WHITE PAPER

How COVID-19 Liquidity Shock Threatens Uganda's Financial System

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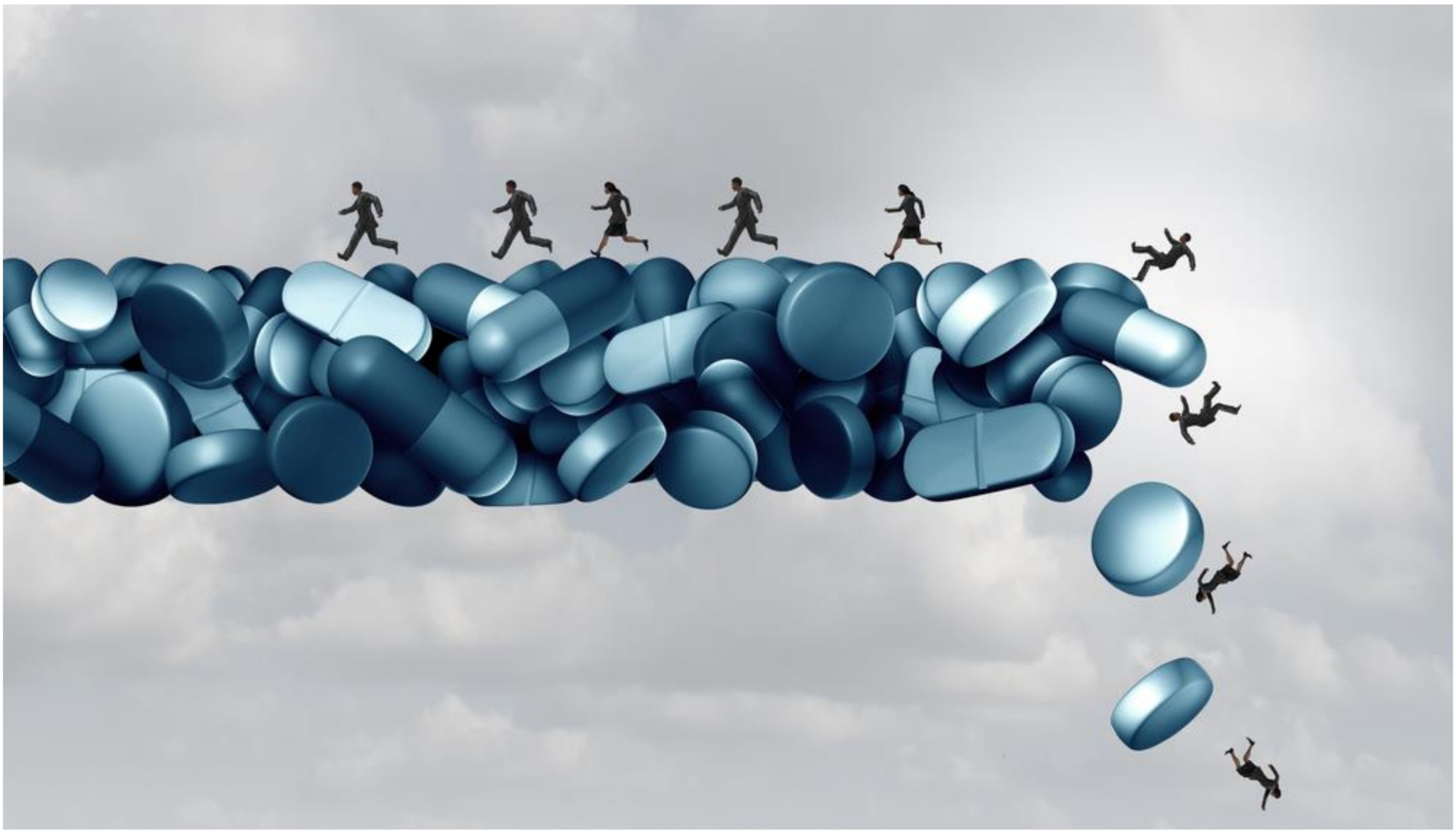
A Case of Centenary Bank or Any Other Local Bank

Preface



Credit: Internet photo

Bank Financial Risk Managers in the past 12 years have been the busiest bunch recovering from the aftermath of the financial crisis of 2007-2008. These particular effects brought about the adoption of more robust and prudent credit risk models such as the prominent International Financial Reporting Standards 9 (IFRS9) that was fully adopted in Uganda in 2018. However, these models are inadequate when the economy is threatened to collapse in the shortest time possible.

