates for commerce fell from 41 per cent in December 1991 to 22 per cent in December 1994.²¹ Both real savings and real time deposit rates were positive in 1992/93 when inflation fell sharply, although they were negative at the end of the following year when inflation picked up again.

The attainment of positive real interest rates and low inflation is an advance for the workings of financial markets. There are signs that holdings of bank deposits are beginning to recover from the severe decline that took place in the 1980s. Bank deposits rose from 4 per cent of GDP in 1989/90 to 5.8 per cent in 1993/94 (Table 4). Moreover because nominal interest rates have not risen sharply, interest rate liberalisation has not led to a major shift in the composition of banks' assets from loans to treasury bills, as has occurred elsewhere in Africa. There was an increase in banks' holdings of government securities at the expense of loans to

²⁰ Data from Sharer *et al.* (1995: 7). The fall in government domestic borrowing came about largely because foreign borrowing increased, rather than because of a fall in the fiscal deficit.

²¹ Lending rates are from World Bank (1993: 176) and Bank of Uganda (1994: 52).

the private sector, but the shift in asset composition was modest.²² However bank credit to the private sector failed to expand as a percentage of GDP, despite liberalisation and reduced government domestic borrowing from the banking system as a whole (i.e. the commercial banks and the BOU). The most likely reason for this was the reluctance of the foreign banks, which already had excess liquidity prior to the financial reforms, to lend to new customers because of the risk involved, while the UCB was constrained by lack of liquidity from expanding its lending to the private sector.

Despite the improved macroeconomic context for financial reforms in Uganda, liberalising interest rates is unlikely to have more than a marginal impact on competition and efficiency in banking markets while the UCB remains in the public sector and retains its virtual monopoly of most segments of these markets. What is required to improve allocative efficiency is a significant expansion in the scale of operations of soundly managed commercially oriented banks, in sufficient numbers to ensure more than token competition. The entry of the local banks (which in most cases preceded financial liberalisation) has injected some competition into banking markets, but this has mainly been confined to retail banking markets in Kampala, and further growth in this sector is threatened by the distress afflicting some of the banks. The foreign banks have the resources to expand and widen their participation in Uganda, but have shown little inclination to do so. Resolving the future role of UCB in a manner which substantially improves its efficiency, insulates it from political pressures and reduces its monopoly position is therefore imperative if financial liberalisation is to achieve its objectives.

4 CONCLUSION

Reforming financial markets to create an efficient, competitive and solvent banking industry in Uganda is likely to prove a difficult and lengthy enterprise. The institutional fabric of the industry was severely damaged during the 1970s and 1980s as a result of misguided financial policies and the effects of civil war and economic decline. Financial repression led to large negative real returns on financial assets and a very steep decline in the financial depth of the economy. The government owned UCB expanded into a near monopolistic position in banking markets while the established foreign banks retrenched to concentrate on a narrow section of the market. The UCB provided poor services, incurred a succession of operating losses, and lost large amounts of money from bad debts. By the early 1990s it was insolvent with 75 per cent of its loan portfolio non performing. Government efforts to use UCB to channel credit to farmers and other priority sectors on developmental grounds made a major contribution to UCB's financial distress. It also over expanded its branch network and

²² As a percentage of their deposit liabilities to the private sector, commercial bank loans to the private sector fell from 70 per cent in June 1992 to 62 per cent in June 1994, while holdings of government securities rose from 6 per cent to 10 per cent (Bank of Uganda 1994: 47).

staffing levels which raised overheads to excessive levels. Similar problems afflicted the Cooperative Bank which was also insolvent in the early 1990s. Weak prudential regulation failed to curb the prolonged mismanagement of the public sector banks and also allowed the emergence of several undercapitalised and imprudently managed local banks in the late 1980s.

The financial reform programme initiated in 1991 contains three major strands: institutional reforms, including the restructuring of the UCB and Cooperative Bank, legislative reforms, and the liberalisation of controls on financial markets, which mainly entails interest rate deregulation. The reforms have made progress in terms of several of their objectives. Prudential regulation has been strengthened, real interest rates have been achieved without a sharp rise in nominal rates, and a start has been made in restructuring the public sector banks. But major problems crucial to the success of the reforms have yet to be overcome.

The banking legislation has been revised with the enactment of the 1993 Financial Institutions Statute. This has corrected most of the legislative deficiencies in the 1969 Banking Act, providing the BOU with much greater authority to supervise banks and other financial institutions and enforce prudential regulations. The increased emphasis accorded to prudential regulation has already been demonstrated with the take over by the BOU of three insolvent local banks in 1993 and 1994. One of these banks has been closed down and the other two are being restructured under management appointed by the BOU. Illiquid banks are also no longer receiving automatic overdrafts from the BOU, a facility which provided a major disincentive to discipline in the banking industry in the past. The local banks can make a contribution to the development of banking services in Uganda. They are prepared to lend to borrowers denied credit by the established banks and often provide better customer services. In view of the deficiencies of the established banks it is important that this sector should be encouraged to develop, but effective supervision is essential to ensure that they are prudently managed, and not least to prevent them from lending to themselves.

