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POLICY PERSPECTIVES ON STRENGTHENING UGANDA'S NON-PERFORMING LOANS STRATEGY (NPLS)

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Introduction

"Banks operate in a strictly regulated environment and every borrower, whether an insider or the man from the street, must meet their financial obligations to their bank. The reasons for this are not hard to find; first, banks operate with customers' funds which must be available on call; second, non-performing loans interfere negatively with the macro-economic stability of the country; third, to allow borrowers to go into perpetual default in loan repayments is to hand them a rope for financial suicide. Overall, it is never in the public interest to allow non-performing loans." Linnet Ndolo, J (***Jacob Kelly Omondi Onyango v National Bank of Kenya [2017] eKLR***)

This policy brief seeks to address some of the salient principles necessary for reform of Uganda's NPL strategy with a view of improving the viability and resilience of the banking sector. A number of banks in Uganda are currently experiencing a big portfolio of NPLs, and it is generally accepted that high NPLs negatively impact on banks' profitability thus negatively impacting bank lending to the economy. Capital constraints faced by banks with high NPL ratios may also lead to bank failures, which may cause financial instability and erosion of public confidence in the banking sector. According to the Bank of Uganda[2] Annual Supervision of Report of 2015, an analysis of default by the banks' three largest borrowers and an increase in NPLs by 200 percent revealed large potential losses to the banking sector. The report revealed that if each bank's three largest borrowers were to default, with a loan loss of 100 percent, 17 banks in Uganda would become under-capitalized with an aggregate capital shortfall of Ush. 595.4 billion.[3]

Furthermore, the Bank of Uganda Monetary Policy Report (MPR) for February 2016 revealed that asset quality, as measured by the NPLs deteriorated in December 2016, with the NPL ratio increasing to 10.5 per cent of total loans, up from 7.7 per cent in September 2016. This is the highest level of NPLs recorded in Uganda's banking history in more than a decade. This high level of NPLs has increased risk aversion amongst lenders, thereby weakening private sector access to credit and negatively impacting economic growth.

The international context

In September 2016, the Banking Supervision of the European Central Bank (ECB) issued a "Draft guidance to banks on non-performing loans". The ECB's focus on NPLs began with the 2014 comprehensive assessment, which comprised of two main pillars – an asset quality review and stress testing. Subsequent to the comprehensive assessment, the ECB's banking supervision continued to intensify its supervisory work on NPLs. In the context of on-going supervisory engagement, the joint supervisory teams (JSTs) observed varying approaches by banks to the identification, measurement, management and write-off of NPLs. In this regard, in July 2015 a high-level group on non-performing loans comprising staff from the ECB and national competent authorities was mandated by the Supervisory Board of the ECB to develop a consistent and harmonized supervisory approach to NPLs. As part of ongoing supervisory work, the JSTs are tasked to engage with banks regarding the implementation of the NPLs guidance in line with the scale and severity of the NPL challenges the banks face.

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[2] Bank of Uganda hereinafter "BoU" is the Central Bank of Uganda by virtue of the Bank of Uganda Act, Cap. 51 Laws of Uganda.

[3] See pg. 4.

The Ugandan context

Two of the three domestically systemically important banks (D-SIBs) had NPL ratios above the industry average of 8.3 percent in June 2016. The industry NPL ratio has been on an upward trend since June 2015, and had more than doubled from 4 percent in June 2015 to 8.3 percent in June 2016. Indicators showed that bad loans rose in all the economic sectors, particularly in the building and construction sector and the trade and commerce sector.

Furthermore, according to the BoU state of the economy report of March 2017, provisioning for bad debts, given the rising NPLs, and structural rigidities in the financial sectors largely remain the key drivers of sticky lending rates in Uganda. This had had the negative effect of slowing down private sector growth, and thus negatively impacting on economic growth across key sectors of the economy. Much as the ratio of Non-Performing Loans (NPLs) to total loans declined to 6.3 per cent in March 2017, from 10.5 per cent in December 2016. Over the same period however, loans in watchful category (one step away from being classified in the NPLs category) increased to Shs. 1.7 trillion, from Shs. 1.44 trillion, which could point to further increases in NPLs in the future.[4]

The commercial real estate (CRE) segment has faced unique risks. A survey that covered banks and the borrowers in the CRE market undertaken by BoU in August 2016 revealed that the occupancy rate for commercial real estate (high end apartments, office blocks and shopping arcades) has reduced over the past 5 years. Between 2012 and 2016, the average occupancy rate reduced from 85 percent in 2012 to 52 percent in 2014, which affected annual returns and loan repayments.