While this lockdown has not restricted banks from carrying out their activities, there has been a significant decline in the number of transactions and businesses carried out at these intermediaries with most people looking to fast-move on most of the high-risk banks. But this only applies to rational clients who can tell what high risk and low risk is. Nevertheless, most of the high-risk banks have rational clients and these clients are there to leverage from the extra reward given to them for taking this risk. However, when the risk goes beyond a certain level of tolerance, there will soon be several bailout applications.

Like Ben Bernanke stated in the aftermath of the financial crisis of 2008 before the Financial Crisis Inquiry Commission on 2nd September 2010, “Should the safety of their investments come into question, it is easier and safer to withdraw funds than to invest time and resources to evaluate in detail whether their investment is, in fact, safe”, earmarking the run on banks.

A case of Centenary Rural Development Bank (CERUDEB)

For our case in Uganda, consider the case of Centenary bank, a commercial bank with a high loan to deposit ratio and one whose impact is not affected by global diversification exposures. CERUDEB has for many years been the dominant local bank.

Centenary is not listed on the Uganda Stock Exchange.

Despite this, financial analysts put the initial public offering (IPO) price per share for its listing at highs of UGX. 2,555 and lows of UGX. 2,028 guaranteeing investors projected rates of return close to 100% over and above the cost of capital at about 15.6%.

This is the perfect case to examine as most banks have diversified into several different entities and have drifted away from traditional commercial banking. At the time of writing this analysis, Centenary bank had not published her 2019 financial year report. Accordingly, we shall project the financials for 2019 based on previous annual reports. The financial information and projections used in this case are prior years published audited reports by the bank.

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CERUDEB's performance in prior years

Centenary's deposit growth has averaged 18.4% from 2016 to 2018 growing from UGX. 1.6 trillion to 2.82 trillion. We project further growth to not less than UGX. 2.6 trillion in 2019 financials which we will confirm a few weeks from now. During the same period, the bank disbursed more than UGX 140 billion in loans recording a profit after tax of more than Ugx. 107 billion. But the bank's performance is not our goal here. This paper examines the impact of the covid19 lockdown on CERUDEB and what risk the bank might be exposed to if this persists over a year, as it is being projected to happen in our developed cities.

Performance assuming no #covid19 pandemic lockdown

First, let's take the financial projections if this storm had not happened. The balance sheet below shows projected asset liability management in case there was no pandemic and the 2020 lockdown that has seen a slow down of many business activities.

Ugx in billions	12/31/2019	12/31/2020	12/31/2021	12/31/2022	12/31/2023
Cash and balances with Bank of Uganda	661.34	739.54	969.63	1,287.11	1,595.82
Deposits and balances due from other banks	117.17	148.50	192.13	211.42	256.96
Government securities	962.38	1,244.20	1,469.00	1,704.77	2,060.35
Loans and advances to customers	1,693.91	1,908.11	2,131.52	2,391.08	2,676.64
Other assets	70.16	75.50	89.19	110.05	127.67
Property and equipment	128.68	119.62	105.30	97.73	89.57
Intangible assets	37.73	69.11	65.71	84.55	91.23
Deferred income tax asset	1.76	0.66	0.98	1.47	1.27
Total assets	**3,673.13**	**4,305.25**	**5,023.48**	**5,888.17**	**6,899.50**
Customer deposits	2,703.42	3,215.34	3,816.46	4,534.56	5,385.04
Deposits and balances due to other banks	7.61	9.46	9.90	11.23	12.76
Other liabilities	103.89	119.21	134.60	149.01	167.68
Managed funds	16.11	18.67	21.51	26.30	30.95
Borrowed funds	104.82	94.43	82.80	69.76	55.17
Current income tax payable	7.56	7.98	10.04	10.64	11.90
Deferred income tax liability	0.81	1.21	1.36	1.39	1.66
Deferred grants	0.40	0.40	0.39	0.50	0.54
Provision for litigation	2.61	2.40	2.95	3.34	3.61
Total liabilities	**2,947.22**	**3,469.11**	**4,080.01**	**4,806.74**	**5,669.30**
Ordinary share capital	25.00	25.00	25.00	25.00	25.00
Preference share capital	0.12	0.12	0.12	0.12	0.12
Share premium	1.14	1.14	1.14	1.14	1.14
Regulatory reserve	11.70	11.70	11.70	11.70	11.70
Proposed dividends	27.57	36.96	35.99	46.26	49.88
Fair value reserve (AFS)	-	-	-	-	-
Fair value reserve (FVOCI)	(0.19)	(0.19)	(0.19)	(0.19)	(0.19)
Retained earnings	660.57	761.41	869.71	997.41	1,142.55
Total equity	**725.91**	**836.14**	**943.47**	**1,081.44**	**1,230.20**
Total equity and liabilities	**3,673.13**	**4,305.25**	**5,023.48**	**5,888.17**	**6,899.50**

