IGC
International Growth Centre

Event report

Why are lending rates high in Uganda?

A brief report on key points discussed at the IGC BOU interest Rate Seminar

On the 30th November 2020, the Bank of Uganda and the International Growth Center held a policy seminar on the issue of lending rates in Uganda.

Following a presentation by Dr. Keith Jefferis on 'Exploring Interest Rate Spreads in the Uganda Banking System', a high-level panel considered policy recommendations for lowering lending rates. This note summarises discussions from the seminar and key policy actions discussed.

Lending rates: a critical issue for Uganda

While the financial sector has developed significantly in Uganda, there remains an ongoing issue with high lending rates facing firms and households – and in particular, the large difference between lending and deposit rates. This makes it difficult for firms to borrow for the productive investment that is required to achieve high rates of economic growth.

In Uganda, commercial bank lending rates are typically 20% and above, while deposit interest rates reach up to 5%. This large 'interest rate spread' is a key issue because:

- High interest rate spreads increase costs of borrowing for businesses and their profitability
- It impacts retail borrowers trying to match the shortfall between current expenditure and income
- It handicaps economic growth

It is therefore crucial to understand what is driving this 15% spread.

Why are interest rate spreads high in Uganda?

The results of the study suggest the following:

1) Interest spreads in Uganda are relatively high compared to other countries in the region, and have been consistently so from 2007 to 2018 (see Figure 1). This has been associated with high real lending rates. However, it does not seem that banks in Uganda are making abnormal profits, when compared to other countries in the EAC and SADC.

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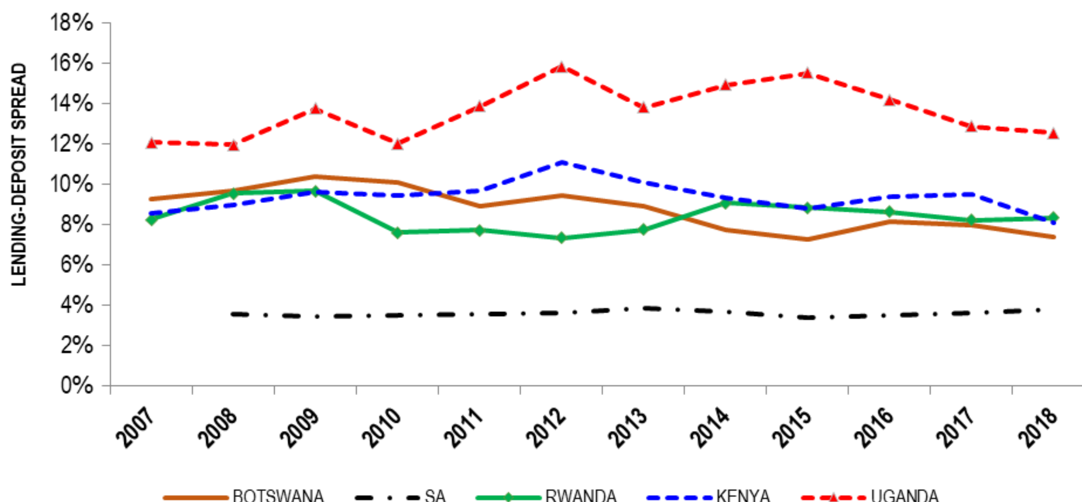
2) A large proportion of bank loans are not going to consumers and businesses (around 50%). Banks in Uganda are instead significantly investing in government bonds, whose yields are at least double that in comparator countries. These high yields for low risk loans effectively place a floor on any other bank lending rate and disincentivize banks from providing loans to businesses and consumers.

Figure 1: Regional Interest Rate Spreads



3) The degree of capitalization in Ugandan banks is relatively high and often well above the regulated requirements. Banks are using high cost capital on to provide loans, thus putting upward pressure on lending rates. There are two potential reasons for this – first, high risk aversion by banks leading to high liquidity buffers. Second, Uganda is a low-deposit environment, with many individuals choosing to do financial business with savings groups rather than with banks. There may be liquidity mismatches between depositors wishing to save money for extremely short durations, and longer term financing needs of borrowers.

4) Costs of operation among Ugandan banks are high, and made up 61% of spreads on average over 2008 to 2018. Though this proportion is not out of line with peer countries (in Botswana, operating costs make up 4% of the overall 7% spread) the absolute value is higher than average. This is followed by loan loss provisions – and the contribution of both of these factors has increased in recent years.

   Big banks, domestic banks and banks with less operation efficiency had a higher contribution to the interest rate spread.

Key policy recommendations

Below are key policy implications emerging from discussions at the seminar:

PART I: REDUCE THE HIGH INTEREST RATE 'FLOOR' FROM GOVERNMENT BORROWING

1) **Limit government borrowing where possible, to incentivize banks to provide and plan for 'riskier' loans to consumers and businesses instead.** Without doing so, there will continue to be a disconnect between the Central Bank Rate and bank lending rates, rendering monetary policy less effective.