Salient features of the Draft guidance to banks on non-performing loans

"NPLs" is used as an acronym. However, in technical terms, a comprehensive strategy should cover aspects of all non-performing exposures (NPEs), foreclosed assets, and performing exposures that have a high risk of turning to non-performing status (called "watch-list" exposures) and performing forborne assets. This trend follows the cycle of NPL management such as supervisory expectations on NPL strategies; NPL governance and operations; forbearance treatments; NPL recognition and assessment; NPL provisioning and write-off; and collateral valuations of both movable and immovable assets.

A robust NPL strategy should establish strategic objectives for high NPL banks to achieve NPL reduction targets within a practical timeline, while cognizant of the fact that addressing NPLs requires a medium term focus and other interventions such as loan restructuring, foreclosures, and insolvency procedures such as administration and winding up, depending on the particular facts and circumstances of each case scenario. Therefore, an adequate strategy should outline the bank's approach and objectives regarding the effective management (maximisation of loan recoveries) and ultimate reduction of NPL stocks in a clear, credible and feasible manner for each relevant portfolio.

According to the European Central Bank, the following steps are considered to be the core matrices/indices governing the development and implementation of an NPL strategy:

(a) Assessing the operating environment, including internal NPL capabilities, and external conditions impacting NPL workout and capital implications of the NPL strategy.

[4] Bank of Uganda Monetary Policy Report, June 2017.

(b) Developing the NPL strategy, including targets in terms of development of operational capabilities (qualitative) and projected NPL reductions (quantitative) over the short, medium and long-term.
(c) Implementing the operational plan, including any necessary changes in the organizational structure of the bank.
(d) Fully embedding/incorporating the NPL strategy into the management processes of the bank, also including a regular review, assessment and independent monitoring. The NPL strategy needs to be fully embedded in the risk management framework and relevant departments of the banks.

NPL strategy benchmarks

There is need to strengthen compliance with the early warning and identification of debt distress mechanisms. Detection and resolution of distress in its early stages helps preserving the value that can be recovered by the banks, while minimizing overall deadweight costs to the economy. In this regard, efficient early warning and detection tools/mechanisms enable debtors, notably the small and medium enterprises that characterize the majority portion of Ugandan corporate debtors, to test regularly their financial soundness and a timely recourse to adequate intervention instruments to deal with debt distress. It is vital for banks to support this process in order to maximize returns and reduce their NPL portfolios.

Both the banks and the Central Bank should strengthen their operational capacity in terms of NPL monitoring, assessment and evaluation, tools, data quality, IT/automation, staff/expertise, decision making, internal policies, and any other relevant area. There is need for thorough self-assessment to determine strengths, significant gaps and areas of improvement required for them to reach their NPL reduction targets. The resulting internal reports should be shared with top management bodies and supervisory teams.

There is need to involve external stakeholders in NPL reduction strategies through assessing the expectations of credit rating agencies, credit reference bureaus, market analysts, researchers, and clients with regard to acceptable NPL levels and coverage. This will help to determine the extent to which, and the pace at which high NPL banks should reduce their portfolios. This will help to improve public confidence in the NPL strategies and the banking sector as a whole.

It is also important to acknowledge that there cannot be a one-size-fits-all policy/strategy for all the banks in the sector. This, it is imperative to have supervisory flexibility that is cognizant to the size, complexity and interconnectedness of various banks. However, an adequate NPL strategy should encompass minimum standards, such as time-bound quantitative NPL targets supported by a corresponding comprehensive, relevant and practical operational plan. It should be based on a self-assessment and an existing and futuristic analysis of feasible NPL strategy implementation options. The NPL strategy, including the operational plan, should be approved by the banks' Board and reviewed at least annually. The specific recovery targets should be reviewed, assessed and reported monthly. Any deviations from the strategy should be highlighted and reported to the management body and the Central Bank in a timely manner with appropriate remediation actions/fallback options to be put in place.