Figure 1: Asset Liability Management Before COVID-19

The bank's assets would grow from Ugx. 3.67 trillion to Ugx. 4.3 trillion in the year ended 2020 and attracting customer deposits of over Ugx. 3.2 trillion due to the healthy condition the bank would be in. This would lead to a growth in profit to UGX. 149.6 billion on the high note, or UGX.147.2 billion if the economy was to remain the same, and considering elections were around the corner, a more realistic bottom-line number would be the UGX. 144.8 billion. Either way, the reported profits were sure to grow relative to 2019 and prior years.

This would give Centenary a cushion to absorb high-risk assets, inform of default and still encourage business growth through extensive lending. Also, more interest would be recovered compared to the previous year. The bank is also projected to reduce the total number of write-offs with more efficient loan mechanisms supported by the adoption of IFRS9 credit risk assessment models.

As projections show, the bank's growth trajectory was outstanding. However, such forecasts did not envisage the #covid19 pandemic as a worst-case scenario that could disrupt business.

Facing the unexpected...

The 2020 financial tempest that is COVID-19

2020 can only be described as a financial tempest, a tempest because it has stormed many markets across the global economy including the real sector, where more than 90% of their customer deposits are derived, as real estate is the asset base that forms acceptable collateral for many banks.

The panic due to the covid19 lockdown has triggered what is referred to as fast movers, those clients who will want to withdraw their money early with looming risk of assets. The panic is projected to reduce customer deposits in banks as these monies are being withdrawn at voluminous rates for companies and individuals to prepare for the shortage. While inflation is rising at extensive rates, the high prices on essential products have also soared. This means clients will withdraw more than they normally do and considering the panic, most of them if not all will want to have their money at hand rather than in an institution as the opportunity cost might be extremely high.

Increasing counterparty risk will further reduce liquidity as interbank borrowings will be limited and at a high-interest rate. The following asset liability projection will be as a result of the looming financial crisis as a result of the global pandemic.

Commercial banks like CERUDEB may experience a loss spiral, where a decline in the value of their assets would erode the bank's enterprise value and push their share value on any exchange to lows of Ugx. 278.2 per share falling by more than 89.1% in net worth. Rates of return are also set to fall fro close to 100% to less than 6% way below the bank's cost of capital.

While depositors shall continue demanding their monies, they will leave the banks with no option than to sell their assets at lower amounts than fair value to cover their obligations, which they might or might not cover.

