BANK OF MAURITIUS

Annual Report on Banking Supervision 2004

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1. Overview of Supervisory Developments

INTRODUCTION

The role of bank supervisors is constantly being stretched in the wake of rapid changes taking place in the financial world. As watchdogs of the soundness of national financial systems, central banks need to be alert to all developments in the field of supervision so as to take timely measures. This section aims at giving a brief overview of recent developments that took place in the supervisory field both locally and internationally.

LOCAL DEVELOPMENTS

Basel II Accord

The New Basel Accord is set to revolutionise the whole system of measuring, managing and mitigating risks. The Accord calls for increased powers of bank supervisors so that they may intervene in a timely manner when a bank's capital shows the least signs of impairment. Banks will have to put up sophisticated systems to manage their risks. In brief, the objective of the New Accord is to enable banks to assess their risk profile in a more accurate manner than under the present Accord. The Bank of Mauritius has set up a Working Group within the Supervision Department to establish the groundwork for Basel II implementation.

Given the intricacies of the New Accord, the Bank has intensified its staff training programmes. The Bank has enrolled all its supervision staff on a two-year e-learning course with the Financial Stability Institute (FSI) Connect. The FSI Connect consists of a comprehensive set of online tutorials ranging from banking supervision to specialised topics.

Guidance Notes on Anti-Money Laundering and Combating the Financing of Terrorism

The Bank of Mauritius issued new Guidance Notes on Anti-Money Laundering and Combating the Financing of Terrorism (Guidance Notes) in November 2003. The Guidance Notes are binding on banks and cash dealers as from 5 January 2004.

The Guidance Notes set out the broad parameters which banks and cash dealers should respect in order to ward off money laundering and terrorism financing risks. They lay down the minimum standards expected of all banks and cash dealers operating in the local jurisdiction. The Bank of Mauritius monitors adherence to these Guidance Notes. The Guidance Notes have been issued under the authority of the Miscellaneous Provisions (Anti-Money Laundering) Act 2003.

Banking Committee

The Banking Committee, chaired by the Governor and including the Chief Executives of Category 1 banks and senior management of the Bank of Mauritius meets on a quarterly basis at the Bank. One of the objectives of the committee is to provide information and views on the functioning of the wider financial sector with the aim of ensuring that financial institutions are effectively meeting the demands placed on them. The Banking Committee has set up a sub-committee of compliance officers of Category 1 banks. The committee of compliance officers, chaired by the Assistant Director – Legal of the Bank of Mauritius, meets once per month to discuss and share experiences on issues relating to money laundering and to increase awareness of the anti-money laundering legislation and the Guidance Notes on Anti-Money Laundering.

Report on Observance of Standards and Codes

In the context of the IMF – World Bank Survey on observance of standards and codes (ROSC), the World Bank assessed the insolvency and creditor rights systems in Mauritius. The assessment was carried out by reviewing the applicable legislation and analysing the information gathered through interviews conducted by the World Bank team. Five commercial banks participated in the survey by sharing their experiences in credit risk management and corporate recovery practices with respect to the resolution and collection of non-performing loans.

The main finding of the assessment is that although systems for credit protection and credit

recovery are modern in Mauritius, the court proceedings prevent the secured creditors from recovering their dues speedily. This problem of recovery is amplified by the absence of liquid markets for freehold properties.

The assessment team made some recommendations; the most important of which are:

- Creditor rights and enforcement areas need to be refined in order to maximise the values of assets sold under seizure;
- Enforcement procedures should be rationalised to speed up debt recovery;
- A credit information bureau should be set up;
- Credit ratings agencies should be developed; and
- Informal rules and a guide for addressing credit risk management policies should be developed.

One of the recurrent complaints of banks relates to the protracted delay in the liquidation of securities taken against credits that have become impaired. The final course of action available to banks in Mauritius is to foreclose the assets and dispose of them through sale by levy. Unfortunately, the sale by levy is an unduly lengthy process and the proceeds realised usually fall short of the market values of the assets. The authorities have responded to this concern of banks. The Government has set up a Steering Committee on Insolvency and Creditor Rights in January 2003 to look into the existing legislation with a view to streamlining the whole procedure of debt recoveries, taking into consideration the recommendations of the ROSC findings.

Credit Information Bureau

A financial institution granting a loan to a borrower exposes itself to credit risk, that is, the risk that the counterparty may default. The lender needs to appraise the application for loan prudently to minimise credit risk on the basis of up-to-date and accurate information on the creditworthiness of the borrower. To meet this need more fully, a credit information bureau which will collect, consolidate, store and disseminate credit information on borrowers is being set up. The Bank of Mauritius is steering this project which is chalked out for implementation in 2005.

Section 52 of the Bank of Mauritius Act 2004 provides for the establishment of a Credit Information Bureau for the purpose of ensuring a sound credit information system in Mauritius. The credit information bureau will:

- maintain a database on borrowers and guarantors;
- collect, consolidate and collate trade, credit and financial information on borrowers;
- store the information so collected; and
- discuss with, or allow access to, such institutions as it may approve, the information so collected, subject to such conditions as it may impose.

Banking Legislation

The Bank of Mauritius Act 1966 and Banking Act 1988 have been modernised with a view to removing certain limitations and bringing them to international norms. The new Bank of Mauritius Act endows the central bank with more independence and the new Banking Act provides the bank supervisor with an adequate legal framework to carry out his functions more effectively. The Bank of Mauritius Act 2004 and certain provisions of the Banking Act 2004 were proclaimed on 4 November 2004.

The new Banking Act substantially reinforces the powers of supervisors with regard to corporate governance in banks and with respect to its dealing with distressed banks.

On corporate governance in banks, the Act:

- provides that the Bank may require a bank to undergo an independent assessment of its creditworthiness or financial stability by a person or organisation nominated or approved by the central bank;
- requires every bank and non-bank financial institution to establish an audit committee whose functions are clearly laid down; and
- provides the Bank with a host of remedial measures when an examination leads it to believe that any director or senior officer or employee of a financial institution is not a fit and proper person or when any of those officers have engaged in unsafe or unsound practices in conducting its business in a manner detrimental to the interests of its depositors. The Bank may, *inter alia*, issue an order to suspend from office any of those officers responsible for such actions or violations.

The Banking Act 2004 endows the supervisors with legal powers to deal with distressed banks in a more expeditious manner.

The new Act

- empowers the Board of the Bank to appoint any person as receiver to take possession of a financial institution whose viability is threatened, giving the receiver wide ranging powers to protect the interests of different stakeholders in a financial institution; and
- authorises the central bank, where it deems it necessary to protect the assets of a financial institution, to appoint a conservator which may be the central bank or any other person directed by the central bank, to rehabilitate or reorganise the financial institution so that it may be returned to management eventually.

The appointment of a conservator would avoid all the usual difficulties arising from the revocation of a licence.

The new Act provides for an integration of the onshore and offshore sectors. There will be a single banking licence. Accordingly, all banks will be free to conduct business denominated in both the local currency and foreign currencies. The current distinction between Category 1 and Category 2 banks will thus be eliminated.

The new Act provides for the appointment of an Ombudsperson for Banks who will be solely responsible to deal with complaints between banks, non-bank deposit taking institutions, cash dealers and their customers. Such complaints are presently dealt with by the Supervision Department of the Bank.

Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT)

On the regional front, the awareness of risks of financial abuse and the vulnerability of financial systems to money launderers and terrorists abusing the financial structures, is being raised constantly.

In August 2004, Mauritius hosted the 4th Meeting of the Council of Ministers and the 8th Meeting of the Task Force of Senior Officials of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG). The ESAAMLG, a Financial Action Task Force (FATF)-style body grouping 14 countries of the region, was launched at a meeting of Ministers and high-level representatives in Arusha, Tanzania in August 1999. The aim of the ESAAMLG is to combat money laundering and terrorism financing by implementing the FATF Forty Recommendations. This includes co-ordinating with other international organisations concerned with combating money laundering, studying emerging regional typologies, developing institutional and human resource capacities to deal with these issues and coordinating technical assistance where necessary.

Offshore Group of Banking Supervisors (OGBS)

The Bank of Mauritius hosted the Offshore Group of Banking Supervisors' Plenary meeting between 21 and 23 July 2003. The meeting was held at Le Meridien, Mauritius. Besides the members of the OGBS, the meeting was attended by representatives of the FATF, the International Monetary Fund (IMF) and the Basel Committee of Banking Supervision (BCBS).

Several international issues were discussed including:

- The Revised FATF Forty Recommendations on money laundering;
- The FATF Eight Special Recommendations on combating the financing of terrorism; and
- The Basel Committee's paper on Customer Due Diligence (CDD) for banks.

The members shared their experience of the IMF Offshore Financial Centres/Financial Sector Assessment Programmes. The Offshore Group's Statement of Best Practice on Trust and Company Service Providers was also discussed at the meeting.

Corporate Governance

A Code on Corporate Governance (Code) in Mauritius, initiated in September 2001 by the Ministry of Economic Development, Financial Services and Corporate Affairs, was issued in October 2003.

The Code has taken on board requirements set out in the Bank of Mauritius Guideline on Corporate Governance and Guideline on Public Disclosure of Information. The Code also provides additional

recommendations. The Bank of Mauritius, as regulator, will be responsible for the monitoring of the application of those principles by all the institutions falling under its purview. The Code shall apply to business enterprises including banks and non-bank financial institutions.

Compliance with the Code is a requirement as from the reporting year ending 30 June 2005. Financial institutions are required to comply with the Code as from July 2004. In case of non-compliance, companies will have to disclose and explain the reasons thereof in their annual reports.

Memoranda of Understanding (MoUs)

Mauritius underwent a Financial Sector Assessment Programme (FSAP) in late 2002. The FSAP Report was issued towards mid-2003. The Mauritian authorities published the findings of the FSAP. In the light of FSAP recommendations and with a view to establishing a good working relationship between banking supervisors as laid down in the Basel Committee's Concordat and the Core Principles for Effective Supervision, the Bank of Mauritius entered into two further MoUs, one with the State Bank of Pakistan and the other with Banco de Moçambique, effective as from 26 January 2004 and 15 March 2004, respectively. The MoUs will ensure collaboration in the exchange of supervisory information and strengthen the principle of consolidated supervision.

Audit Command Language

The gathering of information held on computers in banks and other financial institutions requires sophisticated skills and techniques. External auditors and supervisors are increasingly making use of Computer Assisted Auditing Techniques as an analytical tool in obtaining assurance of their audit work. One such audit software, the Audit Command Language (ACL) has proved to be a useful tool in assisting bank supervisors and external auditors in their audit work. The software is able to collect data and information held on the disparate computer systems of banks and other financial organisations and carries out the analysis through its own in-built menus and programmed software. Following a presentation by Mr J. C. Hillion from Commission Bancaire of Banque de France on computer auditing and the merits of ACL to the Bank of Mauritius, the use of ACL was adopted by the Internal Audit Department and the Supervision Department of the Bank.

Financial Institutions

The Bank pursues a selective licensing policy for banks. As at 30 June 2004, 46 financial institutions were regulated by the Bank.

Banque Des Mascareignes Ltée, incorporated in Mauritius by Financière Océor of the Groupe Caisse D'Épargne from France was granted, with effect from 8 January 2004, a Category 1 Banking Licence under section 3 of the Banking Act 1988. It started its banking operations on 14 June 2004.

Banque Internationale des Mascareignes Ltée, which was operating under a Category 2 banking licence since 21 January 1991, changed its name to Mascareignes International Bank Ltd.

Island Leasing Co Ltd surrendered its authorisation to transact deposit-taking business on 22 September 2003. On 26 April 2004, G M L Leasing Ltd of Groupe Mon Loisir which was granted authorisation under section 13A of the Banking Act 1988 to carry on deposit-taking business, subsequently changed its name to Capital Leasing Ltd on 29 June 2004.

Shibani Finance Co Ltd which started operating as a money changer in July 1997, was authorised to carry on the business of a Foreign Exchange Dealer as from 8 January 2004.

Non-Compliance with Section 42 of Banking Act 1988

On 7 June 2004, the Bank of Mauritius issued a communiqué to the public respecting the closure of the places of business of the Mauritius Commercial Bank Ltd (MCB) before the end of its approved operating hours. This was in breach of section 42 of the Banking Act 1988. The Bank of Mauritius required the MCB to place a non-interest bearing deposit of Rs500 million with it for a period of 14 days with effect from 7 June 2004, for MCB's failure to respect its normal opening hours to the public.

Card Fraud Forum

The Mauritius Fraud Forum which was set up in

February 2003 in order to combat fraudulent transactions involving credit cards, issued a brochure 'Card Watch' early in 2004. The brochure sets out security guidelines to be observed during the lifetime of credit/debit cards and protection of privacy while shopping online. While credit card crime rate in Mauritius is estimated as still being negligible, this measure will serve as a safeguard to card users.

INTERNATIONAL DEVELOPMENTS

New Basel Accord

On 18 August 2003, BCBS published a report entitled *'High level principles for the cross-border implementation of the New Accord'*. This interim publication highlights the work of the Accord Implementation Group in developing a set of principles to facilitate closer practical cooperation and information exchange among supervisors and recommends that home supervisors, together with the relevant host supervisors, organise practical plans of cooperation prior to the implementation date. Cross-border responsibilities of home and host country supervisors continue to apply in the final version of Basel II.

From 10 to 11 October 2003, the members of the BCBS met in Madrid to decide on the responses to public comments received over its third consultative paper (CP3) on the New Basel Capital Accord.

On 24 June 2004, BCBS issued its final document titled ***'International Convergence of Capital Measurement and Capital Standards – A Revised Framework'*** on the New Basel Accord after reaching a consensus on some of the pending issues of Basel II proposals. The new framework will serve as a basis for national rule-making and enable banks to be prepared for Basel II implementation. As regards implementation targets, the Committee is of the view that standardised and foundation approaches will be implemented as from year-end 2006 while the most advanced approaches demand additional time for supervisors and the industry to develop a consistent approach for implementation. Thus, the advanced approaches will require one additional year of parallel run and impact analysis and therefore will be implemented at the end of 2007. Non-member countries have the option to proceed at their own pace based on their own priorities.

Financial Action Task Force

BCBS, the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO) highlight initiatives taken by the banking, insurance and securities sectors to combat money laundering and the financing of terrorism.

AML/CFT measures and standards need to be reasonably consistent for institutions offering same services in order to avoid the tendency for criminal funds to flow to those institutions in sectors operating under less stringent standards. However, variations in patterns of relationships between institutions and customers in each sector require AML/CFT requirements to be tailored to the circumstances of the relationship.

Recently the FATF has worked in collaboration with the IMF and the World Bank to develop a *'Methodology for assessing compliance with the FATF 40 Recommendations and the FATF 8 Special Recommendations – Anti-Money Laundering / Combating Terrorist Financing Methodology 2004'* (the Methodology). The FATF endorsed the Methodology at its Plenary meeting in Paris on 23 and 24 February 2004. It was subsequently approved by the Executive Boards of the IMF and the World Bank in March 2004 and endorsed by a series of bodies. The Methodology for assessing compliance with the revised Forty Recommendations on Money Laundering and the Eight Special Recommendations on Combating the Financing of Terrorism has been designed to guide the assessment of a country's compliance with the international AML/CFT standards. This new Methodology has improved mainly for the following reasons:

- It follows the Forty Recommendations more closely;
- Duplications have been eliminated;
- Ratings have been classified;
- Distinctions are made between essential criteria and additional non-mandatory elements; and
- Other enforceable means in addition to laws and regulations have been recognised.

FATF announced that, due to substantial reforms made, Ukraine and Egypt have been removed from its list of Non-Cooperative Countries and Territories (NCCTs) in February 2004. Guatemala was also delisted from the NCCTs list on 2 July 2004 after

addressing the deficiencies identified by the FATF. The six countries still designated as NCCTs are Cook Islands, Indonesia, Myanmar, Nauru, Nigeria and Philippines since they do not meet international standards on money laundering.

As FATF proves itself as the premier international body charged with safeguarding the global financial system against money laundering and terrorism financing, its 33 members have reaffirmed their commitment to the FATF and exceptionally renewed its mandate for another 8 years on 14 May 2004. This renewal, which has occurred every five years till now, runs from September 2004 to December 2012 and is a sign of confidence in the achievements of the FATF since inception in 1989. FATF's efforts on AML/CFT can be found at http://www.fatf-gafi.org.

The Compliance Function in Banks

Over the past few years, compliance risk management has assumed greater importance and banking supervisors must be satisfied that effective compliance policies and procedures are followed. To this effect, the BCBS issued on 27 October 2003, a consultative paper on the compliance function in banking organisations.

The purpose of the compliance function is to assist banks in managing their compliance risk which can be defined as the risk of legal or regulatory sanctions, financial loss, or loss of reputation a bank may suffer as a result of failure to comply with laws, rules and standards.