The fall in inflation, which is mainly due to a reduction in government borrowing from the domestic banking system, has enabled interest rates to be deregulated, and positive real borrowing rates to be achieved, without forcing nominal interest rates up to levels which impose high risks on borrowers. Provided that low inflation can be maintained, the interest rate reforms should provide a stimulus to a further revival in holdings of bank deposits and other financial assets by the Ugandan public as well as allowing interest rates to assume a greater role in allocating credit.

The most important component of the reforms, and the key to how successful they eventually turn out to be, is the restructuring of UCB. Because of its dominant position in the banking industry, the restructuring and future of UCB affect virtually all the objectives of the reform

programme; competition, efficiency of credit allocation, the quality and availability of banking services and bank solvency. The restructuring of the UCB has made some progress, particularly in terms of reducing its overheads and operating costs, and the bank can be restored to solvency, albeit at a significant cost to the budget, by replacing its bad debts with government bonds. But resolving its future role poses acute dilemmas for the government because the various different objectives expected of the bank may not be compatible.

Privatisation, to insulate UCB from political pressure to compromise commercial principles, is probably necessary if it is to avoid future operating losses and the recurrence of bad debts. But much of the rural network may not survive if UCB were privatised (unless the government were to provide some form of subsidy), leaving large sections of the country without basic banking services and a payments mechanism. A privatised bank would also be very reluctant to continue the UCB's extensive lending to agriculture, which is the largest sector of the economy. Nor is it clear how privatisation of a near monopoly would enhance competition in banking markets, which would be necessary if efficiency improvements are to benefit consumers of banking services.

A major obstacle facing the reform programme is that a market oriented solution to the problems of the banking sector may have only limited efficacy in the economic conditions currently prevailing in Uganda. The economy is too underdeveloped, incomes too low and lending opportunities too few to provide sufficient incentive for private sector banks to compete for business throughout the country and provide a comprehensive range of banking services.

Table 1**Interest Rates and Consumer Price Inflation (%): 1981-90**

Year	Lending Rate: Commerce	Lending Rate: Agricultural Development	Time Deposits 7-12 months	Bank Rate	Consumer Price Inflation
1981	15.0	13.0	12.0	10.0	109
1982	20.0	14.0	13.0	11.0	49
1983	22.0	18.0	17.0	15.5	24
1984	25.0	24.0	20.0	24.0	43
1985	25.0	24.0	20.0	24.0	157
1986	40.0	38.0	30.0	36.0	161
1987	30.0	25.0	20.0	31.0	200
1988	40.0	35.0	30.0	45.0	196
1989	50.0	40.0	35.0	55.0	61
1990	45.0	36.0	32.0	50.0	33
1991	41.0	37.0	35.0	46.0	28
1992	n/a	26.0@	32.3	41.0	52
1993	23.0*	25.0*	12.9	24.0	6.2
1994	22.5	22.5	7.0	15.0	9.7

@ March 1993

* March 1994

Bank Rate is the rate at which the BOU lends to commercial banks.

Sources: Interest rates, World Bank (1985: 183 and 1993: 176), Economist Intelligence Unit Country Profile (1995-96: 23), International Financial Statistics, and Bank of Uganda (1994: 52); inflation, World Tables.

Table 2**Indicators of Financial Depth: 1970-1990**

	1970	1975	1980	1985	1990
M2/GDP (%)	17.6	20.7	13.7	9.5	7.3
Currency/M2 (%)	35.5	29.3	39.5	40.0	40.8
Bank Deposits/GDP (%)	11.3	14.6	8.2	5.4	4.2

Sources: International Financial Statistics and Sharer *et al.* (1995: 32-33).

Table 3
Commercial Bank Branches in 1991

Bank	Number of Branches
Uganda Commercial Bank (g)	190
Cooperative Bank (g)	24
Bank of Baroda (f/g)	6
Barclays Bank (f/g)	5
Libyan Arab Bank (now Tropical Africa Bank) (f/g)	3
Gold Trust Bank (lp)	3
Nile Bank (lp)	2
Standard Chartered Bank (f)	1
Grindlays Bank (now Stanbic) (f/g)	1
Tieffe Bank (lp)	1
Greenland Bank (lp)	1
Total	237

Notes: g - Denotes banks owned by the government.
 f/g - Banks with 51 per cent foreign and 49 per cent government equity stakes.
 f - Denotes foreign ownership.
 lp - Local private sector ownership.

Sources: Numbers of branches are from Mukwanason (1994: 23).

Table 4
Interest Rates, Prices, Money and Credit: 1989/90-1993/94

Fiscal Year	89/90	90/91	91/92	92/93	93/94
Inflation (%)	2.9	32.0	62.9	-0.6	16.1
Savings Deposit Rate (%)	30.0	32.0	21.0	15.0	2.0
Bank Rate (%)	55.0	44.0	49.0	26.0	20.0
M2/GDP (%)	6.8	7.6	7.8	7.8	8.7
Bank Deposits/GDP (%)	4.0	4.5	4.7	5.2	5.8
Domestic Bank Financing of Govt Deficit/GDP (%)	-1.4	0.2	1.9	-0.4	-0.8
Credit to Private Sector/GDP (%)	5.1	5.9	4.9	4.3	4.6

Figures in this table differ from comparable figures in Table 1 (e.g. inflation) because the former pertain to fiscal years and the latter calendar years.

Source: Sharer *et al.* (1995: 25, 32, 33, 34, 35).

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