Ugx in billions	12/31/2019	12/31/2020	12/31/2021	12/31/2022	12/31/2023
Cash and balances with Bank of Uganda	661.34	(380.19)	(388.73)	(317.40)	(250.31)
Deposits and balances due from other banks	117.17	58.59	80.14	87.48	105.49
Government securities	962.38	481.19	612.69	705.40	845.80
Loans and advances to customers	1,693.91	1,693.91	1,882.32	2,100.07	2,338.33
Other assets	70.16	31.74	37.20	45.54	52.41
Property and equipment	128.68	110.62	97.15	89.35	81.28
Intangible assets	37.73	16.09	48.68	64.08	68.67
Deferred income tax asset	1.76	0.59	0.87	1.29	1.11
Total assets	**3,673.13**	**2,012.54**	**2,370.31**	**2,775.81**	**3,242.78**
LIABILITIES					
Customer deposits	2,703.42	1,351.71	1,591.78	1,876.31	2,210.63
Deposits and balances due to other banks	7.61	8.40	8.74	9.86	11.14
Other liabilities	103.89	105.83	118.86	130.87	146.49
Managed funds	16.11	7.85	8.97	10.88	12.71
Borrowed funds	104.82	94.43	82.80	69.76	55.17
Current income tax payable	7.56	7.09	8.86	9.35	10.40
Deferred income tax liability	0.81	1.07	1.20	1.22	1.45
Deferred grants	0.40	0.36	0.34	0.44	0.47
Provision for litigation	2.61	2.13	2.61	2.93	3.15
Total liabilities	**2,947.22**	**1,578.86**	**1,824.17**	**2,111.64**	**2,451.60**
EQUITY					
Ordinary share capital	25.00	25.00	25.00	25.00	25.00
Preference share capital	0.12	0.12	0.12	0.12	0.12
Share premium	1.14	1.14	1.14	1.14	1.14
Regulatory reserve	11.70	11.70	11.70	11.70	11.70
Proposed dividends	27.57	-	37.71	39.57	42.59
Fair value reserve (AFS)	-	-	-	-	-
Fair value reserve (FVOCI)	(0.19)	(0.19)	(0.19)	(0.19)	(0.19)
Retained earnings	660.57	395.91	470.66	586.82	710.82
Total equity	**725.91**	**433.68**	**546.14**	**664.17**	**791.18**
Total equity and liabilities	**3,673.13**	**2,012.54**	**2,370.31**	**2,775.81**	**3,242.78**

Figure 2: Projected Asset Liability Management after the Pandemic

A projected loss after tax of more than Ugx. 292 billion will leave the bank in the negative cash balance, which may require it to source at least Ugx. 381 billion from its stakeholders to continue operating and this is only if the pandemic lockdowns last not more than a year. A persistent lockdown would pose further harm to the individual banks and the entire financial system ecosystem.

A reduction in customer deposits, increasing default rates on financial assets, delayed payments from institutional and government investments and last but not least, a prudent interbank market would generate a never-ending spiral until a number of these financial institutions and intermediaries collapse if there is no clear intervention at a policy level.