Bank Supervision Application

The Bank Supervision Application (BSA) project has now materialised into the BSA solution through the efforts of the Bank of Mozambique, the South African Reserve Bank and the Banking Supervision and Information Technology in the East and Southern Africa Banking Supervisors Group – ESAF. The team involved ESAF, Southern African Development Community (SADC) and Information and Communications Technology (ICT) personnel and the participation of 12 central banks. This ICT solution aims at enhancing supervision of banks and non-bank financial institutions through the efficient submission of data and hence, an improved supervision function in the ESAF/SADC central banks, in line with ESAF's best practice strategies. BSA allows banks to easily produce financial reports.

CONCLUDING REMARKS

The most challenging current issue for supervisors, both locally and internationally, is the implementation of the Basel II Accord. The Accord's second pillar requires that the powers of supervisors be substantially enhanced given the fundamental role they have to play in its implementation. The revision of the Banking Act is timely in this respect. The setting up of a credit information bureau will also be instrumental towards a more effective measurement and management of credit risks, in line with the objectives of Basel II.

2. A Review of the Performance of Banks

2.1 INTRODUCTION

As at 30 June 2004, the banking sector comprised Category 1 and Category 2 banks. Under the provisions of the New Banking Act, there will be no distinction between the two categories of banks as all banking business will be undertaken under a single banking licence. A review of the performance of the banking sector for the year ended 30 June 2004 is given below.

2.1.1 CATEGORY 1 BANKING SECTOR

The Category 1 banking sector comprises eleven banks. Seven Category 1 banks are locally incorporated. Of these, two are foreign owned. The remaining four Category 1 banks operate as branches of foreign banks. Banque des Mascareignes Ltée was granted a Category 1 Banking Licence on 8 January 2004. It was authorised under section 3(1) of the Foreign Exchange Dealers Act 1995 to carry on the business of foreign exchange dealer in Mauritius on 31 March 2004. Banque des Mascareignes Ltée started operations on 14 June 2004.

As at 30 June 2004, the market share of two locally incorporated Category 1 banks represented 68 per cent in terms of the total assets of the Category 1 banks.

2.1.2 CATEGORY 2 BANKING SECTOR

There are twelve banks operating in the Category 2 banking sector. Four Category 2 banks are branches of foreign banks, seven are subsidiaries of foreign banks and one is a joint venture between a locally incorporated Category 1 bank and a foreign bank.

During the year under review, one Category 2 bank, namely Banque Internationale des Mascareignes Ltée, a sister company of Banque des Mascareignes Ltée, changed its name to Mascareignes International Bank Ltd with the approval of the Bank of Mauritius. African Asian Bank Ltd, a Category 2 bank, ceased operations since June 2003 and surrendered its banking licence on 8 October 2004.

A list of the Category 1 and Category 2 banks as at 30 June 2004 is shown in Appendix I.

2.2 PERFORMANCE OF CATEGORY 1 BANKS

A slowdown in the growth of the activities of Category 1 banks was observed during the year 2003-04. On-balance sheet assets of Category 1 banks went up by Rs20,081 million or 13.0 per cent from Rs154,560 million at end-June 2003 to Rs174,641 million at end-June 2004, compared to a growth rate of 14.8 per cent in the preceding year. Individually, the growth in assets of the Category 1 banks excluding Banque des Mascareignes Ltée ranged between negative 4.8 per cent to 682.2 per cent. The 682.2 per cent growth rate was recorded by one Category 1 bank which started operations on 31 July 2002 and is therefore largely a statistical factor.

During the year under review, Category 1 banks recorded a slight increase in their foreign currency assets which rose from Rs21,511 million at end-June 2003 to Rs21,845 million at end-June 2004. Foreign currency assets as a percentage of total assets continued to decline, going down from 14.0 per cent at end-June 2002 to 13.9 per cent at end-June 2003 and further to 12.5 per cent at end-June 2004. Category 1 banks had an overall short foreign exchange position of Rs2,526 million at end-June 2004, compared to an overall short foreign exchange position of Rs1,169 million at end-June 2003.

Off-balance sheet assets comprising acceptances, guarantees and documentary credits went up by Rs714 million, from Rs17,052 million at end-June 2003 to Rs17,766 million at end-June 2004.

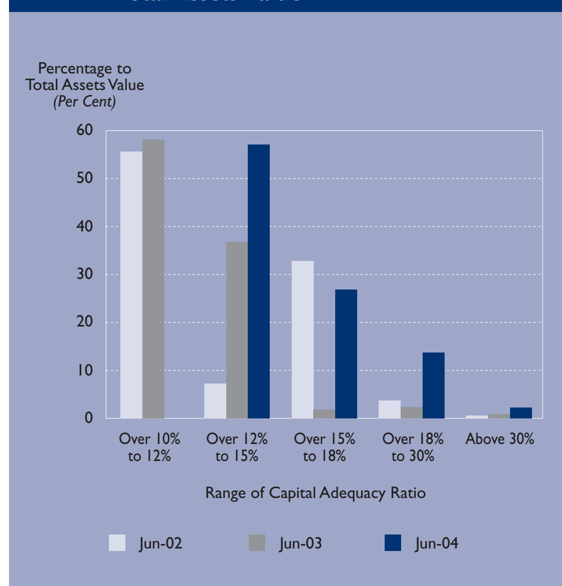
Chart 1 depicts the year-on-year comparison of assets and liabilities of Category 1 banks. At end-June 2004, the bulk of the assets of Category 1

banks was constituted of advances and investments in Bank of Mauritius Bills, Treasury Bills and Government Securities, which represented 52.3 per cent and 25.5 per cent of total assets, respectively. The respective percentages for the previous year were 55.6 per cent and 21.5 per cent. Deposits represented 75.7 per cent of Category 1 banks' total resources as at end-June 2004, compared to 74.9 per cent at end-June 2003.

A detailed review of the performance of Category 1 banks over the past two years with respect to capital adequacy, asset quality, liquidity and profitability follows.

2.2.1 CAPITAL ADEQUACY

During the year under review, all Category 1 banks complied with the minimum risk weighted capital adequacy ratio of 10 per cent. On average, the risk weighted capital adequacy ratio maintained by Category 1 banks fluctuated between a low of 14.3 per cent in December 2003 and a high of 15.0 per cent in March 2004 during the year ended 30 June 2004.



2.2.1.1 Capital Adequacy Ratio of Category 1 Banks in terms of their Total Assets Value

Chart 2 provides an analysis of the capital adequacy ratio maintained by Category 1 banks in terms of their total assets value. As may be seen from Chart 2, there was a marked change between the capital adequacy ratio and the balance sheet value at end-June 2003 and at end-June 2004. At end-June 2003, Category 1 banks that reported ratios between 10 per cent and 12 per cent held in aggregate the biggest share, that is, 58.2 per cent, of the banking sector's total on- and off-balance sheet assets. In contrast, at end-June 2004, the biggest share of banking sector's total on- and off-balance sheet assets, at 57.1 per cent, was accounted for by banks reporting capital adequacy ratios between 12 per cent and 15 per cent. The relationship between capital adequacy ratio and total assets value gives an indication that banks were maintaining a higher than the minimum required capital cushion during 2003/2004. However, this relationship cannot be interpreted in isolation. Other important ratios that need to be considered include, the ratio of non-performing advances to total capital base, which provides meaningful insights on the management of a bank's capital base as we plan to move on to more sensitive risk-based capital adequacy under Basel II.

At end-June 2004, banks with capital adequacy ratios ranging between 15 per cent and 18 per cent held the next biggest portion of the banking sector's total on- and off-balance sheet assets at 26.9 per cent, as opposed to only 1.9 per cent a year earlier.

2.2.1.2 Capital Base

The aggregate capital base of Category 1 banks increased by Rs2,683 million, from Rs12,543 million at end-June 2003 to Rs15,226 million at end-June 2004. The average capital adequacy ratio of banks at end-June 2004 stood at 14.7 per cent, up from 12.6 per cent at end-June 2003. In this regard, it is worth noting that since the introduction of capital adequacy requirements in 1993, banks have at all times met their minimum capital adequacy ratio requirements.

During the year under review, the aggregate capital base grew by 21.4 per cent while the total risk weighted assets of banks went up by 4.2 per cent. Consequently, a significant improvement in the overall capital adequacy ratio of the Category 1 banking sector was observed.

At end-June 2004, Tier 1 capital constituted the bulk of total capital and accounted for 81.3 per cent of total gross capital of Category 1 banks. During the year under review, Tier 1 capital grew by 12.6 per cent from Rs12,905 million at end-June 2003 to Rs14,533 million at end-June 2004. On the other hand, Tier 2 capital, which represented 18.7 per cent of total gross capital at end-June 2004, grew by 30.7 per cent from Rs2,564 million to Rs3,352 million during the year. At end-June 2004, Tier 2 capital comprised 23.1 per cent of Tier 1 capital up from 19.9 per cent at end-June 2003.

Chart 3 illustrates the split between Tier 1 and Tier 2 capital over the period of end-June 1997 through end-June 2004. As may be seen from Chart 3, on average, the underlying increasing trend in the buffer of capital (that is, the difference between the required capital and the actual capital) observed over the years, was maintained during the year under review.

Chart 3: Minimum Required Capital v/s Actual Capital

2.2.1.3 Risk Profile of On-and Off-Balance Sheet Assets

Total on-balance sheet assets of Category 1 banks increased by 12.6 per cent from

Table 1 : Comparative Change in the Riskiness of Banks' Portfolios of On-balance Sheet Assets

Risk Weights (%)	On-balance Sheet Assets (Rs million)	Percentage to Total On-balance Sheet Assets	On-balance Sheet Assets (Rs million)	Percentage to Total On-balance Sheet Assets
	June 2004		June 2003	
0	60,155	36.3	46,471	31.5
10	448	0.3	–	–
20	11,316	6.8	11,588	7.9
50	7,854	4.7	6,102	4.1
100	86,164	51.9	83,177	56.5
	165,937	**100.0**	**147,338**	**100.0**

Rs147,338 million to Rs165,937 million at end-June 2004 while the corresponding risk weighted assets value grew by a much lower rate of 4.4 per cent from Rs88,546 million to Rs92,399 million. Three factors explaining the slower pace of growth of the risk-weighted assets are tighter credit standards being applied by banks, a generally low demand for loans and a shift of assets from higher to lower risk.

Table 1 shows the comparative movement in the riskiness of Category 1 banks' total on-balance sheet assets between end-June 2003 and end-June 2004. The 100 per cent risk weight band continued to carry the bulk of Category 1 banks' total assets at 56.5 per cent and 51.9 per cent at end-June 2003 and end-June 2004, respectively. The decreasing trend in the holding of high risk assets observed during preceding years, continued with assets weighted at zero per cent growing from 31.5 per cent of the total assets at end-June 2003 to 36.3 per cent at end-June 2004.

Table 2 sets out a comparison of the total on- and off-balance sheet assets of Category 1 banks together with their corresponding risk weighted value and their average combined risk weighting over the period June 1999 to June 2004.

As may be observed from Table 2, from June 2003 to June 2004, the growth by Rs22,203 million or 12.7 per cent in total on- and off-balance sheet assets outpaced the growth of Rs4,160 million or 4.2 per cent in total risk weighted assets. This highlights the prudent attitude adopted by banks towards risk. The corresponding growth rates for the preceding year were 14.2 per cent and 9.6 per cent, respectively.

The shift to less risky assets is further illustrated by the average combined risk weighting which registered a drop from 57.0 per cent in June 2003 to 52.7 per cent in June 2004. As a result of the decrease in the proportion of risky assets to total assets, the capital adequacy ratio improved from 12.6 per cent to 14.7 per cent.

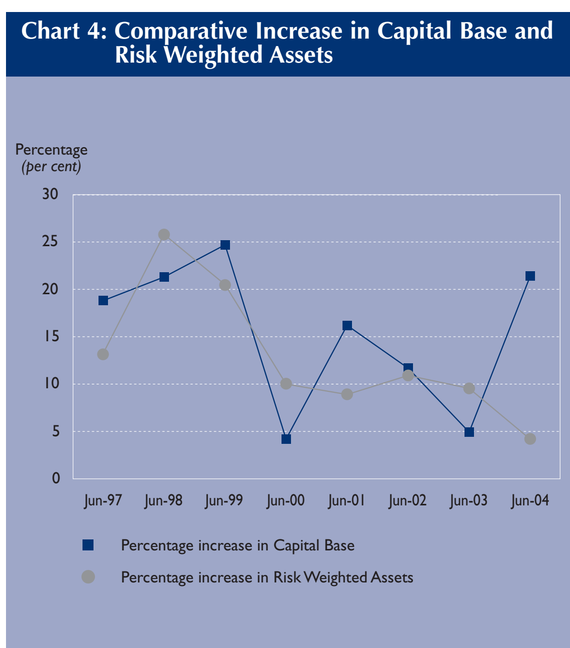
Table 2: Total On- and Off-Balance Sheet Assets of Category 1 Banks, Equivalent Risk-Weighted Assets and Average Combined Risk Weighting

		June 99	June 00	June 01	June 02	June 03	June 04
A	Total On- and Off-Balance Sheet Assets (Rs million)	111,064	125,884	133,244	153,023	174,731	196,934
B	Total Risk-Weighted Assets (Rs million)	68,403	75,264	81,986	90,927	99,607	103,767
C*	Average Combined Risk Weighting (Per cent) B/A	61.6	59.8	61.5	59.4	57.0	52.7
D	Capital Adequacy Ratio (Per cent)	12.9	12.2	13.1	13.1	12.6	14.7

*B/A

Chart 4 compares the percentage increase in capital base and risk-weighted assets over the period June 1997 to June 2004.

Chart 4: Comparative Increase in Capital Base and Risk Weighted Assets



2.2.2 ASSET QUALITY

Assets embody future economic benefits that will accrue to a business enterprise in the form of future cash flows. Accordingly, the quality of assets impacts directly on the financial condition and performance of a bank.

A major cause of concern to bank supervisors is the level of and the trend in the non-performing asset ratio. Non-performing assets reduce the income-earning capacity of a bank while requiring charge-off against existing profits. As a result of a high-level of non-performing assets, severe losses may be incurred, which would persist if no corrective action is taken. Persistent losses would gradually erode capital and could even put into jeopardy the very existence of a bank. As banks hold the means of payment and the liquidity of business enterprises and households, the collapse of a bank can have a significantly disruptive effect on an economy, in particular where a failure leads to panic.

In Mauritius, Category 1 banks hold a substantial part of their assets in the form of loans and advances. The credit risk is accordingly the highest element of risk in banks' balance sheets. Credit risk is the probability that a borrower will not be able to pay interest or repay the principal according to the terms specified in a credit agreement. It is characterised by delayed repayments or no repayment at all which would in turn cause cash flow problems and affect a bank's liquidity.

The Bank of Mauritius has issued several prudential guidelines to the financial sector with the main objective of promoting sound asset management practices. In this respect, the guideline on Credit Risk Management issued by the Bank in December 2003 sets out the responsibilities and accountabilities of the Board of Directors and management with respect to credit risk management. The guideline also outlines the processes to be used in managing the credit activity in a financial institution taking into account the specific nature of an institution's business, its constraints, risks, opportunities and strategies.

Risk Weighted Assets

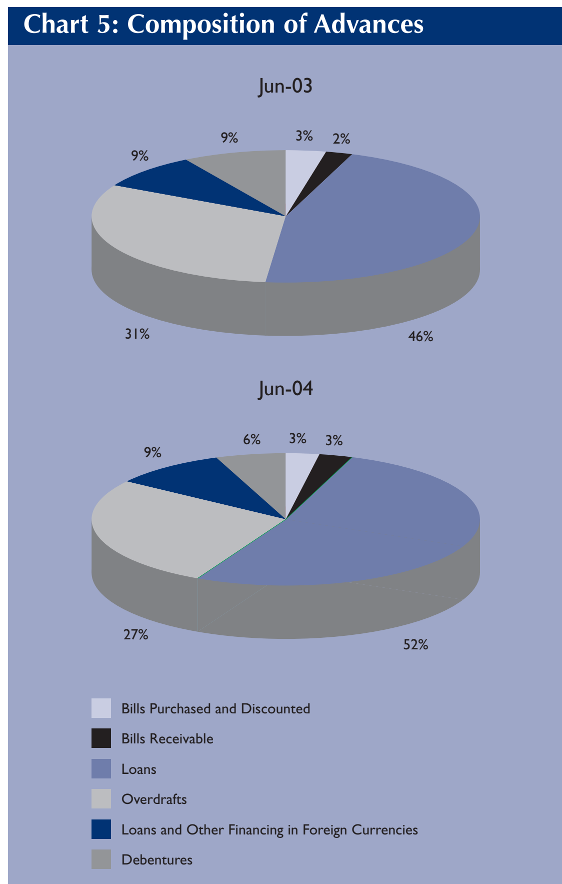
In terms of the Guidance Notes on Risk Weighted Capital Adequacy Ratio issued by the Bank pursuant to the Basel Capital Accord 1988, assets are assigned specific risk weights which range between 0 and 100 per cent. Zero risk weighted assets are those assets which bear no counterparty risk of default; they include, for instance, cash and balances with Bank of Mauritius. Where an asset carries an element of a counterparty risk, it will be assigned a risk weight which reflects the risk profile of the counterparty. For instance, a claim on Government of Mauritius is zero risk rated while a claim on a private company will be weighted at 100 per cent.

