# Bank interest rates can fall without policy change - UBA

Over the last weeks, there has been a public outcry about the current interest rate regime with calls for interventions be taken to stem the cost of borrowing in Uganda. We spoke to Wilbrod Humphreys Owor, the Executive Director Uganda Bankers Association (UBA), about the significance of a change in policy similar to what Kenya has done.

**What is UBA's position on the current push for adjustments in the interest rate regime to match that of Kenya?**

We do believe our economies have different dynamics or drivers and our counterpart in Kenya, the Kenya Bankers Association is responding to the developments as they deem appropriate. As far as the Banks in Uganda are concerned, we do believe, Uganda as an economy has registered considerable strides in its liberalization policy stance and that any major policy reversal is not warranted going by the experience we have had in the past, with legislated interest control regimes and lessons learnt therein.

Kenya's GDP is Ugx equivalent of approximately 216 trillion and its tax to GDP ratio is 18.7% while our GDP is approximately Ugx equivalent of 89 trillion with a tax to GDP ratio of 13%. There are also very different structural & supply side rigidities between Kenya and Uganda including the level of depth & sophistication of their financial markets.

**What are the key determinants/drivers of interest rates?**

These are divided into two that is external and internal factors. External factors influencing the cost of credit include things like treasury bill rates which gives the indicative signal on Government borrowing, the Central Bank Rate which is often spoken about, the prevailing inflation rate and regulator cash reserve requirements. Internal drivers include operating costs, the structure & cost therein of deposits or alternative funds (capital), risk factors including the Non-Performing Loan (NPL) ratios and what we call the liquidity premium. It's therefore a blend of a number of key economic indicators and market trends besides the cost of borrowing from within and in there lies the pricing of risk and sector appetite.

If you like, interest rates can be equated to the price of money, the same way we have the price of fuel or electricity or food, clothing etc. Please also remember that none of these items have price caps or legislation regimes.

**But Banks take deposits (customers money) and use it to lend to borrowers and at very high interest rates. Why can't banks lend this money at more reasonable costs since its comes free of charge?**

Banks actually pay a premium for client deposits and this applies considerably to Time deposits. I mentioned the structure of deposits earlier and here I meant three types of deposits namely current accounts, savings accounts and fixed deposits. Current accounts hardly attract a cost because these monies have to be provided to the client on demand and yet there are high costs of keeping it safe. Savings attract a rate of about 3% while fixed deposits are much higher from 14% and above. Since current & savings deposits cannot be committed for long or medium term Investment and yet most of the client needs are medium and long term, Banks therefore have to find alternatives funds to bridge the gap to avoid funding mismatches and this comes at high cost (Cost of Capital).

Also as mentioned earlier, not all deposits are lent out due to cash reserve requirements and such cash earns no revenue at all to the banks.

**There are arguments that if there's no change in the interest rate regime in Uganda, commercial banks will continue to charge exorbitant rates on customer credit hence discourage business growth and Uganda's competitiveness. What's you view on this?**

The current interest rates reflect our macro-economic environment and take into consideration a variety of factors as mentioned above. A shift in policy could benefit a selected number of borrowers only mainly the Corporate sector & government inform of bonds and treasury bills which would obviously crowd out credit for the rest of sectors in the economy. Our own experience from Uganda's past and other markets show that legislated interest rate regimes do not necessarily translate into lower cost of credit and discourage players from investing in the financial sector, which sector is the fuel of an economy. There is little evidence to show that similar laws have led to credit growth in other countries. On the contrary, incorrect pricing of risk has often led to the collapse of banks, with millions of savers monies getting burnt & lost out in the process.

You may want to remember that when mobile phone services came into this country many years back, it was not legislation that brought down the price of mobile phones or airtime etc.

What is important for us is to address the external factors I mentioned that impact on the cost of credit and for us Banks to examine our modes of operations to bring about efficiencies that we can then pass on to customers & stakeholders through more competitive pricing, better

customer service and accessibility of financial services across all segments of the population.

There exist several other fiscal & supply side issues including cost of doing business that could be addressed to make Uganda more competitive.

**How would a policy reversal like introduction of an interest rate legislated regime affect the customer and the banking industry at large?**

One of the benefits of the liberal policy stance has been a very good growth of provate sector credit. Between Dec 2010 and June 2016, private sector credit has grown from 5.4 trillion Ugx to 10.9 trillion Ugx with significant growth in  Building & Real Estate, Trade & commerce, Personal Loans, Manufacturing and Agri business.

With a policy reversal like the one above, we could see a number of shifts in the dynamics around Banking.

Like it has happened in other markets, credit tends to contract in a legislated interest rate regime, because of reluctance to price risk using caps & un-regulated lenders take more space. Instead we are likely to see banks revise their cost structures to meet their operation costs in the face of lower interest income. We foresee a reduction in network costs as a result. Banks could be forced to close unprofitable and non strategic touch points hence impacting customer service for particular segments.

Banks could introduce new fees and commission lines that will help the industry bridge the gap created by a drop in income on net interest income lines. As a result, transacting services will become more expensive. We could see the banking industry increase lending in US dollars hence dollarizing the economy. This as you may appreciate can be very dangerous owing to fluctuations in exchange rates, but also because there can be mis-matches between the currency in which the business earns revenue namely shillings vs the currency in which the loan is paid. This obviously would limit the amount of credit to people borrowing for personal development because most borrow to finance domestic initiatives paid in local currency.

