CENTRAL BANKING
MUBS

18th October 2024

Role of central Banks

- Controlling Interest Rates
- Maintaining price stability
- Regulating Banks
- Managing Currency
- Providing Emergency Lending
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- Maintaining Financial Stability:
- Promoting Payment Systems:
- Banker to the government and banks:
- Financial Inclusion:
- *However, increasing demands on central banks to address broader societal challenges like climate change or income inequality are prompting discussions about the potential trade-offs involved in expanding their mandates.*
- *Northern Rock - Example*

Monetary Policy

- The overarching objective of most central banks is to maintain price stability. – Controlling inflation
- Controlling inflation is important because it helps to stabilize the economy, reduce uncertainty, and maintain the value of money.
- Unexpected inflation can lead to inequitable wealth transfers.
- Inflation can reduce the information content of market prices
- High inflation can lead to economic booms and busts
- High inflation can erode the purchasing power of money

Central banks use three primary tools to manage monetary policy:

- Open market operations: Buying or selling government bonds to increase or decrease the amount of money in circulation.
- The central bank's policy rate: Setting the official interest rate at which it lends money to commercial banks, influencing short and long-term interest rates.
- Reserve requirements: Setting the minimum amount of reserves commercial banks are required to hold, affecting their lending capacity.

Monetary policy …

Monetary policy, while a powerful tool for managing an economy, faces several challenges:

- Lack of liquid government bond markets: This limits the central bank's ability to implement open market operations, a key tool for adjusting liquidity.

- Rapidly changing economy: This makes it difficult to determine the "neutral rate" of interest, which is the rate that neither stimulates nor hinders economic growth.

- Rapid financial innovation: This can create confusion about the meaning of monetary aggregates and make it harder to understand the relationship between money supply and economic activity.

- Poor past track record: A history of ineffective inflation control can make it difficult for the central bank to gain credibility and for its pronouncements to be taken seriously by the market.

- Lack of independence: If the central bank is not truly independent of the government, it might be pressured to implement policies that are politically motivated, rather than those that are best for the economy.

- Difficulty in Identifying the Source of Inflation
- Example 2 and three

Challenges Central Banks face

- Huge development financing needs: Many countries need significant funding for development, which can strain the central bank's ability to manage monetary policy.

- Persistent current account deficits and exchange rate pressures

- Decreasing international reserve buffers
- High public debt:
- Financial sector risk management: With the rise of large Pan-African banks, there are concerns about weaker oversight and regulatory asymmetry, which requires careful management.
- Financial innovations: Mobile money services and crypto assets pose unique challenges for central banks as they need to adapt their digital capabilities and manage risks.
- Inflation: The war in Ukraine has caused a major supply shock pushing up inflation. Central banks have responded with tighter monetary policy, which has helped stabilize inflation expectations and curb price increases.
- Fragmentation: The war has further fueled global economic fragmentation, leading to trade restrictions and higher transaction costs. This compounds existing challenges, creating pressure on central banks to expand their mandates to address broader societal issues.

- Central Bank Independence: Calls for premature interest rate cuts and political interference threaten the hard-earned credibility of central banks and their independence. The literature highlights the need to resist these pressures and maintain the foundation of independent central banking

Banking Regulation

1 Legal and Regulatory Framework:

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A Bank of Uganda Act:

B Financial Institutions Act (FIA) of 2004 (amended):

- Scope: Provides the legal basis for licensing, regulating, and supervising commercial banks and credit institutions.
- -Key Elements:
  - Licensing requirements
  - Capital adequacy
  - Corporate governance
  - Risk management
  - Consumer protection
  - Disclosure and reporting

C Microfinance Deposit-Taking Institutions Act (2003):

- Purpose: Regulates microfinance institutions that take deposits from the public.
- Supervision: Falls under the purview of the BoU.

2 Licensing of Banks:

Application Process: Licensing: Issuance

3 Prudential Regulation and Supervision:

• A Capital Adequacy:

- Requirement: Banks must maintain a minimum capital level to absorb potential losses.
- Standard: The BoU follows international best practices, such as the Basel II and Basel III frameworks, to set capital adequacy ratios.

• B Liquidity Management:

- Objective: Ensure banks have sufficient liquid assets to meet short-term obligations.
- Ratios: Measures such as the Liquidity Coverage Ratio (LCR) are used.

• C Asset Quality:

- Monitoring: Regular assessments of asset quality to identify non-performing loans (NPLs) and provisioning requirements.
- Standards: Guidelines on classification and provisioning for bad debts.

4 Corporate Governance:

• Board and Management:

- Requirements: The BoU mandates fit-and-proper criteria for board members and senior managers to ensure competent and reliable leadership.
- Internal Controls:
  - Objective: Robust internal controls and audit functions to manage risks effectively.
- -Processes: Policies and procedures to ensure sound operational practices and compliance.

5 Risk Management:

• Comprehensive Framework:

- Components: Includes credit risk, market risk, operational risk, and other financial and non-financial risks.
- Requirements: Banks are required to have risk management systems and procedures in place.
- Stress Testing:
  - Purpose: Identify the resilience of banks under different stress scenarios.
- Implementation: Regular stress testing exercises to evaluate potential vulnerabilities.

6 Consumer Protection:

• Financial Consumer Protection Guidelines:

- Focus Areas: Transparency, fair treatment, complaint handling, and redress mechanisms.
- Education: Financial literacy programs to educate consumers on banking products and services.
- Disclosure Requirements:
    - o Mandate: Banks must provide clear and accurate information to consumers regarding products, services, fees, and charges.

7 Supervisory Practices:

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- On-Site Inspections:
    - o Frequency: Regular and ad-hoc inspections to assess compliance and operational practices.
    - o Scope: Covers various aspects of a bank's operations including risk management, internal controls, and financial health.
- Off-Site Monitoring:
    - o Tools: Collection and analysis of periodic reports submitted by banks.
    - o Objectives: Continuous oversight and early identification of potential risks.
- Remedial Actions:
    - o Enforcement: The BoU has the authority to take corrective measures such as issuing directives, imposing penalties, or in severe cases, taking over management.

8 Technological Innovation and Cybersecurity:

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• **Digital Banking:**

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- -Regulation: Guidelines for digital banking activities including internet banking and mobile banking to protect consumers and ensure security.
- -Innovation: Promotion of fintech and financial inclusion through supportive regulatory frameworks.

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• **Cybersecurity:**

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- Standards: Specific guidelines for protecting banks from cyber threats and ensuring data security.
- Monitoring: Regular audits and assessments to ensure compliance with cybersecurity standards.

9 Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT):

• Framework:

- Law: The Anti-Money Laundering Act.
- Regulator: The Financial Intelligence Authority (FIA) in collaboration with the BoU.
- Compliance Requirements:
- Customer Due Diligence (CDD): Mandatory KYC (Know Your Customer) procedures.
- Reporting: Obligations to report suspicious transactions to the FIA.
- Training: Regular training and awareness programs for bank staff.