Bank of Uganda

Remarks by

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Rt. Hon. Dr. Ruhakana Rugunda - Prime Minister

Hon. Maria Kasaija - Minister of Finance, Planning and Economic Development

Mr. Patrick Mweheire - Chairman of Uganda Bankers Association,

Wilbrod Humphreys Owor - Executive Director of Uganda Bankers Association

Eminent speakers and panellists

Ladies and gentlemen

Good morning

I would like to begin by commending the Uganda Bankers' Association for organising this Annual Bankers' Conference. The theme of the conference - **Financial Sector Stability: Managing Risk in a Fast Growing and Fast Changing Environment –** is pertinent and I want to speak about it from the perspective of a financial sector regulator.

The financial services industry is evolving rapidly because of the application of information technology to the nature and delivery of financial services as well as to the operations of financial institutions.

The transformation of financial services is also changing the risks facing financial institutions and financial markets. In particular, operational risks are becoming more relevant for the financial safety and soundness.

The regulators do not seek to micro-manage the business of financial institutions. We believe that commercial principles together with market competition, should guide the behaviour of financial institutions.

Nevertheless, we recognise that financial markets are neither perfect nor free from negative externalities. Financial institutions may take risks which do not align with the interests of their creditors, especially their depositors. Also, financial systems are vulnerable to external risks, including through contagion, as demonstrated by the global financial crisis of 2007-09.

As a regulator, the primary objectives of the Bank of Uganda (BoU) are: to protect the interests of depositors and to ensure the overall stability of the financial system, through prudential regulation and supervision of deposit-taking institutions. We seek to enhance public confidence in the financial system; thereby fostering financial intermediation and limiting the harmful effects of systemic crises.

We aim at having deposit taking financial institutions that hold sufficient capital buffers, so as to enable them to absorb any losses that may be incurred. Supervised financial institutions are also required to implement sound risk management frameworks. In implementing our remit, and pursuant to the Financial Institutions Act; we take corrective action in distressed financial institutions, in a manner that is intended to remedy any problems before they escalate into the loss of depositors' funds.

In spite of our best efforts, we must be realistic about what prudential regulation and supervision can feasibly deliver in a market oriented financial system. It is not possible for regulators to detect all instances of fraud that may occur in financial institutions, not least because such frauds are often carefully concealed from external auditors as well as regulators.

It is also not possible for regulators to guarantee that no bank will ever fail, because that would require the elimination of risk-taking by banks, which would in turn hinder the very purpose of financial intermediation.

Instead, regulators can ensure that bank failures are the exception rather than the norm; that timely interventions in distressed banks protect depositors' funds; and that when a systemically important bank fails, it gets resolved without undermining the stability of the financial system.

I would like to explain the rationale for, and modalities of, our intervention in distressed banks because this has been the subject of criticism from some quarters; particularly with regard to the intervention in Crane Bank, which took place in 2016 and early 2017.

A fundamental tenet of our prudential regulation is the avoidance of regulatory forbearance, which involves the regulator allowing a bank to breach prudential regulations or to continue operating as normal when it cannot meet the minimum capital adequacy regulations. Regulatory forbearance crates moral hazard, which worsens the incentives for banks to be managed in a safe and sound manner. This is particularly pertinent in respect to a bank's ability to comply with capital adequacy regulations.

Capital investment provides an incentive to the owners of a bank to manage it prudently, in order to protect their interests. Higher levels of capital help to align the interests of bank owners and depositors for sound bank management. Conversely, when a bank is undercapitalised or insolvent, the incentives facing its owners for sound management are weakened. This is the rationale for the prompt corrective action provisions in the Financial Institutions Act.

In order to protect the interests of a distressed bank's depositors, the regulator has a responsibility to intervene promptly in a bank that is severely undercapitalised or insolvent, and, if necessary, to take over the bank and resolve it.

