



CSBAG BUDGET NEWS BRIEF

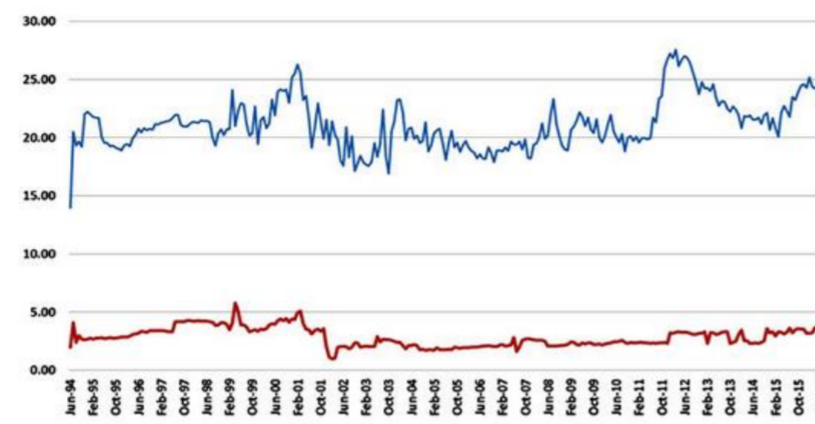


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Advocating for a People Centered Budget that Dignifies Humanity



Banks risk scoring own-goal



Interest rates spread in Uganda 1994 - 2016

by the banks and defended by their regulator, the mighty BOU. To me there an apparent 'principal-agent problem' in Uganda's banking sector. The P-A problem arises when the agent (a manager) cheats the principal (the owner of an asset) simply because, owing to information problems, the principal has difficulty to monitor what the agent does.

In the case of banks, savers (and owners of equity) are the principals while the banks are the agents. It goes without saying that savers find it difficult to monitor the banks to verify that the banks are not solely furthering their own objectives by disregarding those of the savers.

Savings crisis: I will use a simple example. Suppose, I opened a savings account in bank X and deposited my hard-earned Shs.1 million on October 12, 2015. The bank offered me an interest (profit) of 3% per year. I went back to the bank on Wednesday October 12, 2016 and the bank handed me the Shs.1 million I 'saved' with a profit of Shs.30,000. In the meantime, my sister went to the same bank and borrowed the Shs.1 million I had saved with them. She was asked to pay 25% per year to use it in her small business. So on the same day, as I went to pick my savings, my sister also went back to return the Shs.1 million. The bank charged her Shs.250,000 and picked Shs.30,000 of the Shs.250,000 and handed it to me as my share. That is how the situation has been, and still is, in Uganda.

Actually, I formulated this simple example on the assumption that the inflation rate stayed constant throughout the year. This is rarely the case. Inflation in Uganda is volatile. When it increases, the bank reserves the right to raise the interest that my sister was supposed to pay (for my million shillings), say to Shs. 280,000, but the same bank is under no obligation to increase my own interest from Shs.30,000. If you observe keenly, the lending rate curve in the graph is more volatile than the savings rate curve.

Banks in Uganda are quick to insulate themselves against inflation but they don't mind about their savers. Now tell me, how would you expect a rational person with basic financial knowledge to save in Ugandan banks? No wonder Uganda is facing a savings crisis. People simply do not save. The few who are saving, have found other 'sensible' ways - constructing apartments and other real estates (dead capital), buying land or cattle (tied capital), or converting their money into dollars which they keep under their mattresses (smart but economically inefficient banking).

Moral hazard: For years I have been writing in these pages that banks ought to know better a few generic facts that sustain an economy and

by extension the banks themselves. First, a country needs cheap capital to develop. Second, the interest rate a bank charges may itself affect the riskiness of a pool of loans by either sorting potential borrowers (adverse selection) or affecting the actions of borrowers (moral hazard) as we have already seen.

Third, higher collateral requirements (increasing the liability of the borrower if the project fails) lead borrowers to finance smaller projects with higher risk (building apartments and shopping malls, buying trucks to speculate on newly found oil, wedding loans, car mortgages etc.), instead of investing in manufacturing, agro-processing, agriculture production, and tourism.

Fourth, banks in Uganda are making abnormal profits. In economics abnormal profits is defined as unfair profits often made by monopolies and oligopolies. Competitive firms make 'normal profits' or 'reasonable profits'. Abnormal profits are made by businesses that can set prices above their marginal cost (in the case of a bank the cost they incur to serve one additional client).

Ten years ago, someone raised a similar complaint and the BOU Governor, Emmanuel Tumusiime-Mutebile retorted, "What is wrong with banks making money?" I asked him, "What is wrong with banks making money reasonably?" Back then, my question sounded rhetorical to Mutebile and many other Ugandans. Today, I am sure Mutebile and many bank managers have realized there was always some sense of reality in my question. Following Kenya's (unwise?) move to cap interest rates, bankers in Uganda are in a panicky mode. The other day I saw BOU and the bank managers trying to persuade Ugandan MPs not to go the Kenyan way. Banks have finally agreed to follow the base rate (the CBR) set by the BOU.

Incentive to cheat: Yet I am hesitant to blame the banks. There is every incentive in this country by market players to flout the rules of the game and make the money Mutebile wants them to make. Banks know it is damn difficult to cost-effectively monitor them. They are more familiar with the industry. They have more information than their regulator. I have no doubt that BOU gets most of its information about the performance of banks from the banks themselves. At the same time, it doesn't require one to be a genius to know that by continuing to pursue maximum profits by colluding to charge high interest rates, banks in Uganda might be bordering the risk their Kenyan counterparts sought. And this is what I refer to as an 'own goal'. Soon it will get in.

Conventionally, banks are advised to identify borrowers who are more likely to repay in order to get a higher expected return. The interest rate which an individual is willing to pay should act as the main screening device to identify "good borrowers". Everywhere else, except in Uganda and Africa in general, bankers know that high interest rates increase the average "riskiness" of those who borrow. Secondly they also know that higher interest rates induce firms to undertake projects with lower probabilities of success but higher payoffs when successful.

So my question is simple: Why don't Ugandan banks reward 'good' borrowers by lending them at lower interest rates, which in turn would induce them to undertake safer projects to create a win-win situation? Is this rocket science?

This article was originally published in [the Sunrise](#) on 14th October 2016 authored by Ramathan Goobi

OUR WEEK IN PICTURES



CSBAG this week met with the Uganda Banker's Association to discuss the challenges around cost of credit in Uganda. ©|CSBAG 2016



CSBAG exhibition during the just concluded 3rd Women's Week. Increasing citizens' access to simplified, analyzed budget information is one of CSBAG core functions. ©|CSBAG 2016



CSBAG was part of the team that met with Ministry of Health to submit CSO input into the fiscal decentralization grant guidelines. Others present included UIDN and the White Ribbon alliance among others.



Together with Agriculture Private Sector Organisations, Feed the Future Uganda Enabling Environment for Agriculture Activity, CSBAG developed a roadmap for FY 2017/18 budget advocacy. ©|CSBAG 2016