2.2.2.1 Advances

Advances, including investment in debentures, are the highest income earning assets of banks. Accordingly, there is a strong relationship between a bank's performance and the quality of its advances portfolio.

Over the years, the ratio of advances to total assets showed a decreasing trend. This tendency persisted during the year under review, with the proportion dropping from 55.6 per cent at end-June 2003 to 52.2 per cent at end-June 2004. However, despite this

Chart 5: Composition of Advances



tendency, the major part of the gross income of banks in 2003-2004 was derived from advances.

Total advances extended by Category 1 banks increased by Rs5,382 million or 6.3 per cent, from Rs85,885 million at end-June 2003 to Rs91,267 million at end-June 2004, compared to a lower growth of Rs4,643 million or 5.7 per cent in the preceding year. The expansion of the advances portfolio of individual banks ranged from 17.8 per cent to 63.3 per cent during 2003-2004 compared to 19.4 per cent and 68.8 per cent in 2002-2003.

Chart 5 compares the composition of advances at end-June 2003 and 2004. The shift from debentures and overdrafts to loans in local currency and loans and other financing in foreign currency observed during the year ended 30 June 2003, persisted during the year ended 30 June 2004.

Investment in debentures dropped substantially by Rs2,057 million or 27.8 per cent from Rs7,392 million at end-June 2003 to Rs5,335 million at end-June 2004, as these instruments were redeemed at maturity.

Concentration of Risks

Well-managed banks limit their exposure, including off-balance sheet items, to a single borrower or related group of borrowers by diversifying their loan portfolios with the view to avoiding the risk that failure on the part of one large borrower or a related group of borrowers may result into excessive losses for the bank.

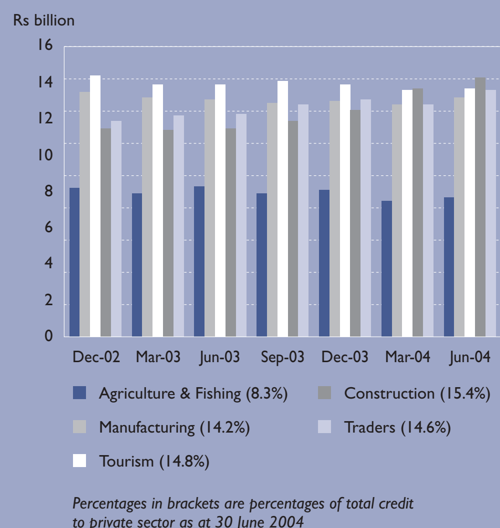
During the year under review, banks were generally observing the requirements of the Bank's Guideline on Credit Concentration Limits with respect to large exposures. Large exposures as a percentage of the capital base of individual banks ranged from 37 per cent to 556 per cent in 2003-2004 compared to 44 per cent to 676 per cent in 2002-2003.

Total credit facilities extended to any one customer/group of closely related customers for amounts aggregating 15 per cent or more of individual bank's capital base (large exposures) totalled Rs38,637 million at end-June 2004, down from Rs40,447 million at end-June 2003. At end-June 2004, the large exposures of banks represented 35 per cent of the overall on- and off-balance sheet commitments of banks compared to 39 per cent for the preceding year. Overall, banks' exposure in terms of capital base decreased from 257 per cent at end-June 2003 to 226 per cent at end-June 2004.

In addition to the normal risk of loss, sectoral concentrations (i.e. excessive exposure to particular sectors of the economy) pose additional business risks to banks, linked to unanticipated cyclomatic economic downturns. Banks should therefore properly diversify their sectoral exposures so as to ward off any potential threats resulting from downturns affecting particular sectors of the economy. The Bank closely monitors lending by banks to industry groups through reports submitted by banks on a monthly basis.

As can be seen from Chart 6, the 'Construction' sector accounted for the highest share or 15.4 per cent of total credit to private sector at end-June 2004 followed by the 'Tourism' sector at 14.8 per cent, 'Traders' at 14.6 per cent and 'Manufacturing' at 14.2 per cent.

Chart 6: Sectorwise Distribution of Credit to Private Sector



Related Party Transactions

Loans to counterparties connected to a financial institution such as directors, managers, shareholders, and their families, pose additional risks to a bank in view of the fact that the rationale for granting such loans may be based purely on the relationship existing with the counterparty without any business/commercial logic. Also, large loans to related borrowers, if not made on an arm's length basis may become uncollectable and therefore cause losses to the financial institution.

With the view to avoiding abusive self-dealing practices by banks, the Bank has issued in January 2002 a guideline on related party transactions, setting out the limits up to which loans may be granted to related parties.

Asset Classification

Sound risk management involves the classification of assets in a scientific manner reflecting their performance. Taking into consideration that companies in Mauritius have to prepare accounts on the basis of International Accounting Standards (IAS), the Bank has, after consultation with the industry, finalised and issued in November 2004 a Guideline on Credit Impairment Measurement and Income Recognition. The guideline which supersedes the Guideline on Credit Classification for Provisioning Purposes and Income Recognition, elaborates on fair accounting principles laid down in IAS 39 with respect to impaired assets.

Loan Loss Provisioning

Asset classification provides a basis for determining an adequate level of provisions for possible loan losses. Such provisions contribute to a bank's capacity to absorb losses arising from non-performing loans. Loan loss provisioning can be in the form of a general provision and/or a specific provision. General provision is made as a prudential measure and is equivalent to one per cent of the aggregate amount of performing assets. On the other hand, specific provisioning refers to the provision made on specific delinquent accounts. The amount of specific provision to be set aside is largely dependent on the realisable value of security given as collateral for the granting of credit facilities and on the duration of the delinquency.

Specific provisions for bad and doubtful debts on delinquent advances for Category 1 banks went up from Rs2,222 million at end-June 2003 to Rs3,174 million at end-June 2004. As a proportion of total non-performing advances, these provisions increased from 30.6 per cent to 41.6 per cent.

Bank of Mauritius also closely monitors deterioration of advances by industry sector. Table 3 summarises non-performing advances by industry sector and the relative loan loss provision made in respect thereof over the period end-June 2003 to end-June 2004. As may be seen from Table 3, the sectors which appear to be more vulnerable to economic shocks are Manufacturing, Construction and Traders which taken together represent more than 75 per cent of total non-performing advances as at end-June 2004.

2.2.2.2 Investments in Securities

The portfolio of investments in securities of Category 1 banks is constituted of readily convertible liquid assets in the form of Treasury Bills, Bank of Mauritius Bills and Government Securities. These assets have central bank and

Table 3: Provision for Credit Losses by Industry Sectors

	End-June 2002		End-June 2003		End-June 2004	
	Non-performing advances	Specific Provision	Non-performing advances	Specific Provision	Non-performing advances	Specific Provision
	(Rs million)					
Agriculture and Fishing	103	20	96	16	93	28
Manufacturing *(including EPZ)*	2,560	722	2,481	970	2,626	1,258
Tourism	202	25	278	30	201	48
Transport	68	17	63	12	51	19
Construction	1,171	195	1,680	356	1,485	554
Traders	1,288	378	1,197	431	1,670	689
Financial and Business Services	68	9	146	21	51	35
Personal *(including credit card advances)*	735	150	939	216	1,131	368
Professional *(including credit card advances)*	118	28	58	17	77	21
Others	362	112	331	153	253	154
	6,675	**1,656**	**7,269**	**2,222**	**7,638**	**3,174**

government support and are consequently risk free and weighted at zero risk for capital adequacy purposes.

On account of a slowdown in the growth of their loan portfolio, banks have been increasingly placing their excess liquidity in these securities which guarantee a stable return and sustain profitability. For instance, investments in securities as a percentage of total deposits rose from 28.6 per cent at end-June 2003 to 33.6 per cent at end-June 2004. Consequently, the composition of this category of assets in the total assets shot up from 21.5 per cent at end-June 2003 to 25.5 per cent at end-June 2004 as can be seen from Chart 1. For individual banks, the corresponding percentage ranged between 15.4 per cent and 74.3 per cent at end-June 2004 compared to 10.7 per cent and 70.8 per cent at end-June 2003.

During the period end-June 2003 to end-June 2004, Category 1 banks' investments in Treasury Bills, Bank of Mauritius Bills and Government Securities increased substantially by Rs11,278 million or 34.0 per cent from Rs33,171 million to Rs44,449 million.

2.2.2.3 Balances with Banks

Apart from making placements with other banks, banks also maintain credit balances with their correspondents abroad to cater for the daily operational requirements, such as satisfaction of payment obligations, e.g. to meet commitments on letters of credit on behalf of clients.

On an aggregate basis, balances held with banks by Category 1 banks recorded a 5.8 per cent growth from Rs8,432 million at end-June 2003 to Rs8,918 million at end-June 2004. However, there was a decline in this category of assets in the balance sheet structure of the banks on an overall basis from 5.5 per cent at end- June 2003 to 5.8 per cent at end-June 2004.

At end-June 2004, balances held with banks abroad and balances held with Category 2 banks amounted to Rs6,438 million and Rs1,619 million, respectively. The corresponding figures at end-June 2003 were Rs7,604 million and Rs788 million.

2.2.2.4 Investment in Corporate Shares

Category 1 banks have invested a non-negligible proportion of their resources in the capital of their subsidiaries and associates and in shares of other companies, as well. At end-June 2004, the portfolio of investment in corporate shares constituted 2.6 per cent of total assets, up from 1.8 per cent at end-June 2003. In fact, the investments expanded by Rs1,782 million or by 65.1 per cent from Rs2,736 million to Rs4,518 million. The bulk of the expansion was in the local private sector, where such investments increased from Rs1,823 million to Rs3,519 million or by 93.0 per cent while cross border investments increased by Rs85 million or 9.4 per cent to reach Rs998 million at end-June 2004. Apart from being highly illiquid, investments in corporate shares are subject to high volatility in their market prices. In this regard, the Bank is developing a guideline that deals with many essential elements of market risk assessment with reference to the banking industry in Mauritius.

2.2.2.5 Fixed Assets

Fixed assets of Category 1 banks increased by Rs344 million from Rs8,188 million at end-June 2003 to Rs8,532 million at end-June 2004. During the same period, banks made additional provisions amounting to Rs329 million for depreciation on fixed assets, causing the accumulated depreciation to reach Rs3,691 million or 43.3 per cent of the gross fixed assets at end-June 2004 compared to 41.1 per cent previously. As a result, net fixed assets increased slightly by Rs15 million or 0.3 per cent to attain Rs4,841 million at end-June 2004. Some Category 1 banks also have property revaluation reserve, resulting from surplus arising from periodic revaluations of their land and buildings. On an overall basis, the reserves have declined by Rs29.6 million, from Rs316.0 million at end-June 2003 to Rs286.4 million at end-June 2004.

The proportion of fixed assets, which are illiquid and non-income earning assets in the Category 1 banks' assets has been falling since year 2002. The ratio of gross fixed assets to total assets fell from 5.6 per cent at end-June 2002 to 5.3 per cent at end-June 2003 and further to 4.9 per cent at end-June 2004. The percentage of the fixed assets to core capital has also gone down from 63.4 per cent at end-June 2003 to 58.7 per cent at end-June 2004.

2.2.2.6 Cash Reserves

On a weekly average basis, Category 1 banks are required to maintain 5.5 per cent of their deposit liabilities as cash reserves, comprising cash in hand and balances with Bank of Mauritius. The obligation to maintain the minimum level of cash reserves as imposed by the Bank of Mauritius causes a significant amount of the resources of Category 1 banks to be locked up in the non-interest earning assets. However, banks are not required to maintain capital with respect to these risk free assets.

Cash reserves increased by Rs1,611 million or 22.7 per cent from Rs7,098 million at end-June 2003 to Rs8,709 million at end-June 2004. These reserves constituted 5.0 per cent of total assets at end-June 2004 compared to 4.6 per cent at end-June 2003. For individual banks, the percentage ranged between 2.7 per cent and 9.1 per cent at end-June 2004 compared to 4.2 per cent and 6.1 per cent at end-June 2003.

2.2.3 PROFITABILITY

Earnings provide meaningful indication of the financial health of banks. The long-term viability of banks is highly reliant on their capacity to earn adequate income that will contribute towards the consolidation of their capital and provide incentives to their shareholders.

A profitable banking sector is better able to withstand adverse shocks and accordingly helps to preserve the stability of the financial system. Losses, on the other hand, eat up capital and strain liquidity, and may erode public confidence.

The consolidated profitability figures are based on the audited results of the ten banks operating during 2003/04 involving financial years ended

Table 4: Category 1 Banks – Consolidated Profit Performance

	2001/02	2002/03 (Rs million)	2003/04
Total Interest Income	**10,096**	**10,572**	**12,154**
Interest Income from Advances	7,961	8,075	8,493
Interest Income from Investment in Treasury Bills,			
Bank of Mauritius Bills and Government Securities	1,730	2,187	3,331
Other interest income	405	310	330
Total Interest Expense	**6,412**	**6,371**	**7,232**
Interest Expense on Deposits	6,083	6,059	6,750
Other Interest Expense	329	312	482
Net Interest Income	**3,684**	**4,201**	**4,922**
Add: Non-interest income	1,927	2,093	3,006
Operating Income	**5,611**	**6,294**	**7,928**
Less: Staff Costs	1,278	1,341	1,674
Other Operating Expenses	1,286	1,600	1,979
Operating Profit before Bad and Doubtful Debts and Taxation	**3,047**	**3,353**	**4,275**
Less: Charge for Bad and Doubtful Debts	680	906	805
Exceptional Items	6	37	520
Operating Profit	**2,361**	**2,410**	**2,950**
Share of profits in subsidiaries and associates	184	201	163
Profit before Tax	**2,545**	**2,611**	**3,113**

Table 5: Category 1 Banks – Growth in Interest Income v/s Growth in Non-Interest Income

	2001/02	2002/03	2003/04
Growth in Interest Income (%)	-1.7	4.7	15.0
Growth in Non-Interest Income (%)	-4.7	8.6	43.6

30 June, 31 December and 31 March and are referred to as 2003/04. Category 1 banks posted an overall pre-tax profit of Rs3,113 million in 2003/04 as compared to Rs2,611 million in 2002/03.

The profit performance of Category 1 banks over the past three years is summarised in Table 4 while Charts 7 and 8 compare the main components of income and expenses respectively, for the periods 2002/03 and 2003/04.

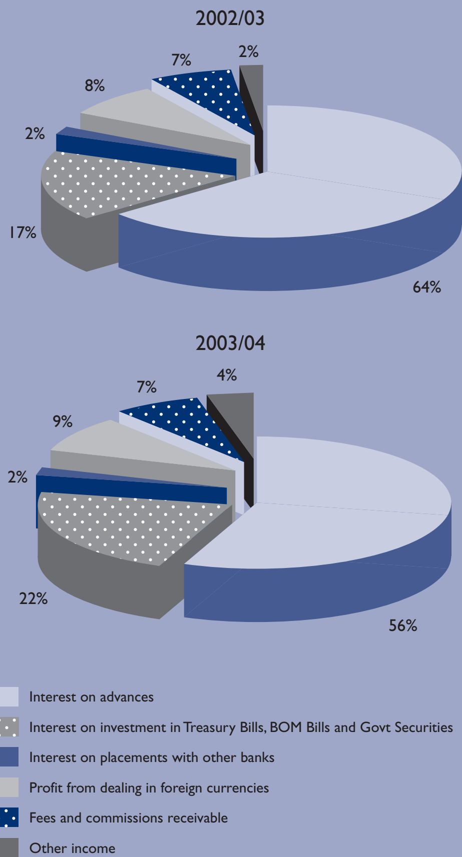
2.2.3.1 Income

Total income of Category 1 banks rose from Rs12,665 million in 2002/03 to Rs15,160 million in 2003/04, representing an increase of 19.7 per cent. Advances and investments in Treasury Bills, Bank of Mauritius Bills and Government Securities remain the main sources of interest income for Category 1 banks. Interest income derived from these two sources represented an average of 80.1 per cent of the total income of Category 1 banks through the years 1999/00 to 2003/04.

During the year under review, Category 1 banks derived a growing proportion of income from sources other than interest. A comparison of the growth rate between interest income and non-interest income for Category 1 banks is presented in Table 5.

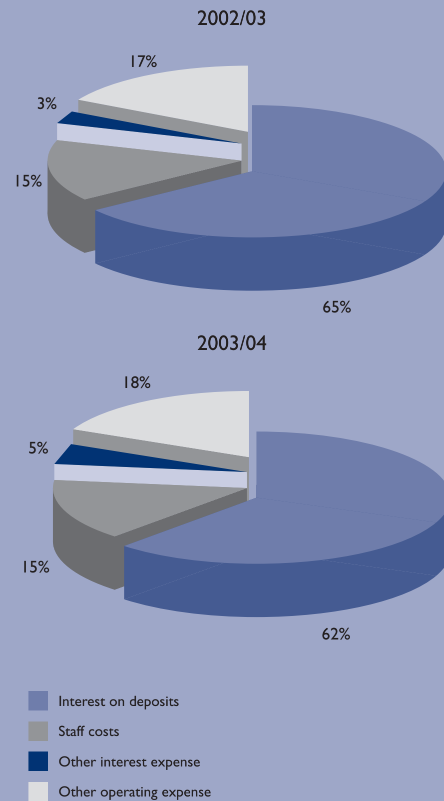
Chart 9 shows the evolution of net interest income, other income, operating income and operating profit over the past five years.