The BoU has no obligation to bail out a distressed bank by providing it with liquidity support, in the hope that it will somehow be restored to financial health. Such an option would be extremely dangerous. It would allow the distressed bank to continue being mismanaged in the same manner that caused it to become distressed, thereby incurring further losses at the taxpayers' expense. It would also send a signal to all participants in the financial markets that mismanagement carries no consequences for the owners and managers of banks.

After the BoU had intervened in Crane Bank and taken it over in October 2016, an inventory of its assets and liabilities was commissioned and carried out by a reputable accounting firm. This inventory found that Crane Bank was massively insolvent, with core capital of **negative** Shs. 240 billion, as a result of mismanagement and fraud. The notion that this bank could have been rehabilitated by its owners - the same people who were responsible for its failure - if only the BoU had provided more liquidity support and allowed the owners to remain in control, is not tenable.

In reality the BoU had no other options, if it wished to minimise the losses incurred by the bank and protect the interests of its depositors, other than to take over Crane Bank and resolve it.

In resolving a failed bank, the Financial Institutions Act provides for several resolution modalities; for example, the failed bank can be sold as a going concern, it can be merged with another financial institution, it can be subject to a purchase of assets and assumption of liabilities transaction (P&A) or put into liquidation.

In practise, the options are usually more limited. Most of the banks, which have failed in Uganda during the last 20 years, either had very little franchise value or were too heavily insolvent to be sold on a going concern basis or merged with another bank. Hence in these cases, the feasible options were a P&A or a simple liquidation.

A P&A has the advantage of transferring a substantial part of the failed bank's business, including all or most of its deposits and parts of its loan book, to one or more acquiring banks; thereby minimising the disruption to the failed bank's customers. This is why the BoU has used the P&A modality on several occasions over the last two decades in resolving failed banks, as was the case with the resolution of Crane Bank.

Two factors are crucial in determining how a P&A transaction is carried out, and in the selection by the regulator of feasible partners, to acquire the assets and assume the liabilities of a failed bank.

First, an acquiring bank must have the resources – financial, managerial, and infrastructural – to absorb the assets and liabilities of the failed bank quickly and smoothly so as to avoid disruptions to its customers. For example, a bank, which has branches only in Kampala cannot absorb the assets and liabilities, and serve the customers of a failed bank, which had a nationwide branch network.

Second, a P&A must be organised and implemented quickly, so that a failed bank's customers do not face a long wait to access services or to ensure that the regulator does not have to manage the failed bank on a statutory basis for an extended period.

I believe that a balanced and fair evaluation of the BoU's record of intervention in, and resolution of, failed banks would conclude that these interventions and resolutions have been successful in achieving the primary policy objectives of prudential regulation; to protect the interests of depositors, and to ensure the stability of the financial system.

Since 2010, the BoU has intervened in five banks; closing three of them, and taking two others into temporary statutory management. In none of these banks did depositors lose their money, nor was there any danger caused to the stability of the financial system.

The intervention in Crane Bank, was the most difficult of these interventions and the one which was potentially the most problematic, because it was a large bank of systemic importance, and because of the huge magnitude of the losses it had incurred.

Nevertheless, the BoU was able to resolve Crane Bank smoothly. It remained open under statutory management until most of its assets and liabilities could be transferred through a P&A to a suitable acquiring bank, DFCU Bank, thereby avoiding disruption to its customers. None of its depositors lost the money.

Furthermore, despite the size of the bank and its links with other banks through the interbank market, there was no contagion to the rest of the financial system and no loss of public confidence in bank deposits.

To conclude, the risks facing the financial services industry in Uganda are evolving, driven by changes in business models, technology, and the development of innovative financial products.

The regulatory framework will need to adapt to meet the challenges posed by the changes in the risks facing the financial sector. However, our strategic approach remains sound. This approach focusses on financial institutions holding strong capital buffers and having in place sound risk management policies and procedures. In addition, we will continue prompt regulatory intervention in distressed banks.

Thank you for listening to me.