Ugx in billions	2019	2020	2021	2022	2023
Interest on loans and advances	388.19	-	427.52	479.53	533.29
Interest on treasury bills at amortised cost	82.89	31.54	41.47	51.58	58.18
Interest on treasury bills at FVOCI	1.41	0.94	0.97	1.18	1.47
Interest on inter-bank placements	29.89	17.32	21.48	23.88	29.42
Interest income	**502.38**	**49.80**	**491.44**	**556.17**	**622.36**
Interest expense	**(69.80)**	**(40.13)**	**(43.32)**	**(48.35)**	**(53.18)**
Net interest income	**432.58**	**9.67**	**448.13**	**507.82**	**569.18**
Fee and commission income	**113.67**	**117.07**	**129.69**	**143.58**	**160.86**
Net interest, fee and commission income	**546.25**	**126.74**	**577.82**	**651.40**	**730.04**
Interest on treasury bills FVPL	6.54	2.67	2.91	4.02	4.51
Interest on treasury bonds- FVPL	7.66	4.25	5.72	6.14	7.58
Fair value loss/(gain) on FVPL	0.67	(0.45)	(1.10)	(0.48)	(0.96)
Loss/(gain) on sale of securities	0.69	0.44	0.27	0.49	0.58
Foreign currency trading commission	10.47	5.37	6.55	7.66	9.18
Realised revaluation (loss)/gain on foreign exchange trading	0.37	(0.65)	(0.35)	(0.36)	(0.69)
Unrealised revaluation (loss)/gain on foreign exchange trading	(0.14)	(0.02)	(0.04)	(0.06)	(0.05)
Charges on T-bills/Bonds secondary market	0.01	0.01	0.00	0.01	0.01
Net trading income	**26.27**	**11.62**	**13.96**	**17.42**	**20.14**
Income from bullion van hire	-	-	-	-	-
Recovery of written off loans	8.89	-	11.22	11.91	13.59
Sale of ATM cards & banking stationery	7.95	-	4.51	5.36	6.25
Grant income	0.21	0.21	0.26	0.27	0.30
Uncollected ATM cards	0.30	-	0.08	0.13	0.12
Other income	2.36	1.33	1.25	1.65	1.95
Other operating income	**19.70**	**1.54**	**17.32**	**19.32**	**22.22**
Operating income	**592.21**	**139.90**	**609.09**	**688.14**	**772.40**
Employee benefits	(171.20)	(179.76)	(169.78)	(191.46)	(214.96)
Impairment of financial assets	(24.45)	(25.67)	(25.17)	(30.14)	(33.49)
Depreciation expense	(20.30)	(18.24)	(15.13)	(13.53)	(12.33)
Amortisation expense	(53.29)	(26.77)	(15.23)	(40.30)	(56.86)
Operating expenses	(173.03)	(181.68)	(177.47)	(196.69)	(222.02)
Profit before income tax	**149.94**	**(292.24)**	**206.31**	**216.02**	**232.74**
Income tax expense	(40.15)	-	(56.13)	(58.42)	(63.15)
Profit for the year	**109.79**	**(292.24)**	**150.18**	**157.60**	**169.59**

Figure 3: The liquidity plunge 2020 will pose to commercial banks

How can Banks respond to these shocks

a) It's time the banks accessed their capital reserves from the Central Bank

Banks have for many years-maintained capital reserves with Bank of Uganda with tier 1 required to have at least UGX. 25 billion and tier 2 to have at least UGX. 1 billion. These reserves should be accessed to boost liquidity in these trying times. However, this will only cover a little of their liquidity problems. Banks that will fall short of more than UGX. 600 billion, the likes of Stanbic Bank Uganda, might not have enough coverage in these times.

The Fed in the United States has already given a green light in respect to this provision and big banks have been able to access their reserves to cover for short term liquidity challenges. When people are lockdown in their homes, the biggest activity they do is consume. Lots of spending on health, and considering that the biggest percentage of Ugandans are not insured, it means they need cash to spend. This structural set up will drive withdrawals as prior explained which must be absorbed quickly.

While IFRS9 called for prudence, there has been no financial institution of sorts especially those on Uganda that had projected a steep liquidity bubble. The impact of #covid19 lockdown is far worse than could have been envisaged, albeit happening after two years of first time IFRS 9 adoption which had already prepared banks well and corrected unsecured and non-performing assets in their portfolio.

Like a private equity firm, the government should aid these banks with what is known as convertible bonds. These bonds finance companies for a given period after which bonds have an option for conversion into equity which the government can take over as stake or opt-out and sell them back at interest. Once the COVID-19 is subdued and there are no more lockdowns, BoU could decide on which side to take, either to sell back the securities to the banks or take up a stake in these companies.

b) Bank of Uganda repurchase agreements should also include a cushion to protect current assets

There is a threat to these banks' balance sheets as they will have credit-impaired assets of more than UGX. 100 billion especially for those banks that have lent to individuals like Centenary with huge middle and low-end segments. These assets are set to default on their payments as most businesses have closed. We expect the figure to soar even bigger on a bottom-up assessment of each facility.

Repos should also have extended periods.

Bank of Uganda should give these banks at least 6-months to part with the liquidity they have borrowed for the short term.

This would also prevent these banks from precautionary hoarding.

c) In case of a bailout, the Central Bank should issue a Wealth Fund in the form of convertible debt

Banks that will struggle and fail to come out of this liquidity dump are likely to ask for bailouts. Of course, the government has bailed out several firms but at what cost. Bailouts are good if the management teams learn from what happened. However, those firms that have been applying for persistent bailout might have to offer BoU equity holdings in exchange for financial aid.