Chart 7: Category 1 Banks – Components of Income



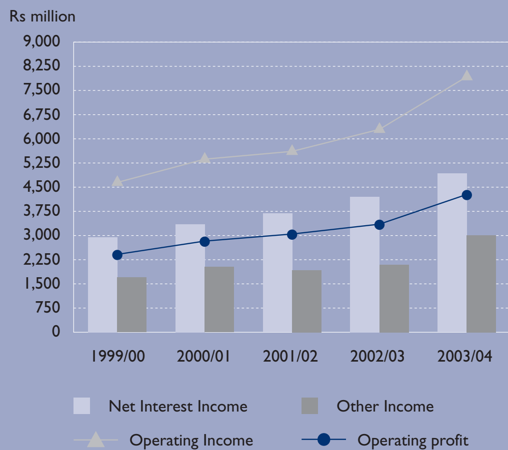
Based on combined audited data for financial years ended 30 June, 31 December and 31 March.
All figures are for the period.

Chart 8: Category 1 Banks – Components of Expenses



Based on combined audited data for financial years ended 30 June, 31 December and 31 March.
All figures are for the period.

Chart 9: Category 1 Banks – Evolution of Net Interest Income, Other Income, Operating Income and Operating Profit

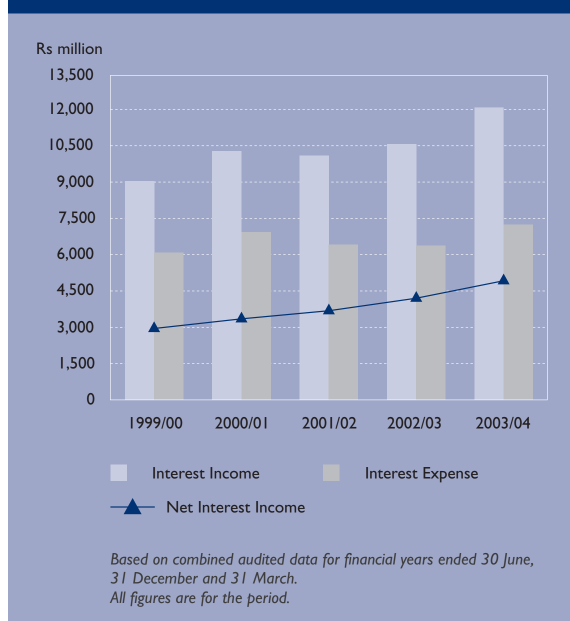


Based on combined audited data for financial years ended 30 June, 31 December and 31 March.
All figures are for the period.

2.2.3.2 Net Interest Income

Chart 10 shows the increasing trend in net interest income for Category 1 banks from 1999/00 through 2003/04. Nonetheless, income in the form of interest received on advances narrowed down and represented 69.9 per cent of total interest income in 2003/04 from 76.4 per cent in 2002/03. On the other hand, interest earned on Investment in Treasury Bills, Bank of Mauritius Bills and Government Securities went up from 20.7 per cent of total interest income in 2002/03 to 27.4 per cent for the year under review. This illustrates the tendency for Category 1 banks to review their risk profile from high risk assets to low risk assets, although advances continued to remain their main source of interest income. Interest received on placements with other banks remained stable at 2.7 per cent of total interest income in 2003/04. Total interest income registered a growth of 15 per cent from

Chart 10: Category 1 Banks – Components of Net Interest Income



Based on combined audited data for financial years ended 30 June, 31 December and 31 March. All figures are for the period.

Rs10,572 million in 2002/03 to Rs12,154 million in 2003/04. The growth rate in the main components of total interest income is given in Table 6.

Total interest expense made up of interest paid on deposits, borrowings from other banks and other interest expense accounted for 93.3 per cent, 5.0 per cent and 1.7 per cent of total interest expense respectively in 2003/04. Interest paid on deposits and borrowings from other banks went up by 11.4 per cent and 36.7 per cent respectively contributing to the growth of 13.5 per cent in total interest expense which stood at Rs7,232 million for the year under review. Total net interest income increased by Rs721 million or 17.2 per cent from Rs4,201 million in 2002/03 to Rs4,922 million in 2003/04.

As can be seen from Table 7, interest earned on Rs100 of advances and the interest paid on Rs100 of deposits dropped by Re0.25 and Re0.18 respectively reflecting the decreasing trend in interest rates. Consequently, there was a fall in interest spread from Rs3.79 to Rs3.72.

2.2.3.3 Non-Interest Income

Non-interest income went up significantly by 43.6 per cent to Rs3,006 million in 2003/04 on account of additional income generated mainly from fees and commissions, dealings in foreign currencies and investments amounting to Rs104 million, Rs428 million and Rs298 million respectively. Accordingly, the ratio of non-interest income to total income went up from 16.5 per cent in 2002/03 to 19.8 per cent in 2003/04 while the ratio of interest income to total income went down from 83.5 per cent in 2002/03 to 80.2 per cent in 2003/04.

2.2.3.4 Non-interest expenses

Non-interest expenses consisting of staff costs and other operating expenses rose by 24.2 per cent to reach Rs3,653 million in 2003/04. Staff costs recorded a growth of 24.8 per cent in 2003/04 compared to 4.9 per cent in 2002/03. Other operating expenses increased by 23.7 per cent to stand at Rs1,979 million in 2003/04.

The cost to income ratio, that is, the ratio of staff costs and other operating expenses to gross

Table 6: Category 1 Banks – Growth in Interest on Advances v/s Growth in Interest on Treasury Bills, Bank of Mauritius Bills and Government Securities

	2001/02	2002/03	2003/04
Growth in Interest earned on Advances (%)	-0.6	1.4	5.2
Growth in Interest Income from Treasury Bills, Bank of Mauritius Bills and Government securities (%)	-6.9	26.4	52.3

Table 7: Category 1 Banks – Interest Spread

	2001/02	2002/03	2003/04
Interest earned on Rs100 of advances	10.98	9.97	9.72
Cost per Rs100 of deposits	7.02	6.18	6.00
Interest spread	3.96	3.79	3.72

operating income (net of charge for bad and doubtful debts) dropped from 54.6 per cent in 2002/03 to 51.3 per cent in 2003/04. The ratio varied in the range of 38.9 per cent to 98.6 per cent for individual banks.

The reduction in the ratio illustrates a higher degree of efficiency achieved during 2003/04 mainly attributable to the return on investments in state-of-the-art technologies made in preceding years.

2.2.3.5 Operating Profit

Category 1 banks realised operating profit before bad and doubtful debts of Rs4,275 million for 2003/04 representing an increase of Rs922 million or 27.5 per cent over the figures of 2002/03. The increase of Rs922 million was, however, partly offset by the rise in exceptional expenses amounting to Rs483 million during the period under review. Consequently, Category 1 banks achieved operating profit before tax to the tune of Rs2,950 million in 2003/04, Rs540 million higher than the pre-tax profit of Rs2,410 million realised in 2002/03.

2.2.3.6 Return on Average Assets and Equity

Return on average assets and return on equity are important indicators of a bank's profitability. They give useful insight as to whether a bank is making optimum use of available resources and reflect the quality of management, as well.

The return on average assets for almost all individual banks improved in 2003/04 compared to 2002/03. All individual banks recorded a positive return on average assets in 2003/04 ranging from a low of 0.05 per cent to a high of 3.34 per cent compared to a range of negative 2.57 per cent to a high of 3.20 per cent in 2002/03. However, an exceptional loss incurred by one Category 1 bank had a restraining effect on the overall ratio resulting in a marginal increase from 2.05 per cent in 2002/03 to 2.08 per cent in 2003/04. Four Category 1 banks achieved ratios above 2 per cent.

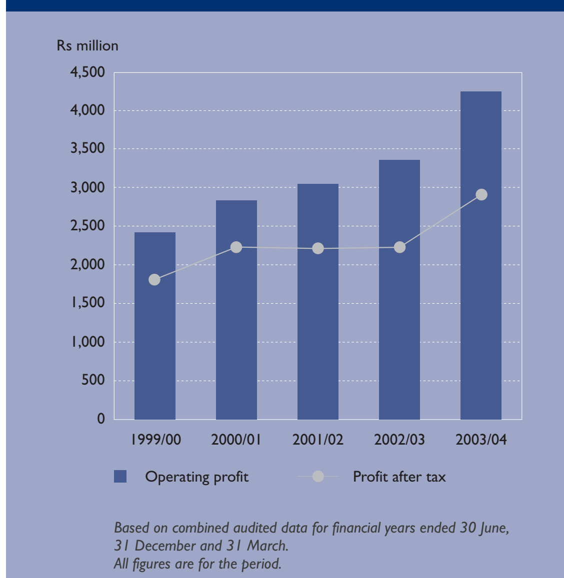
Return on equity increased from 15.6 per cent in 2002/03 to 18.0 per cent in 2003/04. For individual banks, return on equity ranged from 0.4 per cent to a high of 25.8 per cent in 2003/04 with five banks achieving ratios of over 15 per cent, compared to negative 27.3 per cent to a high of 20.5 per cent in 2002/03.

Chart 11 reflects the evolution of banks' profit for the years 1999/00 through 2003/04 while Chart 12 shows the variations in return on average assets and equity for the same period.

2.2.4 LIQUIDITY

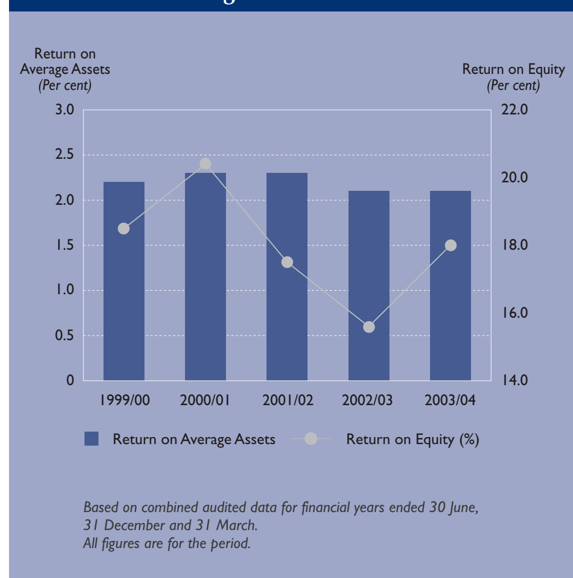
In January 2000, the Bank of Mauritius issued a Guideline on Liquidity to banks, pursuant to the publication by the Basel Committee of the Paper entitled "Sound Practices for Managing Liquidity in

Chart 11: Category 1 Banks – Operating Profit and Profit after Tax



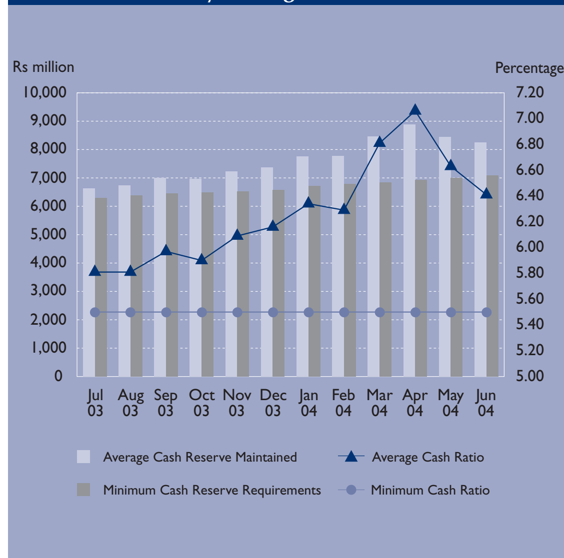
Based on combined audited data for financial years ended 30 June, 31 December and 31 March.
All figures are for the period.

Chart 12: Category 1 Banks – Return on Equity and on Average Assets



Based on combined audited data for financial years ended 30 June, 31 December and 31 March.
All figures are for the period.

Chart 13: Category 1 Banks – Fluctuations in Monthly Average Cash Holdings and in Monthly Average Cash Ratio



Banking Organisations". The Bank of Mauritius Guideline broadly sets out qualitative standards for liquidity risk management by banks. In addition to the qualitative standards, banks are required to adopt a quantitative approach to liquidity risk management. The aim is to ensure that a bank has adequate liquidity at all times, even though there is no prescriptive minimum liquid assets ratio at present. In this regard, banks are advised to carry out maturity mismatch analysis which involves the classification of expected inflows and outflows of funds into time-bands according to their maturity.

Effective management of the structure of the assets and the liabilities of banks is the foundation of sound liquidity management practices. Banks require an adequate stock of liquid assets to fulfil both expected and unexpected financial commitments as they arise. On the other hand, the structure of a bank's liabilities affects its ability to resist a liquidity shock – the need to repay liabilities at short notice.

2.2.4.1 Cash Ratio

During the year 2003-04, Category 1 banks were required to observe the minimum average cash reserve of 5.5 per cent of their total deposit liabilities inclusive of foreign currency deposits.

The monthly average cash ratio maintained by Category 1 banks in 2003-04 ranged from 5.8 per cent to 7.1 per cent as compared to a monthly average cash ratio varying between 5.6 per cent and 6.1 per cent in 2002-03. Fluctuations in the monthly average cash holdings of banks against the prescribed limit over the last year is depicted in Chart 13.

2.2.4.2 Non-Cash Liquid Assets Ratio

Category 1 banks are not mandatorily required to observe a minimum non-cash liquid assets ratio. However, banks are expected to establish their own threshold of non-cash liquid assets ratio, which will reflect their risk appetite.

Investment in Bank of Mauritius Bills, Treasury Bills and Government Securities, which are the prime liquefiable non-cash assets available to banks, expressed as a percentage of total deposits, went up from 28.6 per cent as at end-June 2003 to 33.6 per cent as at end-June 2004 indicating a shift of resources by banks towards risk-free assets. During the year under review, Category 1 banks' holdings of Bank of Mauritius Bills, Treasury Bills and Government Securities rose by an amount of Rs11,278 million from Rs33,171 million at end-June 2003 to Rs44,449 million at end-June 2004 and represented 25.5 per cent of total assets at end-June 2004, up from 21.5 per cent in the previous year, indicating a higher investment in near liquid assets by some banks.

2.2.4.3 Deposits

During the year under review, deposits remained the primary source of funding of Category 1 banks, and constituted the bulk of their total liabilities. Deposit structure building and stability of a bank's deposit base also contribute towards sound liquidity management. Large deposit base does not, however, automatically imply that a bank has a strong liquidity position. A large deposit base may result from an attempt by a bank to balance a mismatched portfolio by edging up its interest rate to attract deposits which are not necessarily stable as a source of funding.

Total deposits grew by Rs16,299 million or 14.1 per cent from Rs115,823 million at end-June 2003 to Rs132,122 million at end-June 2004. The growth in total deposits in the previous year was 11.6 per cent. Increase in savings and time deposits together made up for

Table 8: Deposit Structure			
		End of June	
	2002 (Rs million)	2003 (Rs million)	2004 (Rs million)
Demand	13,617	15,915	19,048
	(13.1)	*(13.8)*	*(14.4)*
Savings	46,528	51,573	61,720
	(44.9)	*(44.5)*	*(46.7)*
Time	43,628	48,335	51,354
	(42.0)	*(41.7)*	*(38.9)*
	103,773	**115,823**	**132,122**
	(100.0)	*(100.0)*	*(100.0)*

Rs13,166 million or 80.8 per cent of the increase in all deposits.

As may be observed from Table 8, savings and time deposits continued to be the major components of the deposit mix representing around 86 per cent of total deposits over the past three years. However, during the same period, the proportion of term deposits in total deposits witnessed a gradual decline, falling from 42.0 per cent at end-June 2002 to 41.7 per cent at end-June 2003 and further to 38.9 per cent at end-June 2004.

Concentration of Deposits

Table 9 depicts the degree of concentration of banking sector's deposits according to their value range at end-June 2004. As may be seen from the table, Category 1 banks hold a large deposit base of low value range accounts which provides the banking sector with a cushion against sudden withdrawals from large accounts. Moreover, the main source of deposits remained 'Personal' deposits which constituted around 72 per cent of total time deposits at end-June 2004.

Maturity of Time Deposits

An important element for an effective liquidity management is the maturity pattern of deposits. Maturity patterns guide banks to make forecasts of liquidity needs and to take corrective action as may be necessary.

During 2003-04 the maturity pattern of deposits of banks was well scattered ranging from 7 days' notice to over 60 months and as shown in Table 10 indicates an improved liquidity risk profile. As at end-June 2004, fixed deposits maturing within 12 months constituted 55.6 per cent of total deposits compared to 54.9 per cent in the previous year.