Key actor: Ministry of Finance, Planning and Economic Development

2) **Ensure government borrowing is directed towards productive investments, to reduce interest rates on government bonds and therefore the 'floor' on other types of lending**

Key actor: Ministry of Finance, Planning and Economic Development

3) **Explore alternative financing models for public investments**, for example through public bonds, enhanced domestic revenue mobilization, and concessional borrowing from multilateral development partners.

Key actor: Ministry of Finance, Planning and Economic Development

PART II: INCREASE EFFECTIVE COMPETITION IN THE BANKING SECTOR

4) **Increase competition and potential consolidation through raising minimum capital requirements for banks.** This does not necessarily mean more banks – Uganda already has a large number of banks given the size of the economy. Microfinance and Tier 1 financial institutions are unlikely to be able to lower interest rates or compete effective with larger banks. They rely primarily on fixed deposits which require them to charge high interest rates on loans. What is needed is a 'contestable market' in the banking sector – and experiences from countries such as Kenya highlight that this requires encouraging the growth of smaller/medium sized banks to challenge the dominant, large players. The consolidation of smaller banks, to encourage competition through the creation of medium-sized banks, would also facilitate economies of scale and reduce the duplication of infrastructure across many small banks, thus reducing overhead costs.

Key actor: Bank of Uganda

5) **Create an enabling regulatory environment for banks to allow for the entry of Fintech, mobile money etc. to compete**

Key actor: Bank of Uganda

PART III: REDUCE RISKS AND COSTS OF LENDING

6) **Create an enabling regulatory environment for banks to innovate in reducing non-performing loans.** For example, reducing information asymmetries in loan provision by:
    a. Automate and link 'Know Your Customer' information with information collected by NIRA to ease identification authentication needed for approving transactions.
    b. Leveraging the national ID architecture and linking this to data from the Credit Reference Bureau to allow for real time information on individuals' loans performance
    c. Accredited Credit Provider Regulation for SACCOs and money lenders, so that these institutions provide data to Credit Reference Bureaus so banks are better aware of the entire portfolio of loans and individual holds

Key actor: Bank of Uganda

7) **Innovation in the banking sector is needed to reduce overhead costs.** For example, by transitioning away from branch-based banking to electronic platforms. This process is already underway with some commercial banks.

Key actor: Bank of Uganda / Banking sector

8) **Implement risk mitigation frameworks that limit risk for banks by providing government guarantees that allow for risk sharing in lending**

Key actor: Bank of Uganda / commercial banks

9) **Reduce costs of loan recovery through legislative reforms that speed up and reduce costs of commercial justice.**

Key actor: Ugandan Legislature/ Bank of Uganda

10) **Leverage new systems for borrower identification and URSB system of tracking immovable property to extend credit on the basis of movable securities.** Banks typically lend against immovable property, such as homes or land. This needs to change; 47% of adult population don't have a home in their own name, and only 19% of adults have land deeds (Finscope 2018).

Key actor: Banking sector / Bank of Uganda

11) **Require banks to enhance borrower credit risk assessment through in-depth project analysis before giving loans to assess realistic returns and likelihood of non-performing loans**

Key actor: Bank of Uganda

12) **Strengthen provision of financial literacy training to borrowers (already being offered by the Bank of Uganda) – particularly for informal businesses and the less literate population**

Key actor: Bank of Uganda

13) **Prioritize payment of government arrears to the private sector, as delays and non-payment can cause businesses to default on their loans**

Key actor: Ministry of Finance, Planning and Economic Development

PART IV: FURTHER REGULATION TO LIMIT NON-PERFORMING LOANS

14) **Strengthen regulation and periodic supervision of banks to ensure that banks with very high levels of non-performing loans are black-listed or no longer licensed**

Key actor: Bank of Uganda

15) **Provide banking licenses with the provision that banks expand their lending to businesses and unbanked population.** This will incentivize banks to work with SMEs to bring down the risk of lending.

Key actor: Bank of Uganda

16) **Forward planning for non-performing loans from the COVID-19 crisis is needed.** In light of the economic crisis and shocks to sectors such as tourism and education, there may be a number of non-performing loans in the coming years. While banks may be able to absorb much of this shock through their high capitalization, regulators will need to consider ways in which to limit the effect of this crisis on risk premiums and over-capitalisation in future.

Key actor: Bank of Uganda

PART V: EXPAND SOURCES OF FUNDING FOR BUSINESSES

17) **Establish/encourage the establishment of innovation funds, provident funds, development banks to provide alternative sources of funding for SMEs.** The upcoming Social Security Amendment Bill and capitalization of UDB provides an opportunity to unlock national savings to be used to fund developmental lending.

Key actor: Ministry of Finance, Planning and Economic Development