Like a private equity firm, the government should aid these banks with what is known as convertible bonds. These bonds finance companies for a given period after which bonds have an option for conversion into equity which the government can take over as stake or opt-out and sell them back at interest. Once the COVID-19 is subdued and there are no more lockdowns, BoU could decide on which side to take, either to sell back the securities to the banks or take up a stake in these companies.

This fund would then be financed either by selling back that stake at an interest or maintaining their share positions, depending on the viable options. All the liquidity leveraged from each year would be reinvested in the wealth fund for future shocks. The reason being, to bail out these firms, might need more than trillions of shillings. Let the central bank use this as an opportunity to prepare for other crises.

d) Bank of Uganda should increase the interest rates on treasuries to attract more liquidity to the financial markets

While the 10-year average treasury bill rate is just about 13%, BoU should further increase this rate to attract investors in purchasing these securities for short term liquidity problems. The rate should go up as high as 18%, which is the market risk premium for financial institutions in Uganda. This will also attract funding from global markets and although it will increase the level of nonsovereign debt, it would boost the economy for short term liquidity problems. Uganda's nonsovereign debt problems would worsen. External debt stood at US$ 292.3 million (more than a trillion Uganda shillings). We would do with any type of short-term liquidity for now. Otherwise, many top banks would sink in the hole.

These funds that BoU would source should, in turn, be used to buy-back the government securities issued in the previous term. In 2018 alone, Centenary Bank had bought government securities of more than Ugx. 900 billion. Of course, we do not mean buying back all these, but getting back what would be sufficient to help these institutions survive over at least a year.

e) Institutional M&A should be encouraged for banks on life support

Some banks were already in the RedZone before this covid19 pandemic. **The summitBI Bank Analysis Report 2020** highlighted some of these banks. These banks should look to making horizontal mergers to offset the risks they are exposed to especially those to do with liquidity.

Vertical mergers should also be encouraged for those top banks that are primarily focused on high-risk products during financial crises. Mortgage focused banks have been exposed to the highest risk yet again. The likes of Housing Finance Bank experience worse liquidity problems and could struggle in the coming months. This means such banks should restrict their lending away from Mortgages for the short term and refinance this product after the tempest or the covid19 storm has settled. These institutions should look to merge with smaller institutions like tier 2 or tier 3 deposit-taking institutions to diversify this liquidity risk exposure. The good news is Uganda is predominantly an agricultural country. If the government could prioritize the sector in the coming budget by spending a lot of money there, the economy would stabilize sooner since the sector has a large local and global market.

Many small players might not survive this storm. Although Bear Stearns was a significant global investment bank, it had to be sold to JPMorgan Chase in 2008, whose crisis was a prelude to the risk management meltdown of investment banking in the United States.

f) Issuing Fixed Income Securities at a cost though that can be recovered.

In a time of crisis, fixed income securities could be a form of last resort as the markets lack liquidity. But issuing high yield debt securities like bonds would attract big investors who have ample liquidity and would be willing to invest. Selling bonds over and above the current risk-free rate of around 13-14% would allow investors to think. Going over and above the market risk premium for financial institutions (18%) will more than guarantee these inflows.

e) Need to reduce the dependence on brick and motor mechanisms

DFCU bank has recently left many of the buildings it took over in the acquisition of Crane Bank's assets. This consequently boosted their profit after tax by 21% year on year. This should be the move most financial institutions that have a lot of fixed assets should consider as they move to adopt digital delivery channels. Already, digital channels have been a big hit during this lockdown as people have opted to conduct bank to mobile to an agent or mobile money transactions. Of course, not many people would love to hear this. While it threatens several jobs, it should also open up space for new careers and scalability opportunities.

The cost of fixed assets remains the big hurdle for institutions big and small but can be offset with optimization. That doesn't mean closing every branch but optimizing business applications that when they are not functional could still yield leverage.

Now than before, the use of business intelligence and data analytics critical. Banks must assess the viability of each delivery channel and the future potential for scale. The fact is, online and mobile channels offer more returns than brick and motor.

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