Advances/Deposits Ratio

The ratio of advances to deposits shows the extent of use of deposit funds to support lending activities. Category 1 banks' advances/deposits ratio has been on a declining trend over the past three years, falling continuously from 82.2 per cent at end-June 2001 to 78.3 per cent at end-June 2002 and to 74.2 per cent at end-June 2003 and further to 69.1 per cent at end-June 2004. This situation is

Table 9: Value Range of Deposits			
		End of June 2004	
	No of accounts	Amount (Rs million)	Percentage to Total Deposits
Up to Rs 1 million	1,919,938	72,258	54.7
Over Rs 1 million to Rs 5 million	13,800	25,985	19.7
Over Rs 5 million	1,785	33,879	25.6

Table 10: Maturity Structure of Time Deposits				
	June-2003 Amount (Rs million)	**% of Time Deposits**	**June-2004 Amount (Rs million)**	**% of Time Deposits**
Up to 12 months	26,506	54.9	28,545	55.6
Over 12 months to 48 months	16,305	33.7	16,109	31.4
Over 48 months	5,524	11.4	6,700	13.0
	48,335	**100.0**	**51,354**	**100.0**

explained by a slower growth of credit to the private sector, thus releasing funds for other investments. A tightening of credit standards by banks also explains the falling advances/deposits ratio.

2.2.4.4 Interbank Transactions

Banks are able to fund themselves on the interbank money market. The market enables banks with excess liquidity to channel their funds to other banks in liquidity needs. Transactions are at the very short term end of the market, ranging from overnight to call deposits for periods of up to one month. Funds are provided, depending on individual banks' ratings in the market.

In circumstances where the interbank and other money markets are thin or segmented, banks may resort to repurchase transactions or to borrow under the Lombard facility, which is a stand-by overnight facility provided by the Bank of Mauritius.

Daily average funds transacted on the interbank market decreased from Rs213 million in 2002-03 to Rs163 million in 2003-04. The daily average transactions fluctuated between a minimum of Rs22 million and a maximum of Rs413 million during the year under review.

2.3 ELECTRONIC BANKING TRANSACTIONS

Six out of eleven category 1 banks are presently providing electronic banking services. The number of transactions using electronic delivery channels witnessed substantial growth during the past three years, rising from 1,579,171 at end-June 2001 to 1,706,705 at end-June 2002. They went up to 2,134,469 at end June-2003 and further to 2,286,308 at end-June 2004 peaking during the month of December. Between end-June 2003 and end-June 2004, the number of Automated Teller Machines (ATMs) in operation in Mauritius, inclusive of Rodrigues, increased by 16 from 257 to 273. However, the number of cards in circulation fell by 21,681 from 853,067 to 831,386. The number of credit cards in circulation grew by 4.7 per cent. The number of debit cards fell by 4.3 per cent.

The number of transactions involving the use of credit and debit cards at ATMs and Merchant Points of Sale increased from a monthly average of 2.0 million for a monthly average amount of Rs3,290 million in 2002-03 to a monthly average of 2.4 million for a monthly average amount of Rs3,939 million in 2003-04.

At end-June 2004, outstanding advances on 171,764 credit cards in circulation amounted to Rs822 million, indicating an average outstanding amount of Rs4,786 per card.

Table 11 shows the quarterly positions of Category 1 banks' electronic banking transactions from end-June 2003 to end-June 2004.

2.4 PERFORMANCE OF CATEGORY 2 BANKS

Category 2 banks operate in the same manner as international banks – they tap their business mostly on the international markets. They have a focus on wholesale banking.

The Bank has applied a very rigorous regime so as to ensure that only reputable banking institutions, having a proven track record, are licensed to operate in this sector. The offshore

Table 11: Electronic Banking Transactions					
	Jun-03	**Sep-03**	**Dec-03**	**Mar-04**	**Jun-04**
At end of Month **No. of ATMs in Operation**	**257**	**269**	**270**	**272**	**273**
During the Month **No. of Transactions**	2,134,469	2,241,072	3,207,597	2,595,910	2,286,308
Value of transactions (Rs mn) (Involving the use of Credit Card and Debit Cards at ATMs and Merchant Points of Sale)	3,384	3,686	6,105	4,297	3,598
At end of Month **No. of Cards in Circulation**					
Credit Cards	164,030	167,820	169,620	172,432	171,764
Debit Cards and others	689,037	611,220	625,786	642,937	659,622
Total	**853,067**	**779,040**	**795,406**	**815,369**	**831,386**
At end of Month **Outstanding Advances on** **Credit Cards (Rs mn)**	807	846	872	805	822

banking sector, presently the Category 2 banking sector, is a tightly regulated sector.

The provisions of the Financial Intelligence and Anti-Money Laundering Act 2002 have been further enhanced with the Regulations made by the Minister of Industry, Corporate Affairs and Financial Services, which impose on banks, both Category 1 and Category 2, stringent requirements on money laundering deterrence requirements. All banks are also required to abide by the Guidance Notes on Anti-Money Laundering and Combating the Financing of Terrorism issued by the Bank of Mauritius in November 2003 which became effective since January 2004.

Over the years, Mauritius has managed to enter into a number of Double Tax Treaties with other countries. The treaties have increased the scope for engaging in international financing business.

2.4.1 ASSETS

The activities of Category 2 banks increased substantially during the year under review. Total assets of Category 2 banks grew by 41.1 per cent from USD4,689 million at end-June 2003 to USD6,617 million at end-June 2004, compared to a growth rate of only 8.5 per cent in the previous year.

Placements with banks and loans and advances to non-bank customers remained the two major income-earning items in the asset portfolio of Category 2 banks. There was a diversification from these two activities, as the share of these assets in the books of Category 2 banks dropped from 94.0 per cent at end-June 2003 to 90.0 per cent at end-June 2004.

Chart 14 shows the trend growth of placements with banks and loans and advances to non-bank customers of Category 2 banks over the period June 1998 to June 2004. It is observed that while in June 1998, placements with banks represented 3.2 times loans and advances to non-bank customers; this ratio dropped to 1.8 in June 2000 and further down to 1.1 in June 2004. This indicates a significant change in asset structure

Chart 14: Category 2 Banks – Placements with Banks and Loans and Advances to Non-Bank Customers

of Category 2 banks, with a shift to more remunerative but riskier assets in the form of loans and advances to non-bank customers.

2.4.1.1 Placements with Banks

The bulk of the Category 2 banks' funds was placed intra-group. However, there was also a sizeable amount of claims on 'non-group' banks. At end-June 2004, total placements with banks constituted 47.6 per cent of their total assets, up from 43.0 per cent a year earlier.

Placements with banks increased by USD1,132 million or 56.1 per cent from USD2,019 million at end-June 2003 to USD3,151 million at end-June 2004.

2.4.1.2 Loans and Advances to Non-Bank Customers

Advances to non-bank customers grew by USD419 million, or 17.5 per cent, from USD2,398 million at end-June 2003 to USD2,817 million at end-June 2004, compared to a growth of USD374 million or 18.5 per cent during the preceding year.

The proportion of loans and advances to non-bank customers to the total assets of Category 2 banks fell from 51.1 per cent at end-June 2003 to 42.6 per cent at end-June 2004. The loans and advances remain the most important earning assets for Category 2 banks.

At end-June 2004, 81.4 per cent of total advances of Category 2 banks were granted to residents outside Mauritius, which is marginally higher than the figure of 81.2 per cent a year earlier. Lending to Global Business companies domiciled in Mauritius rose by USD48 million during the year to USD389 million and accounted for 13.8 per cent of Category 2 banks' total advances at end-June 2004, down from 14.2 per cent a year earlier. Advances to residents in Mauritius grew by 22.7 per cent, from USD110 million at end-June 2003 to USD135 million at end-June 2004. The share of such advances in total advances rose marginally to 4.8 per cent.

2.4.1.3 Investments

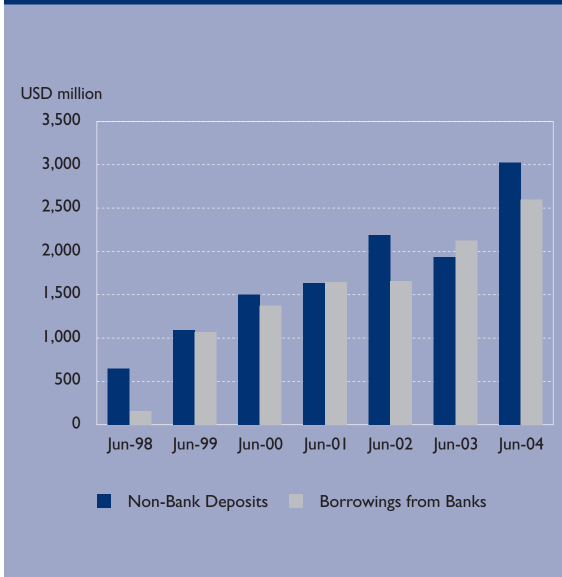
Investments undertaken by Category 2 banks registered an expansion of 60.6 per cent during the year under review, that is, up by USD143 million from USD236 million at end-June 2003 to USD379 million at end-June 2004. The investments comprised mainly securities (bonds and notes) outside Mauritius, with their share in total assets increasing from 5.0 per cent at end-June 2003 to 5.7 per cent at end-June 2004.

2.4.2 FUNDING

Non-bank deposits and borrowings from the international money market were the main sources of funding for Category 2 banks in Mauritius. Funding from these two sources made up 85.0 per cent of the total resources of the Category 2 banks. The trend of Category 2 banks' level of non-bank deposit liabilities and money market funding over the period June 1998 to June 2004 is depicted in Chart 15.

At end June 2004, deposits from non-bank customers accounted for 45.7 per cent of total resources of Category 2 banks, up from 41.3 per cent at end-June 2003. On the other hand, the proportion of borrowings from international banks in total resources fell from 45.4 per cent to 39.3 per cent. On a monthly average basis, non-bank deposits and inter-bank borrowings amounted to USD2,398 million and USD2,422 million

Chart 15: Category 2 Banks – Non-Bank Deposits and Borrowings from Banks



respectively during the twelve months up to June 2004. The corresponding figures for the preceding year stood at USD2,032 million and USD1,801 million, respectively.

2.4.2.1 Non-Bank Deposits

Total deposits from non-bank customers increased by USD1,088 million or 56.2 per cent from USD1,937 million at end-June 2003 to USD3,025 million at end-June 2004 in contrast to a drop of USD250 million or 11.4 per cent in the preceding year. The share of fixed deposits in total deposits dropped from 65.2 per cent at end-June 2003 to 58.7 per cent at end-June 2004.

2.4.2.2 Borrowings from International Money Market

Borrowings from the international money market by Category 2 banks maintained the upward trend with a 22.2 per cent growth from USD2,127 million at end-June 2003 to USD2,600 million at end-June 2004 compared to an increase of 28.3 per cent in the preceding year.

Funds borrowed from banks outside Mauritius accounted for 97.7 per cent of total borrowings. Category 2 banks continued to rely on their head office, parent bank, subsidiaries and fellow subsidiaries for their borrowings. However, borrowings from these sources fell from 87.4 per cent of their total borrowings at end-June 2003 to 79.8 per cent at end-June 2004.

Borrowings by Category 2 banks from banks outside Mauritius other than intra-group banks picked up from USD112 million at end-June 2002 to USD239 million at end-June 2003 and further to USD466 million at end-June 2004. Borrowings from banks in Mauritius rose by 107.0 per cent from USD28 million to USD58 million during the year under review.

2.4.3 LIQUIDITY

The Bank of Mauritius requires Category 2 banks to have in place liquidity management policies for sound management of that area of risk. The Bank reviews the level and trend of funding and borrowing patterns of Category 2 banks from a monthly statement showing their sources and uses of funds on a maturity-wise basis. Table 12 illustrates the consolidated liquidity position of Category 2 banks, based on the maturity of sources and uses of funds as at end-June 2004.

2.4.4 PROFITABILITY

Of the twelve Category 2 banks, eight close their accounts on 31 December, three on 31 March and one on 30 June. The consolidated position of profit and loss accounts of the twelve Category 2 banks based on the combined data at these different financial year-ends up to March 2004 is referred to as 2003/04. All the Category 2 banks realised net profits during these periods.

On an overall basis, Category 2 banks realised an increase of 18.9 per cent in net pre-tax profits, from USD54.9 million in 2002/03 to USD65.3 million in 2003/04, compared to a substantial decline of 43.9 per cent for the previous period. The improvement was mainly attributable to an increase of 9.3 per cent in interest income from USD170.5 million to USD186.3 million coupled with a significant drop of 48.0 per cent in the charge for bad and doubtful debts. Pre-tax profits achieved by the banks, individually, were in the range of USD0.8 million to USD26.1 million in 2003/04 compared to the range of USD0.03 million to USD29.7 million in 2002/03.

Table 12: Maturity of Sources and Uses of Funds of Category 2 Banks as at end-June 2004				
	USD million			
Maturity Bands	Sources (A)	Uses (B)	Mismatch (A) - (B)	Percentage to Total Resources
Call deposits / loans	748	560	188	2.9
Up to 7 days	1,654	1,700	(46)	(0.7)
Over 7 days to 1 month	650	1,091	(441)	(6.7)
Over 1 to 3 months	836	903	(67)	(1.0)
Over 3 to 6 months	1,046	439	607	9.3
Over 6 to 9 months	162	154	8	0.1
Over 9 to 12 months	155	261	(106)	(1.6)
Over 1 to 3 years	433	638	(205)	(3.1)
Over 3 to 5 years	314	411	(97)	(1.5)
Over 5 to 10 years	61	332	(271)	(4.1)
Over 10 years	0	11	(11)	(0.2)
Capital/fixed assets and internal accounts	495	54	441	6.7
Total sources/uses	**6,554**	**6,554**		

Chart 16 shows net profits of Category 2 banks in relation to their total funds for the period 1998/99 through 2003/04.

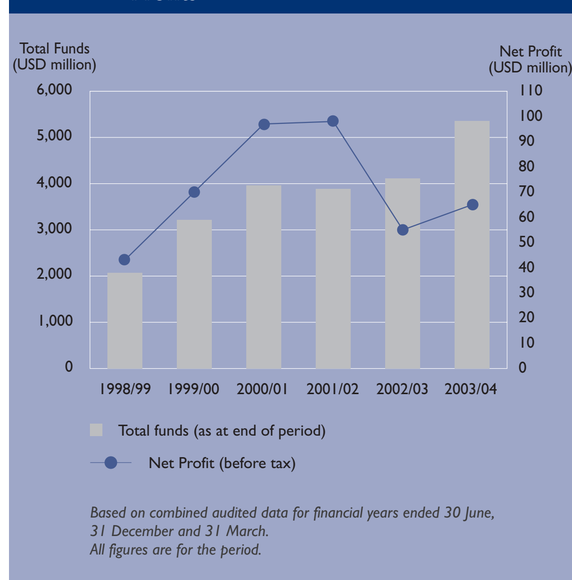
2.4.4.1 Net Interest Income

The significant increase of USD1.9 billion in the overall asset base of Category 2 banks in 2003/04, impacted positively on the volume of their net interest income. Net interest income of Category 2 banks picked up by USD19.5 million or 31.3 per cent, from USD62.4 million to USD81.9 million, compared to a decline of USD2.4 million or 3.7 per cent for the previous year.

The downward trend of total interest earnings of Category 2 banks was reversed in 2003/04. During the year 2003/04, interest income increased by USD15.8 million or 9.3 per cent compared to a decrease of USD46.1 million or 21.3 per cent in the preceding year. The proportion of interest income to total income continued its rising trend from 82.5 per cent in 2001/02 to 91.8 per cent in 2002/03 and further to 97.5 per cent in 2003/04.

Category 2 banks derived the bulk of their interest income from placements with banks and advances to non-bank customers, which together contributed 93.3 per cent of the total interest income or 91.0 per cent of total income. The

Chart 16: Category 2 Banks – Total Funds and Net Profits



Based on combined audited data for financial years ended 30 June, 31 December and 31 March. All figures are for the period.

corresponding figures for the previous year was 91.8 per cent and 84.3 per cent, indicating their greater contribution to the banks' income in 2003/04.

Interest earned on loans and advances to non-bank customers constituted the highest component of interest income of Category 2 banks, rising from USD100.3 million in 2002/03 to USD119.6 million in 2003/04. The share of these earnings in the interest income rose from 58.8 per cent in 2002/03 to 64.2 per cent in 2003/04. In contrast, interest earned from placements with banks fell marginally by USD2.0 million, from USD56.3 million in 2002/03 to USD54.3 million in 2003/04. The share of interest from placements with banks in total interest earnings continued its downward trend from 33.0 per cent in 2002/03 to 29.5 per cent in 2003/04.

Total interest expenses, which fell by USD43.7 million or 28.9 per cent in 2002/03, came further down by USD3.6 million or 3.3 per cent in 2003/04. Interest paid on borrowings from banks and non-bank deposits are the main items of interest expenses of Category 2 banks and together constituted 97.2 per cent of the interest expenses in 2003/04 compared to 99.0 per cent previously.