Further more, we could see a dip in investment budgets and re-evaluation of headcount to keep costs in line with income. Today, the banking sector employs over 10,000 employees directly. That’s a number that may not be sustained with an unfavorable policy for the industry. It’s therefore important that that any decision that is made guarantees job security and investment in the banking industry and related sectors. UBA remains committed to holding a structured dialogue on the drivers of the cost of credit and contributing to solutions around the structural

impediments to sustainable growth and economic development and we surely believe there exists better ways to address these challenges.

**You mentioned Non Performing Loans as a factor to be taken into account on the issue of Lending. What is the NPL ratio today and what does this mean to the industry, when traders are complaining that Banks are selling their property unfairly.**

NPLs which is a ratio of unpaid loans/loans in arrears as a percentage of total loans/credit is currently at 8.3%. it theoretically means for every 100 Shillings lent, only 91.7 would come back. Who would want to lend only to lose money!

As we speak today this figure is 906bn. The figure under what we call "watch category" that is about to fall in the NPL bracket is 1.24 trillion Ugx!

NPLs eat into capital, impacts on liquidity and discourages & increases the cost of credit.

**The more important issue though is what are the key causes of NPLs?**

Delayed payments currently constitute 24%, Cost overruns & insufficient cash-flows 23%, Diversion of funds (Poor Governance & Indiscipline) 15%, others include unforeseen demand shrinkage of markets e.g. challenges in S/Sudan, Unfavorable FX movements, absence of long term credit etc.

Banks have prudential guidelines in pursuit of recovery and collaterals though not the key item in loan appraisal, is a fall back safety valve.

In the recovery process, there are stages of reminders, negotiations, restructure etc and foreclosure is only done after 455 days. Even then the borrower has options to find buyers or can still propose other rescue measures. Banks are not in the business of collateral disposals and indeed this process hurts us and our business relations. Every effort must therefore be made by all parties to avoid this painful process.

**What can banks do to contribute to overcome these challenges & what are you doing as an industry to improve services or even bring down the cost of credit. What new initiatives can we expect from the banking industry?**

The first point of contribution is to improve on financial literacy. It is important for the population to appreciate the dynamics in the financial sector and key drivers that impact on financial services including the key players therein, their rights and roles. On this front the Banks together with the regulator BOU are investing heavily on this front and you will be see more visibility from us going forward.

UBA member banks are already working closely with the regulator to strengthen the credit reference bureau and creditworthiness information sharing which greatly informs the pricing matrix for loans. Good loan payers deserve good and competitive loan prices, while loan defaulters discourage credit and place a big burden to others. It's never in the interest of lenders to raise the cost of borrowing because that leads to less access to credit, less aggregate demand and a contraction of the economy.

We are partnering with the insurance sector to mitigate risk and bring in more sectors that would typically be considered unattractive to banks to make them more attractive, Agiculature being one such area. You will realize that as we enter the industry of midstream and upstream Oil & Gas, lending structures purely tied to physical collateral will be difficult to sustain. Transactions in the O&G tend to be large and there are limits to physical collateral. Performance risk becomes the more critical issue and lending structures are built more based on contracts & gurantees around *capacity to deliver* supported by non collateralized structures ring fencing the whole transaction chain.

Banks are also factoring in more and more aspects of sustainable financing/social impact when undertaking financing appraisals. In project appraisals,we are increasingly giving weight to issues like No of Jobs to be created, the value addition created out of the project, import substitution, tax generation, skills transfer, technology transfer and sustainability of the environment among others.

Under the UBA umbrella, we are currently finalzing the structure & modalities to roll out a local content stimulus scheme of **One trillion Uganda Shillings** to drive growth of domestic private sector service providers in key sectors of the economy. Details of this scheeme will be announced in the 3rd week of October this year.

Uganda Bankers Association is spearheading the formation of the Assets Reconstruction Company (ARC) to assist banks in management of toxic debt through restructure/reconstruction/turnaround of such companies especially those with systemic ramifications. This will open another big window of opportunity that we must all embrace.

We are also undertaking collaboration projects that involve shared technology platforms to bring down the cost delivery of services while increasing outreach/foot. You will going forward see severall technologically driven banking services being extended to the previously unserved or underserved population. In this endeavour we wil collaborate with serveral other stakeholders & players like telecoms, fintech companies, thousands of agents across the country

to reach the wider population. You wil also see more products including loan products extended to this huge chain of agents to enable them run their own businesses as well as reach the population. This whole digital finance era should be able to bring alot more money into the formal financial system which in-turn enables better transmission of monetary policy. This is a matter we have full consensus with Govt, Regulators, Development partners , service providers & consumers themselves.

We intend to engage Government of Uganda and submit structuring & guarantee proposals through special purpose vehicles to enable banks in Uganda participate in raising funding for key economic/infrastructural projects in Uganda/or EAC region that can be syndicated by all banks as well as provide framework to attract/give comfort for other funding partners to come on board. This however means that there will be need to strengthen the governance and monitoring around these projects. We really need to address the challenge of shortage of long term finance as well as how to deepen our capital market.

Clearly Banks play a major role in the development of an economy and our preference in this current debate is that the country challenges us more on playing a more leading role in the economy other than focusing on legislating interest rates. The Banking Industry are among the largest group of tax payers as well as the single largest group of contributors to the retirement benefits sector in the country. The Banking spend on CSR in 2015 was over Ugx 7Bn and on IT alone Banks spent over Ugx 270 billion in the financial year 2015.

**Any final words?**

We are open to & undertake to maintain dialogue with all stakeholders on these matters to find amicable solutions to our internal challenges.

We implore our regulators & policy makers to remain steadfast & resolute in being consistent with monetary policies and urge them to continue with the much applauded consultative approach in tackling challenges which has won the confidence of the industry, investors and wider public as a whole.