As far as the NPL strategy implementation plans are concerned, banks need to strengthen the inter-mix of recovery options by ensuring that their NPL strategies include not just a single strategic option but rather combinations of strategies to best achieve their objectives/outcomes over the short, medium and long term, and an assessment of which options are advantageous for different portfolio segments. The banks should also review options which might not be achievable immediately, such as lack of an immediate NPL investor demand. Operational plans also need to foresee market changes, such as the need for enhancing the quality of NPL exposure data in order to prepare for future investor transactions.

There is need to intensify supervisory reporting requirements for high NPL banks so that it becomes an obligation to report their NPL strategy, its assessment, performance, and their operational plans. Furthermore, the banks should be directed to have a suitable NPL operating model based on dedicated NPL workout units (WUs) which are separate from units responsible for loan origination and approval. The major rationale rationales for this separation are the elimination of potential conflicts of interest and the use of dedicated NPL expertise from staff through to management level. In accordance with the ECB guidelines, it is practical for BoU to direct high NPL banks to implement separate and dedicated NPL WUs, ideally starting from the moment of early arrears but latest by the NPL classification of an exposure. This separation of duties approach should encompass not only client relationship activities such as negotiation of forbearance solutions with clients, but also the decision-making process.

One of the major challenges in Uganda's banking industry is deficiencies in the approaches employed by
banks in relation to the completeness and accuracy of immovable property valuation. Therefore, there is need for a comprehensive review and assessment of policies, procedures and disclosures which banks should adopt when valuing immovable property held as collateral for NPLs. As noted by the ECB, in the past, banks have often failed to obtain periodic financial information from borrowers or updated real estate valuations in order to assess the loan quality on their balance sheets and the adequacy of the collateral held against the loans. Consequently, the banks failed to recognize early warning indicators that asset quality was declining, which resulted in an understatement of balance sheet loan loss provisions. This is a problem shared by Uganda's banking industry. For instance, in the five years to June 2016, there was a strong rise in lending to the real estate sector, which accounted for 25 percent of total loans in 2016. In addition, NPLs to the real estate sector. The problem is made worse by unprofessional conduct by some valuers, and corruption at the land registry. Many banks have reported that they have challenges related to overvaluation of real estate by property valuers. In a number of incidents, some banks were unable to realize full loan recovery after foreclosure, because the appraised value was far higher than the market value. To overcome such challenges, banks must be required to monitor and review the valuations performed by appraisers on a regular basis; develop and implement a robust internal quality assurance policy and procedures for challenging valuations completed internally and externally; ensure that any knowledge gaps are identified during the review process and remediation plans are implemented in a timely manner to close any such gaps; and all these policies and procedures should be fully aligned with the banks' risk appetite statements.

Recommendations and conclusion

Uganda has made major strides in reforming the insolvency legal framework by enacting the Insolvency Act of 2011 that among other provisions, governs aspects of debt restructuring and corporate rescue procedures. However, further policy measures might be needed to address debt overhang and NPLs. Some of these policies may take the form of supervisory innovations and incentives for bank balance sheet clean-up such as;

(a) Enforcement of conservative asset valuation thus encouraging banks to disclose nonperforming debt, and possibly prompting higher capital and provisioning to deal with increased write-off of NPLs.
(b) Dedicated debt resolution vehicles, and development/structuring of secondary markets for impaired assets trading may be needed to ensure that improved insolvency frameworks translate into an accelerated process of balance sheet clean up for the banks.
(c) Tax treatment of provisions and loan write offs need to be reformed and aligned in a way not to discourage NPL write off and underwriting.
(d) There is need to address holistic interventions through adequate social safety nets to ensure minimum living standards for debtors after insolvency or foreclosure to mitigate the negative socio-economic consequences of potential increases in insolvencies and consumer bankruptcies which may result from the process of banks' balance sheet clean up.
(e) There is need to train other stakeholders such as Judges, financial sector regulators, lawyers, insurers, journalists etc on issues relating to NPL strategy and management to ensure coordinated approaches in NPL mitigation and reduction.
(f) There is need for further financial literacy for both individual and corporate borrowers and consumers in order to enhance public knowledge and information in matters of sustainable debt, responsible borrowing and lending. This will go a long way in reducing NPLs, and enhancing proper utilization of the bankruptcy and insolvency tools available to distressed debtors.

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