Interest paid on borrowings from banks represented the highest component of interest expenses and remained more or less unchanged at about USD72 million, representing 69.0 per cent of the interest expenses in 2003/04 compared to 66.5 per cent for the previous year. Interest paid on deposits continued its declining trend from USD35.1 million in 2002/03 to USD29.3 million in 2003/04. As a result, the percentage of such expenses to interest expenses fell from 32.5 per cent in 2002/03 to 28.1 per cent in 2003/04.

2.4.4.2 Non-Interest Income

Non-interest income of Category 2 banks fell by USD10.5 million or 68.6 per cent to reach USD4.8 million in 2003/04, following a sharp decline from USD46.0 million in 2001/02 to USD15.3 million in 2002/03. Non-interest income, comprising mainly profit from translation of currencies and fees and commissions, has been contributing lesser to the income of Category 2 banks on an overall basis. In fact, such income constituted only 2.5 per cent of total income in 2003/04 compared to 8.2 per cent in 2002/03 and 17.5 per cent in 2001/02. The main cause of the declining trend was an exchange loss arising from translation made by one of the major banks, which maintains its books in a currency other than US dollar.

2.4.4.3 Non-Interest Expenses

Staff and other operating costs rose by USD4.5 million or 42.9 per cent from USD10.5 million in 2002/03 to USD15.0 million in 2003/04. As a percentage to total income, non-interest expenses increased from 5.7 per cent in 2002/03 to 7.8 per cent in 2003/04. Staff costs increased by USD1.2 million to USD5.2 million in 2003/04 and constituted 34.7 per cent of non-interest expenses in 2003/04. Other operating expenses which made up 65.3 per cent of non-interest expenses, rose by USD3.3 million to USD9.8 million.

The cost to income ratio rose from 16.0 per cent in 2002/03 to 18.7 per cent in 2003/04.

2.4.4.4 Return on Average Assets And Equity

Table 13 outlines the financial performance of Category 2 banks in terms of their return on average assets and equity in 2001/02, 2002/03 and 2003/04. Profitability indicators were more or less at the same level in 2003/04 compared to the previous period, despite increase in pre-tax profits from USD54.9 million to USD65.3 million.

The overall return on average assets of Category 2 banks fell marginally by 10 basis points to 1.4 per cent in 2003/04, compared to a decline of 1.1 per cent in the previous period. Individual banks' return on average assets ranged between 0.7 per cent and 2.1 per cent in 2003/04 compared to negative 0.3 per cent and 2.5 per cent a year earlier. In 2003/04, only one Category 2 bank achieved return on average assets higher than 1.5 per cent in comparison with four banks in 2002/03.

The overall return on equity of Category 2 banks, which deteriorated from 40.7 per cent in 2001/02 to 18.0 per cent in 2002/03, increased

Table 13: Category 2 Banks – Profit Performance

	2001/02	2002/03	2003/04
		(USD million)	
Interest Income	216.6	170.5	186.3
Less Interest Expense on Deposits & Borrowings	151.8	108.1	104.4
Net Interest Income	**64.8**	**62.4**	**81.9**
Add Non-interest Income	46.0	15.3	4.8
Operating Income	**110.8**	**77.7**	**86.7**
Less Total Operating Costs	10.0	10.5	15.0
Staff Expenses	*3.7*	*4.0*	*5.2*
Provision for Depreciation	–	–	–
Other Expenses	*6.3*	*6.5*	*9.8*
Operating Profit	**100.8**	**67.2**	**71.7**
Less Charge for Bad and Doubtful Debts	2.8	12.3	6.4
Net Profit before Tax	**98.0**	**54.9**	**65.3**
Interest Income as a Percentage of Total Income (Per cent)	82.5	91.8	97.5
Cost to Income Ratio (Per cent)	9.3	16.0	18.7
Return on Average Assets (Per cent)	2.6	1.5	1.4
Return on Equity (Per cent)	40.7	18.0	18.3

to 18.3 per cent in 2003/04. In 2003/04 individual banks' return on equity ranged from 4.1 per cent to 46.4 per cent compared to a range of negative 1.1 per cent to 46.4 per cent in the previous year. Only three banks achieved a return on equity of over 20 per cent in 2003/04, same as in 2002/03.

2.4.4.5 Provision for Bad and Doubtful Debts

Apart from specific provisions on identified impaired loans, Category 2 banks are also required to maintain a general provision of one per cent on their standard advances as a prudential measure in accordance with the provisions of the Guideline on

Table 14: Category 2 Banks – Total Advances, Non-performing Advances and Provision for Bad and Doubtful Debts*

	2001/02	2002/03	2003/04
		(USD million)	
General Provision	13.4	20.2	26.6
Specific Provision	6.3	15.5	10.3
Total Provision for Bad and Doubtful Debts	**19.7**	**35.7**	**36.9**
Total Advances	1,537.9	1,547.0	2,578.7
Non-performing Advances	6.9	52.2	32.3
Ratio of Non-Performing Advances to total Advances (Per cent)	0.5	3.4	1.3
Ratio of Specific Provision for Bad and Doubtful Debts to Non-performing Advances (Per cent)	91.3	29.7	31.9

** based on audited accounts*

Credit Classification for Provisioning Purposes and Income Recognition issued by the Bank. The level of general provision of Category 2 banks has been on the rising trend, increasing by 31.7 per cent in 2003/04 to reach USD26.6 million.

Table 14 shows the trend of the provisions for bad and doubtful debts with respect to non-performing advances and total advances of Category 2 banks during the period 2001/02 to 2003/04. Following an increase of USD45.3 million in the previous year, non-performing advances of Category 2 banks fell by USD19.9 million or 38.1 per cent to reach USD32.3 million in 2003/04. The ratio of non-performing advances to total advances dropped from 3.4 per cent in 2002/03 to 1.3 per cent in 2003/04. This is attributable to faster growth in the advances portfolio of the Category 2 banks and contraction in the level of non-performing advances. With the reduction in the reported figure of non-performing advances, specific provisions for bad and doubtful debts fell by USD5.2 million to USD10.3 million in 2003/04. The ratio of specific provisions to non-performing advances rose from 29.7 per cent in 2002/03 to 31.9 per cent in 2003/04, since the reduction in non-performing advances outpaced the fall in specific provisions.

3. Basel II

INTRODUCTION

The safety and soundness of a bank rests to a large extent on the capital it maintains. With a view to improving the safety and soundness of banks, the Basel Committee on Banking Supervision (BCBS) introduced in 1988 the concept of a risk-based capital adequacy standard which came to be known as the Basel I Capital Accord.

With the sweeping changes taking place in financial markets worldwide and increased risks being taken by large banks since then, the need for a new framework was felt. The BCBS issued in 1999 a proposed New Capital Adequacy Framework which is referred to as Basel II. The main objective of Basel II is to continue promoting the safety and soundness of the financial system and improve risk measurement and management with a view to aligning the amount of required capital to the amount of risk taken. The development of the framework has undergone an extended period of preparation. Since 1999, three consultative documents have been issued and three Quantitative Impact Studies (QIS) have been conducted by the BCBS. The views of banks and regulators from across the world have been sought and their suggestions taken into account before finalising the proposals.

At the outset, it was expected that the Basel II would be implemented by 2003. The implementation has been postponed in view of various concerns raised by the international banking community on the evolving framework. A final version was issued in June 2004 and the Accord is expected to be implemented by end of 2006. However, given the disparate levels of readiness of countries worldwide, the BCBS has deemed it wise to propose several options with respect to the implementation of Basel II.

IMPLICATIONS & CHALLENGES

The implementation of Basel II represents a daunting challenge to banks and supervisors alike. The most common criticism against Basel II is that it is extremely complex. The measurement, management and mitigation of credit risk involve the deployment of significant amounts of resources especially for banks in emerging economies.

A major obstacle that would be faced by banks in emerging countries would be a lack of experienced and trained personnel in the full-fledged implementation of Basel II. The proposed Accord involves greater use of assessment of risks provided by banks' internal systems. The infrastructure which banks will need to set up with respect to Pillar 1 of the Accord will involve a vast data bank on customers, particularly on their probability of default and loss. Banks will have to maintain complete and reliable historic data for 5 to 7 years. It calls for the need for banks to recruit risk analysis specialists who are proficient in credit risk modelling.

The Accord also requires the earmarking of a capital charge for operational risk which has been defined by the Basel Committee as "the risk of loss resulting from inadequate or failed processes, people and systems or from external events". Unlike other risks, operational risk cannot be measured with reasonable certainty nor can the time of its materialization be forecast. Hence, computing the operational risk accurately will pose another problem to banks although the Accord does propose three methods to do so and the Bank has issued a draft consultative Guideline on this subject to banks.

The implementation of the Accord may call for the injection of additional capital from many banks. The third Quantitative Impact Study (QIS) carried out by the Basel Committee revealed that on average, there will be an increase in the capital requirements for non-G10 and non-EU countries.

On the other hand, Basel II will prove a daunting task to national supervisors and their supervisory skills will need to be substantially upgraded. As per Pillar 2 of the Accord - the Supervisory Review - supervisors should have the

authority to take appropriate actions if they are not satisfied with their review and evaluation of banks' internal capital adequacy assessments and strategies.

According to the new Accord, supervisors should also have the authority to require banks to hold capital in excess of the minimum, besides having to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank. These legal backings are not in all cases available to all national supervisors. In those cases, legislations will need to be amended accordingly.

Under the new Accord, cross-border issues are likely to receive greater attention than they do at present. While cross-border responsibilities of regulators will continue to apply, there will be need for enhanced practical cooperation between supervisors. Resources and skills will have to be developed to conduct cross-border supervision. Mutual trust among supervisors should also be fostered.

Basel II also calls for the services of rating agencies as customers will need to be rated in accordance with their risk profile. The insufficient availability of such agencies is a major obstacle in emerging countries.

National supervisors will have the task of developing the necessary conditions to encourage banks to adopt Basel II. Moreover, banks will have to invest in the development and installation of risk management systems associated with the implementation of the new Accord.

BENEFITS

Notwithstanding the extreme complexity and the costs involved in implementing Basel II, everyone recognises that it will certainly entail substantial benefits to banks, supervisors and market participants by way of better risk management and better alignment of economic capital and regulatory capital. Indeed, banks need to better measure and manage their risks if they are to survive under competitive conditions.

It is expected that individual banks in developed markets may expend between USD1 million and USD150 million for the implementation of the Basel II Accord. This process will help them to better control their risks but, clearly, they are also expecting to derive benefits by adopting the sophisticated approaches proposed in the Accord. Where banks are managed in a safe and sound manner, this will contribute to the stability of the banking sector and, by extension, to that of the financial system as a whole.

Banks have, over the past years, already embarked on improving their risk management and measurement approaches. In order to comply with the various guidelines concerned with asset quality, credit classification and provisioning, banks in Mauritius are improving their credit management. Banks have also been required to improve their system of checks and balances in order to run their business along the lines of sound corporate governance. In all these ways, therefore, the work already started will pave the way for moving towards the adoption of Basel II.

OPTIONS

One of the major concerns raised by countries across the world during the consultation stage was the need to have customers rated by credit assessment institutions. The CP3 dealt with this concern and proposed the Simplified Standard Approach (SSA). This methodology dispenses with the need to set up processes to select External Credit Assessment Institutions (ECAIs). Accordingly, alternative approaches will be adopted to quantify the risks objectively and provide for the necessary capital.

Although the Basel II is complex, the Basel Committee has proposed a wide range of options for determining capital requirements for credit risk and operational risk to allow banks to select approaches that are most appropriate for their operations. The Basel committee is fully conscious of the implications of implementing the new framework and the infrastructure that needs to be put in place to that end. It is important to note that no country is under any obligation to implement Basel II. As it may not be appropriate for every country to implement Basel II in the short term, the Basel Committee has advised each country to inform it of its readiness well before taking a decision on whether to adopt Basel II. Countries are

specifically advised to decide whether they have the necessary infrastructure. They are allowed an option on the course they wish to follow. Those countries which feel they are not ready can continue to follow Basel I. Of the three Pillars comprising Basel II, Pillar I is the most complex one. Therefore countries can go for Basel I coupled with Pillar 2 and/or Pillar 3.

Under Pillar I of the Basel II, credit risk may be measured using one of the three options – Standard, IRB (Foundation) and IRB (Advanced), in the ascending order of complexity. Therefore, further options are allowed within the Pillar I. These options widely recognize that Basel II is extremely complex and costly to introduce immediately at one go.

READINESS

In June 2004, the Basel Committee issued the final framework which has been endorsed by the Central Bank Governors and Heads of Banking Supervision of G 10 countries. It is worth underlying that the Committee is encouraging all countries worldwide to adopt the revised framework at such time as they believe is deemed appropriate by them. The Committee recognises that adoption of the framework in the near future may not be a first priority for all non-G 10 countries. Each national supervisor is advised to consider carefully its own financial system in order to come up with a time frame and approach for its implementation.

By now many countries in the world have already made public their intentions with respect to Basel II. It has been estimated that some 60 countries plan to adopt Basel II at the intended date of implementation. More than 100 countries have already adopted the current and simpler Basel I. It is worth noting that China has declared its intention to go along with a revised Basel I. Those countries which are going for Basel II at the intended date of implementation will do so in a phased manner. Some will adopt the standard approach in the first instance and proceed to IRB – Advanced approach over a three-year to five-year period.

In the United States, only a few banks will adopt Basel II. The 10 largest banks will be required to adopt Basel II and 10 more will adopt it voluntarily. However, these banks represent the bulk of banking activities in US. Russia will adopt Basel II but will opt for the simplest credit risk option i.e. standard approach. Some European banks already have in place more sophisticated and efficient risk-management systems which will enable them to implement Basel II earlier than other banks.

WORK CARRIED OUT BY THE BANK OF MAURITIUS

Market Discipline

Pillar 3 of the Basel Accord deals exclusively with market discipline. Market discipline imposes strong incentives on banks to conduct their business in a safe, sound and efficient manner. The philosophy of market discipline is that reliable and timely information enables counterparties to make well-founded risk assessments. Consequently, banks are required to publish in a timely fashion all key features of their capital as well as risk exposures.

In order to implement the requirements of market discipline, the Bank of Mauritius issued the Guideline on Public Disclosure of Information which became effective on 3 January 2003. The Guideline lays down the formats for:

(i) Management Discussion and Analysis (MDA) and
(ii) Annual financial statements.

The MDA covers, inter alia,

(a) capital structure;
(b) risk management policies and controls;
(c) related party transactions policies; and
(d) corporate governance policies.

Banks are required to show in a tabular form the components of their Tier 1 and Tier 2 capital. Any movements in the capital structure need to be discussed. More particularly, any new issues and repurchases of ordinary shares, new issues and redemptions of preferred shares and subordinated debentures should be outlined.

Banks are also required to identify and describe the risks that are significant to their business. These

include credit risk, interest rate risk, foreign exchange risk, liquidity risk and operational risk. Banks are required to provide data on credit quality annually for 5 years. Data on loans, related non-performing loans and provision for credit losses by industry sector also need to be provided.

It is worth noting that the Guideline also requires banks to have operational risk management policies and practices to be approved by their board of directors. Operational risk is defined in the same way as in Basel II.

Operational Risk Management Framework

One of the new requirements under Pillar 1 of Basel II Accord is the need for banks to maintain a separate capital charge for their operational risk. Operational risk has been defined as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'.

In this respect, the Bank of Mauritius has issued a draft Guideline on Operational Risk Management and Capital Adequacy Determination. This Guideline requires each bank to establish an appropriate and comprehensive approach for the identification, measurement, monitoring and control of operational risks. The Accord has laid down three alternative approaches for calculating operational risk capital charge, viz:

(a) Basic Indicator Approach
(b) Standardised Approach
(c) Advanced Measurement Approach

The Guideline allows banks in Mauritius the flexibility of choosing the approach suitable for their operations. As a minimum, banks will be required to compute their capital charge for operational risk under the Basic Indicator Approach. The Guideline recommends banks to use the essential elements outlined in it to formulate a comprehensive framework for managing operational risk which is commensurate with their size and degree of sophistication. The Guideline requires every bank to establish a written policy on operational risk which clearly sets out:

- an appropriate definition of what constitutes operational risk;
- its appetite and tolerance for operational risk;
- the principles for identifying, assessing, monitoring and controlling/integrating operational risk;
- policies for managing risks associated with outsourcing activities, and
- the accountabilities of the Chief Executive Officer to the board of directors.

Capacity Building

Pillar 2 of the Accord – Supervisory Review imposes a lot of responsibilities on national supervisors. The latter should, therefore, be intensely trained so that they are capable to supervise banks adopting Basel II. The Pillar 2 also requires the powers of supervisors to be substantially enhanced. To this end, the Banking Act has been revised and a new Banking Act has been promulgated. Furthermore, the capacity building of the supervision department is proceeding. The staff strength has been more than doubled last year. Recruitment of additional staff is on the way. All the staff of the Department have enrolled on a two-year e-learning programme on Basel II with the Financial Stability Institute. A separate unit has been set up within the Department to monitor the implementation of Basel II in Mauritius.

Implementation of Basel II

A Working Group was set up on 17 July 2003 at the Bank of Mauritius to come up with a strategic plan regarding the implementation of the new Accord in Mauritius. The Bank of Mauritius wrote to all banks seeking their views on their preparedness and willingness to adopt Basel II. It is comforting that all the banks expressed their willingness to adopt Basel II. Whereas the international banks are going to align themselves with the policy of their head office, the local banks are opting for the standard approach with respect to credit risk under Pillar I of the Accord. The Bank of Mauritius also subscribes to the stand taken by the local banks which do not, at present, have the necessary infrastructure to adopt the more advanced approaches.

4. Operational Risk

INTRODUCTION

Banks and other financial institutions face a wide array of risks in the course of their day-to-day operations. Credit risk remains the major risk inherent in the activities of banks. However, growing sophistication in financial technology combined with deregulation and globalisation of financial services are increasing the diversity and complexity of banking activities. Consequently, operational risk is assuming a greater importance than ever before.

Operational risk has always existed in banking activities but the perception of its nature was typically narrow and related mainly to risk arising from operations or more generally from 'back office' activities. The Basel Committee on Banking Supervision (BCBS) has defined operational risk as ***'the risk of loss resulting from inadequate or failed processes, people and systems or from external events.'*** The definition of the BCBS encompasses legal risk, which is the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations, but excludes strategic and reputational risks.

The risk 'from inadequate or failed processes, people and systems' refers to the risk of failure in risk management processes, organisational structure or human resource management. Inadequate controls, poor training, poor staff resources and employee fraud may exacerbate these risks. The Barings episode is a typical example of stratagems used by a single employee to fraudulently exploit flaws in an organisational structure. The substantial foreign exchange trading loss at Allfirst Bank was the result of a lack of appropriate segregation of duties which translated into a breakdown of fundamental internal control processes. 'External events' comprise natural disasters such as flood, earthquakes as well as terrorism and vandalism. The events of 11 September 2001 and the Northeast blackout which directly impacted on the back offices of financial institutions can be classified as externally driven operational incidents.

REGULATORY AND SUPERVISORY MEASURES

Operational risk differs from other risks in that its consequences cannot be measured with reasonable certainty nor can the time of its materialisation be forecast. External events such as natural disasters, terrorist attacks or the discovery of a fraud may occur at the most unpredictable time.

While a robust capital may, to some extent, serve as a cushion against operational losses, it does not at all times guarantee the solvency of an institution. Deficient risk management policies can never be compensated by a large capital. Since business processes are becoming more globally connected, the materialisation of operational risks impacts not only on a particular institution but may have a spillover effect on a financial system as a whole. Supervisory authorities are entrusted with the responsibility of safeguarding the stability of the financial system as well as ensuring the safety and soundness of individual institutions. As the regulatory and supervisory authority, the Bank of Mauritius continually provides guidance to institutions falling under its purview on the efficient management of their operational risk.

The Bank recognises that no financial institution can effectively manage operational risk if its management does not have a sound corporate culture. An internal control system, no matter how robust, cannot by itself ensure an adequate management of operational risk if those controlling the institution are not fit and proper. To this end, operational risks are indirectly dealt with at the licensing stage of banks. Section 7(2) of the Banking Act 2004 sets out in broad lines the criteria to be observed by an institution to be eligible for a banking licence. The Act stipulates at section 7(2)(a)(i) that no licence shall be granted unless the central bank is satisfied as to the technical knowledge, experience, financial conditions and history of the directors and senior officers of the applicant. The Bank thus requests for specific information regarding shareholding structure of the

proposed entity, its directors and its senior management to ensure that the institution will be operated along sound risk management principles. The fitness and propriety of influential shareholders, the Chief Executive Officer and all senior officers are, *inter alia*, assessed on the basis of their history, their previous work experience, their legal track record and their financial soundness. Furthermore, with a view to limiting excessive influence on the overall operation of banks, the Banking Act restricts, the direct or indirect shareholding by any entity to not more than 10% of the capital of a bank.

In the wake of the recent scandals in the financial world, the Bank has deemed it imperative to ensure that influential shareholders, directors and senior officers are assessed on an on-going basis. In this connection, the Bank issued in October 2003 Guidance Notes on Fit and Proper Person Criteria which highlight the responsibility of the board of directors in ensuring the continuing fitness and propriety of relevant persons. The Guidance Notes further require all institutions' board of directors to establish their own fit and proper person policy which should take into consideration the minimum criteria set out in the Guidance Notes.

Since the board is responsible for the stewardship of institutions and for establishing the various risk policies, the Bank also assesses the competence and relevant knowledge of the board members. The latter have to demonstrate their competence and ability to understand the technical requirements of the business, inherent risks and key management processes. The Bank lays emphasis on the independence of the board of directors. In its Guideline on Corporate Governance, the Bank recommends that a board should comprise a reasonable proportion of independent directors for better accountability and depth in corporate governance. The Banking Act 2004 defines an independent director as a director who has no relationship with or interests in, whether past or present, an institution or its affiliates, which could, or could be reasonably perceived to, materially affect the exercise of his judgment in the best interest of the institution. The Bank's Guideline on Related Party Transactions reinforces the concept of independent directors and prescribes that all transactions involving related parties should be carried out at arm's length.

An institution's internal control system, covering all its business areas, determines largely the extent to which operational risks can be managed. A primary requirement in the grant of a banking licence, as per section 7(2)(a)(iii) of the Banking Act 2004, is that an institution should have adequate accounting and control systems and records. Once a licence has been granted, an institution should constantly adapt its internal control systems to meet the growing business needs of the institution. Each institution should have well-defined risk management policies for each area of business. These policies should define clearly the appropriate internal control procedures. The Basel Committee has highlighted the responsibilities of supervisors through its paper 'Core Principles for Effective Banking Supervision' issued in 1997. Principle 13 of the Core Principles states that *'supervisors should ensure that senior management puts in place effective internal control and auditing procedures; also, that they have policies for managing or mitigating operational risk (e.g., through insurance or contingency planning). Supervisors should determine that banks have adequate and well-tested business resumption plans for all major systems, with remote site facilities, to protect against such events.'*

The Bank issued, in November 1994, a Guidance Note on General Principles for Maintenance of Accounting and Other Records and Internal Control Systems. The Guidance Note emphasises the need for internal controls and highlights the role of both directors and management in ensuring the adequacy of accounting and other records and internal control systems. It requires directors and management to review, monitor and test the internal control systems on a regular basis to ensure their effectiveness on a day-to-day basis and their continued relevance to the business. The Guidance Note also requires banks to have in place contingency plans and business continuity plans to ensure that disruptions in their activities are limited. Such plans should cover all the potential operational risks to which a bank is exposed and incorporate the necessary recovery measures to restore operations.

The Guidance Note requires internal auditors to review management adherence to policies and procedures set up by the board in respect of risk

management. They have to determine the appropriateness of risk management measures in relation to risk exposures and test all aspects of risk management. In this connection, the Guidance Note requires that the internal audit function be appropriately structured and resourced to enable it to provide an independent appraisal of internal control. One way of enhancing the internal auditor's independence is to provide the internal auditor with direct access to the audit committee.

The roles of bank supervisors and external auditors are being increasingly perceived as complementary. A key feature of the above-mentioned Guidance Note is the responsibility entrusted to banks' external auditors in the reporting on the adequacy of internal control systems. The Guidance Note requires the external auditors to form an opinion on whether the bank's accounting and other records and internal control systems have been maintained by management during the period examined by them. The report, together with comments of the bank's management, should be submitted to the Bank of Mauritius by the bank along with its audited accounts. In case of a negative opinion, the external auditors must immediately inform the Bank of Mauritius. The Bank's Guideline on Transactions or Conditions respecting Well-being of a Financial Institution Reportable by the External Auditor to the Bank of Mauritius has heightened the awareness of external auditors to their reporting responsibilities. It describes the broad categories of transactions or conditions that are immediately reportable to the Bank of Mauritius. Such conditions, include, *inter alia*, a criminal offence involving fraud, other dishonesty which has been committed or any serious irregularities, including those that jeopardise the security of depositors and creditors.

The Bank's Guideline on Corporate Governance issued in April 2001 places further emphasis on the need to ensure that proper risk management policies are in place and are being adhered to by institutions. This responsibility is shared between the audit committee and the Conduct Review and Risk Policy Committee. The two committees should be constituted of independent directors to promote sound corporate governance. The guideline specifies that one of the principal responsibilities of the audit committee is to provide an oversight over the performance of the external and internal audit functions. This committee further has to ensure that management has implemented an effective system of internal control.

The Bank of Mauritius requires all banks and non-bank deposit taking institutions to have operational risk management policies duly approved by their board of directors. In this connection, the Bank's Guideline on Public Disclosure of Information requires them to make the appropriate disclosure on such policies and procedures in their financial statements. These institutions should disclose their policies with respect to identification and assessment of operational risk and implementation of risk mitigation practices.

While the Bank has continually provided guidance to the industry on the general principles of internal controls and sound corporate governance to mitigate operational risks, it has also provided guidance on the management of such risks in some specific areas. One such area is Internet banking. While Internet banking provides a low cost and convenient financial service to customers, it also increases the complexity and degree of risk to which the banks are exposed. The Guideline on Internet Banking issued in February 2001 by Bank of Mauritius sets out the ground rules to guide banks in establishing systems and processes to control related risks. As per the guideline, banks are required to seek the prior approval of the Bank of Mauritius before providing Internet banking services. Banks are also required to submit to the Bank of Mauritius a yearly report on the extent to which their set objectives are met together with copies of their updated security program and contingency and business resumption plans. The guideline emphasises the importance of maintaining a back-up system that should be tested on a regular basis to minimise the risk of system failures and unauthorised access. Each bank is required to establish, with the approval of its board of directors, its own written policy on the overall security of its Internet banking system and implement an overall security program comprising risk management controls.

Section 42 of the Banking Act 2004 empowers the Bank of Mauritius to carry out on-site inspections of the operations and affairs of financial institutions

under its purview. The prime objective of these on-site inspections is to allow supervisors to make an overall assessment of the institutions and to have a better insight into qualitative factors such as management capabilities and internal control procedures that may not be adequately reflected in returns submitted by the financial institutions to the Bank of Mauritius. The Basel Committee highlights the responsibility of bank supervisors in ensuring that financial institutions have adequate systems and controls in place for the management of operational risk. Principle 14 of the Core Principles states that *'banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.'*

The institutions' corporate governance process is examined during on-site inspections through review of minutes of the boards and their committees such as the audit committee and the Conduct Review and Risk Policy Committee. This is considered as one of the most essential parts of an on-site inspection as it gives a proper insight into the level of corporate governance achieved by the institution. The constitution of the various committees is also examined against the requirements of the different guidelines issued by the Bank of Mauritius. The risk management policies established by the institutions in respect of their different risk areas are reviewed and adherence to these policies is assessed based on a sample of transactions.

Supervisors view the functions of internal auditors and compliance officers as critical in operational risk management. Supervisors rely on internal audit reports to make a first hand evaluation of an institution's internal control systems. During on-site inspections internal audit reports are reviewed with a view to assess their adequacy. One of the primary roles of the compliance officer is to ensure the institution's adherence to laws and regulations as well as to the guidelines issued by supervisory authorities. Reports prepared by the compliance officer are examined during on-site inspections.

ROLE OF THE BASEL COMMITTEE

The Basel Committee has issued several guidance notes that may be used by banks in the setting up of appropriate risk management processes. Its Core Principles for Effective Banking Supervision require bank supervisors to ensure that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all material risks and, where appropriate, to hold capital against these risks.

The Basel Committee has, through its proposed new capital adequacy framework, set out the need for banks to maintain capital with respect to operational risk. The new capital adequacy framework will be implemented by member countries of the BCBS by end-2006. As per the proposal, the capital to be maintained in respect of operational risk may be calculated by adopting one of the three approaches proposed by the Committee. According to the Basic Indicator Approach, which is the simplest approach proposed, banks would have to set aside a capital charge equivalent to 15 per cent of their gross income. Under the Standardised Approach, a capital charge is required for each business line as defined in the new capital adequacy framework. Under the Advanced Measurement Approach banks are allowed to make their own assessment of capital charge. For banks to qualify for these advanced approaches, they need to have effective operational risk management and controls. The Bank of Mauritius has set up a working group with the objective of developing an implementation plan for the Accord. The Bank of Mauritius has already issued to the banking sector, on a consultation basis, a Guideline on Operational Risk Management And Capital Adequacy Determination.

In February 2003, the Basel Committee issued a paper entitled 'Sound Practices for the Management and Supervision of Operational Risk'. The paper lays down a set of principles that provide a framework for the effective management and supervision of operational risk for use by banks and supervisory authorities when evaluating operational

risk policies and practices. It outlines the role and responsibility of the board of directors in the development of an appropriate risk management framework for proper identification and assessment of the operational risks inherent in banks' products and services, monitoring and mitigation of these risks, including disaster recovery and business continuity plans. The role of bank supervisors in ensuring that proper operational risk management is detailed and the importance of making appropriate disclosure of the operational risk management, are emphasised.

CONCLUSION

Notwithstanding the strength of its capital, a bank cannot take a relaxed attitude towards its corporate governance and risk management processes.

Since losses arising from materialisation of operational risk cannot be quantified until the losses actually occur, setting aside a capital charge without putting in place proper risk management practices would not be an effective strategy in operational risk management. During the past few years, the Bank of Mauritius has encouraged banks to have effective operational risk management and adequate internal controls. Good management of information system, a strong internal control culture and contingency planning are all critical elements for an effective operational risk management by banks of any size and complexity.

5. Rationale for Integrated Supervision and The Related Supervisory Issues

THE CHANGING FINANCIAL LANDSCAPE

The stability, integrity and efficiency of the financial system are critical to the performance of an economy. The financial service sectors of most countries are continuously subjected to changes brought about by market developments. Global competition, deregulation of domestic financial markets as well as rapid technological progress, through falling transactions costs are changing the world financial landscape fundamentally. The result has been a blurring of the boundaries within the financial services sector; hence banking and non-banking activities are becoming more integrated. This process of integration poses ever-increasing challenges for supervisors.

Advances in information and telecommunication technologies have allowed banks and non-bank institutions to develop new and more customised products and services which can be delivered over in the local and international markets with greater efficiency. Technology has made it possible to analyse and monitor risks more effectively. Though technological progress has brought about new opportunities, it has also increased the risk of financial crises.

In addition to technological progress which has stimulated innovation in products and delivery channels, regulatory burdens have prompted innovation in products engineered to exploit gaps, inconsistencies and imperfections in the regulatory regime.

Financial globalisation has been a key feature underlying economic activity in the last decade. Falling barriers and reduced communication costs have facilitated faster and smoother flow of information and capital across boundaries, bringing financial markets closer. Removal or relaxation of barriers to entry in both domestic and international financial markets and services has resulted in increased competition.

As competition has intensified, there has been an overlap in the activities and product lines provided by banks and other financial service providers. This has diminished the past distinction between banks and non-bank financial institutions. This trend has resulted in changes in organisational structure with the rapid consolidation both within and between different financial organisations. For example, there has been a growth in financial conglomerates (defined as a group which undertakes at least two major financial activities) resulting mostly from the impact of mergers and acquisitions. This process of market integration has also increased the potential for financial crisis which can transcend national borders with the growing volume of international financial transactions.

CHANGING REGULATORY FRAMEWORK

Since the structure of financial services throughout the world is undergoing considerable changes and traditional product boundaries are becoming increasingly blurred, activities are becoming more integrated, rendering financial regulation more complex. In fact, financial regulation has become a specialisation on its own.

The growth of financial conglomerates which operate diverse groups of financial institutions domestically, and often internationally as well, has led regulators to devise ways to efficiently and effectively supervise their operations. There is a view that, in a multiple regulatory regime, fragmentation of supervision may give rise to concerns about the ability of the financial sector supervisors to form an overall assessment of the conglomerates on a consolidated basis and to ensure that there is no supervisory gap. This could, however, be a simplification of regulatory reality.

Moreover, institutional failures and market crashes have also focused attention on the question of appropriate regulation and supervisory practices which can capture the entire risk of the overall financial sector. Greater integration among financial services, financial institutions failure or other financial market disruptions have caused many countries such as UK, Norway, Denmark, Sweden, Japan, Korea, Luxembourg, Australia to reconsider their regulatory structures and adopt a single regulatory regime or to harmonise more closely regulatory practices.

Coherent approach to supervision of financial services was also felt in Mauritius, taking into consideration global changes in the financial industry and the inherent potential for Mauritius to move into a regional financial hub. To keep pace with the market developments, it was believed that a unified regulatory structure in Mauritius would achieve greater harmonisation of regulations and supervisory practices across the financial sector.

CONSOLIDATION OF FINANCIAL REGULATION WITHIN THE FSC

The Financial Services Development Act 2001 created the Financial Services Commission (FSC) as the new regulatory body for non-banking services, replacing a fragmented regulatory system with a unified regulator concept. The Stock Exchange Commission (SEC), the Controller of Insurance and the Mauritius Offshore Business Activities Authority, once separate supervisory bodies, were merged within the FSC. Other non-bank financial activities, which were previously unregulated, were also brought under the umbrella of the FSC. Bank of Mauritius, on the other hand, continues to license, regulate and supervise the banking sector, in addition to regulating and supervising foreign exchange dealers, money-changers and non-bank deposit taking institutions.

REGULATORY ISSUES

A wide range of arguments has been advanced in favour of unified approach to supervision. Some of them are based on efficiency gains, due to economies of scale or the need to revise supervisory structure in light of the increase in financial conglomerates or to ensure competitive neutrality because of the blurring of the distinctions between the various classes of financial institutions. This is, however, still an open debate.

Effective supervision of financial conglomerates places several responsibilities on various financial supervisory bodies. In the absence of a unified body, it is important for supervisory bodies to establish an effective and efficient system of information sharing among themselves bearing at the same time the need to maintain confidentiality. Moreover, the supervisory bodies must also collaborate to ensure that any suspicious transaction and finding is shared and that regulatory gaps are identified and eliminated. It is also the practice in some jurisdictions to establish a lead regulator who is given the power, authority and responsibility to make an overall risk assessment and to deal with any associated problem.

Although it might be possible to have several regulators to co-operate in the supervision of diversified financial conglomerates, some believe that a unified approach could offer a better prospect of co-ordination and exchange of information than would be the case when there are separate organisations responsible for supervising different classes of financial institutions.

The blurring of lines between institutions may give rise to circumstances where similar activities are treated inconsistently. A multiple regulatory regime which could lead to competitive inequalities in that some products or services may be supervised differently, would need to be addressed. For example, there is a strong likelihood that there may be differences in their regulation and the associated costs of achieving compliance, which may, in turn, give some institutions a competitive advantage in offering a particular service or product. All these potential divergences in regulatory practices may have to be considered.

A system of multiple supervisory authorities can also create incentives for regulatory arbitrage if not properly coordinated. This can involve the placement of a particular service or product in that part of a financial institution where the supervisory costs are the lowest. Firms may also set up new financial institutions or restructure existing ones strictly to minimise or avoid supervisory oversight.

A unified supervisory function would theoretically ensure that such inconsistencies and differences are dealt with effectively. A single management structure which is responsible for overseeing all activities of the financial sector is probably the most effective way to ensure that some financial institutions do not have an unfair advantage for competing for customers. Some believe that a single regulator can respond much more quickly and effectively to market innovation and development.

In the context of regulation, unification could result in cost savings through a single set of central support services by the sharing of infrastructure and administrative resources. The existence of various supervisory bodies has generally resulted in the

duplication of support infrastructures, for example, data collection and processing, and personnel administration where data are not shared. Integration would in that case allow better use of information technologies which become cost effective only beyond a certain level of transactions. Moreover, a unified approach to data collection could also lead to a more efficient reporting system.

An essential requirement of effective supervision is the ability of the regulatory bodies to attract, develop and retain a body of skilled professional staff. Integration is expected to be of help in this process since a unified body is better placed to develop a coherent human resource policy and career planning strategy and thus offer greater prospects for its personnel. Further, integration facilitates the sharing of specialised knowledge among supervisors and the deployment of specialised staff who have gathered know-how in specialist areas.

Unification could also enhance international co-operation as it provides a single contact point for dealing with regulatory issues in so far as other countries are equally structured. Moreover, more harmonised methods of supervision are developed across the financial system through the development and implementation of internationally recognised standards and codes of good practices. Consequently, this will result in cooperation among supervisors rather than each supervisor defending his separate turf.

Unification is expected to enable the pooling of information with regard to all financial activities and hence to facilitate the formulation of effective monetary policy and its implementation. Sustained macroeconomic conditions are in turn expected to enhance stability and safety of financial markets.

Another argument used in favour of integration is that it increases transparency and improves the accountability of regulation. Accordingly, it is believed that the existence of multiple regulatory bodies with overlapping responsibilities makes it difficult to hold regulators responsible for any regulatory failures as opposed to a unified agency with a single management structure to which the overall responsibility can be attributed.

It is vital to manage the process of change with utmost care, as an optimal structure does not necessarily result in optimal regulation. An integrated system of regulation may also give rise to some shortcomings. It may be difficult for the unified regulatory agency to strike an appropriate balance between the different objectives of regulation as it may be difficult to design a single set of objectives for the entire financial sector (depositor protection for banks v/s investor protection for capital markets). Such situation might diminish rather than improve accountability.

Despite the argument of economies of scale in favour of unified regulation, some believe that it is possible that a single integrated regulator could nevertheless suffer from Christmas tree effect and diseconomies of scale. The larger the organisation, the more bureaucratic it is likely to be especially if its operations are so broad that the line managers are unable to understand the range of operations of the organisation. It is also believed that a single regulator may be overburdened with numerous functions attached to its primary objective.

Since the culture, focus and perception of risk are different for different financial institutions, it is argued that the synergy gains to be obtained from integration may not be very large. For example, the sources of risks of banks are on the asset side while most of the risks of insurance company are on the liability side.

One of the most powerful arguments against a single regulator is stated to be the "moral hazard" problem. There is a big risk that public will tend to assume that all creditors of financial institutions which are supervised by a single regulator will receive equal protection. Thus if depositors are protected from loss in the event of a bank failure, then customers of other non-bank financial institutions which are supervised by the similar regulatory authority may expect to be treated in the same manner. To reduce the potential for moral hazard, the single regulator would have to raise public awareness of the risks, costs and benefits of different financial services, and make people aware of the limitations of regulation.

There is the perceived risk that the change process may be mismanaged, for example, the legislative framework may not cover adequately the scope of all the financial activities. There is also the risk of loss of key personnel as some staff may view the integration process with apprehension. Moreover, the process of creating a unified regulatory body places heavy

demands on management resources, which may be in short supply.

THE MAURITIAN CONTEXT

In pace with developments on the global financial market, the Mauritian financial sector has also evolved. The last two decades have been marked by the modernisation of the economy with the suspension of the exchange controls, the launching of the offshore sector and the setting up of the stock exchange. These developments have brought about major changes in the financial landscape. Financial activities, which were predominantly centred on banking and insurance, have gradually diversified with the emergence of non-bank financial operators, including, inter alia, stockbrokers, insurance brokers, foreign exchange dealers, money changers, leasing companies, investment companies and venture capital companies. The range of services has also been growing. The scope of services provided by the banking sector has widened to include, inter alia, asset accumulation, Internet banking, participation in issues of securities and custodial services. Rapid integration within the financial sector, spurred by the acceleration in financial innovation, has accelerated the trend of gradual erosion of the traditional barriers between the different financial institutions. Consequently, the structure of financial institutions has altered. Domestic banks have diversified into non-banking business; through their subsidiaries and affiliates, they have engaged into leasing, stockbroking, fund management and insurance business. Similarly, a number of non-bank financial institutions have emerged to play a vital role in mobilising saving, stimulating investments and providing financial support to the productive economic sectors.

With the tendency towards consolidation within the financial industry and the continuing developments in technology and innovation, it became imperative to reconsider the institutional regulatory structure to facilitate greater competition and efficiency in the financial system and promote Mauritius as a credible financial centre.

Prior to the establishment of the Financial Services Commission, regulation of the financial institutions was carried out by different regulators having specific responsibilities for the banking, securities, insurance and offshore sectors. However, given the growing complexity of financial products, this product-based approach to regulation gave rise to substantial supervisory gaps across different financial sector activities, with banking being regulated at international standards while other sectors were under-regulated or not regulated at all. This uneven level of supervision coupled with poor disclosures were an impediment to a proper assessment of financial conditions of the institutions, thus exposing certain segments of the industry to reputational and other risks, including fraud and malpractice.

The offshore sector evolved in parallel with the domestic sector with its own sets of rules and regulations. In line with the Government policy to harmonise the ‘onshore’ and ‘offshore’ banking activities, the Banking Act 2004 provides for the issue of a single banking licence under which both domestic and international banking activities are to be conducted. Under this law, similar rules and regulations apply to all banking activities.

A Steering Committee was set up by Government in October 2000 to advise on a new regulatory framework for the financial services sector, which would provide a coherent policy structure and a sound regulatory and supervisory environment.

The Committee recommended that a unified financial regulatory authority, covering both banking and non-banking activities, be established in a phased manner.

To foster co-operation between supervisors of the Bank of Mauritius and the Financial Services Commission, a Memorandum of Understanding (MoU) was signed on 18 December 2003. The MoU covers specific areas of co-operation and exchange of information with a view to maintain a safe, efficient and stable financial system. The MoU also requires the establishment of a joint Co-ordination Committee for the facilitation of such co-operation through discussion on items of supervisory concern. In this context, some preliminary suggestion on the conduct of joint regulatory activity in areas where both the Financial Services Commission and the Bank of Mauritius share responsibility have been identified and proposed.

6. Market Risk

INTRODUCTION

Deregulation of international financial systems over the 1980s was accompanied by a period of high price volatility in financial markets. Increased volatility in the prices of financial instruments and other financial assets paved the way for new opportunities for financial institutions from the trading of those instruments. The new opportunities entailed the risk for losses. While banks' market-related exposures remained relatively small and actual losses minimal, the case for the formal recognition of market risk within the supervisory structure did not seem strong. The growth in market-related exposures began to accelerate over the later half of the 1980s. The nature of banks' exposures to the market also changed. The traditional risks associated with large holdings of fixed interest securities persisted but were supplemented by additional risks associated with the rapid growth in off-balance sheet items and derivative markets. As banks were increasingly engaged in derivatives business, the risk taken by them in that field was still less significant than their credit risk.

Market Risk – A cause for concern

Concerns over market risk were focused more on future developments and the possibility that banks' exposures in the related areas would continue to expand. It was against this background that work on the prudential treatment of market risk began. As the risk became more prominent in the final years of the 1980s and into the 1990s, three separate, though related, themes emerged as the main factors driving the market-risk exercise internationally.

1. *A desire to see the existing capital adequacy framework generally expanded and strengthened;*

2. *A desire to remove distortions within the banking sector that may have arisen from the focus of capital standards on credit as opposed to other forms of risk; and*

3. *A desire to achieve greater consistency in supervisory treatment between international banking and securities regulators.*

The first of these themes was a direct consequence of the market developments noted above. The case for expanding the capital framework grew stronger with growth in market exposures faced by banks. Increasing complexity of market-related instruments compounded the problems in identifying and assessing exposures.

As per the second theme, it can be argued that the existing capital standards, by focusing largely on credit risk, provided a strong incentive for banks to turn their attention towards activities where credit risk was deemed relatively low from a regulatory perspective, but where non-credit-related risks could be greater. Many countries have pointed to the growth in banks' off-balance-sheet/derivative business as evidence of that process. A strong case can be made that inconsistencies in supervisory arrangements can cause banks to shift their resources to activities, which are less regulated.

The third motivation was broader in concept and concerned the desirability of applying consistent supervisory standards to institutions doing similar forms of business. Few countries would argue the case for equal supervisory treatment across all financial institutions as competitive inequalities can arise when one set of institutions doing similar, or in some cases identical business, is supervised more rigorously than others.

At the international level, debate on competitive inequality focused on the regulatory treatment of international security houses vis-a-vis banks. There were growing concerns that differing supervisory treatments carried the potential for a significant shifting of business towards the unregulated or less regulated group. These concerns, while always present to some degree, increased as the distinctions between banking and non-banking activities blurred and as banks' market activities caught pace with the

activities of the international securities houses. An important catalyst to the work on market risk was the desire to develop consistent supervisory guidelines for these two groups of institutions.

DEFINITION

Market risk is defined as the risk of losses in positions arising from movements in market prices. Banks operating in the *foreign exchange, commodities, interest rate or equity* markets may be exposed to potentially large swings in market prices and significant consequential losses. Potential losses may arise from both general market price movements and, in the case of interest rate and equity instruments, from price movements specific to particular issuers. The capital required to guard against potential loss should be commensurate with the risks involved.

METHODS FOR MEASURING MARKET RISKS

For the purpose of measuring market risks, Basel came up with two broad methodologies in its Paper on market risk in January 1996. One methodology will be to measure the risks using the "Standardised approach". The alternate methodology, known as the "Internal model approach" requires the explicit approval of the bank's supervisory authority subject to the fulfilment of certain conditions.

Standardised Approach

This method uses a "building-block" approach in which specific risk and the general market risk arising from debt and equity positions are calculated separately. The standard approach is comprised of five sections: traded debt securities and other interest rate related securities, traded equities and other equity instruments, foreign exchange, commodities and options on each of these asset classes.

Internal Models

Much of the debate in recent years concerning the management of market risk within banks has focused on the appropriateness of so-called Value-at-Risk (VaR) models. These models are designed to estimate, for a given trading portfolio, the maximum amount that a bank could lose over a specific time period with a given probability. VaR models can be developed to varying degrees of complexity. The simplest approach takes as its starting point, estimates of the sensitivity of each of the components of a portfolio to small price changes (for example, a one basis point change in interest rates or a one per cent change in exchange rates), then assumes that market price movements follow a particular statistical distribution (usually the normal or log-normal distribution). This simplifies the analysis by enabling a risk manager to use statistical theory to draw inferences about potential losses with a given degree of statistical confidence. For example on a given portfolio, it might be possible to show that there is a 99 per cent probability that a loss over any one-week period will not exceed, say, Rs1 million.

Mix Approach

Banks are free to use a combination of the internal model approach and the standardised approach to measure their overall market risk. As a general rule, however, a combination of two methodologies for the same risk category (e.g interest rate risk) is not permitted.

A bank using an internal model will not be permitted, save in exceptional circumstances, to revert to the standardised approach. However, even banks using comprehensive models to measure their market risks may still incur risks which are not captured by their internal model, for example, in remote locations, in minor currencies or in negligible business areas.

MARKET RISK IN MAURITIUS

The Financial Sector Assessment Program (FSAP) report, issued in August 2003 following an assessment conducted jointly by IMF-World Bank mission from October 21-31, 2002 and December 3-17, 2002, recommended that the Bank of Mauritius should introduce a guideline on market risk.

The Bank of Mauritius has drafted a guideline on market risk, which is proposed to be issued on a consultation basis to the industry. The guideline is

based on the paper on market risk issued by the Basel Committee on Banking Supervision in January 1996 but tailored to suit the local environment.

The draft guideline would deal with the essential elements of market risk that will be appropriate to the banking industry in Mauritius. Consequently, it is not as exhaustive as the BCBS paper on the subject.

The Management of banks in Mauritius will need to ensure that they have adequate systems and processes to identify and measure market risk, established limits and triggers, constantly monitor the magnitude of risk and report to appropriate authorities within the organisation and to the board on the evolving risk positions and patterns. The management of risks should pay adequate attention to governance issues such as identification of responsibilities, provision of adequate segregation of duties and avoidance of conflict of interest. The Bank of Mauritius would have to be informed of all significant changes in these systems and their market risk profile. The systems and processes will have to cover both the trading and banking books of a bank.

As per our draft guideline on market risk, capital requirements will initially apply to a bank as a stand-alone entity. Bank of Mauritius will in due course come up with the appropriate approaches to assess market risk for a bank's consolidated operations and identify the appropriate capital charge.

The Guidance Notes on Risk Weighted Capital Adequacy Ratio (Guidance Notes) issued in November 1993 prescribes a minimum capital ratio of 10% for credit risk. In order to ensure consistency in the calculation of capital charge between credit risk and market risk, a numerical link between the two will be established. This will be done by multiplying the capital charge for market risk by a factor of 10 (the reciprocal of the minimum capital ratio of 10 per cent) and adding the resulting figure to the risk based assets calculated under the Guidance Notes. The ratio is then calculated by dividing the capital base (calculated under Guidance Notes) by the sum of total risk weighted assets (credit risk assets plus market risk assets).

Banks would be required to maintain a minimum composite capital adequacy ratio, so determined, of 10 per cent.

As regards the method to be used for measuring market risks in Mauritius, the standardised approach will comprise five sub-parts, which deal with interest rate risk, equity position risk, foreign exchange risk, commodities risk, and the price risk arising from options. The last two will be dealt with rather briefly in the Guideline, as banks in Mauritius are not engaged in commodities operations, or buying or selling options in any significant fashion. Capital charge for each asset class will be determined separately and then added together to arrive at the total capital charge. As to the interest rate risk and the equity position risk, the standardised approach envisages separate identification and assessment of specific risk and general market risk.

It is expected that the internal models approach will be used only rarely in Mauritius, at least for the first few years of coming into effect of the Guideline. Its use by a bank will be subject to prior written approval of the Bank of Mauritius and to the fulfilment of a minimum number of conditions.

Banks shall manage the market risk in their trading book in such a way that the capital requirements are met on a continuous basis i.e. at the end of each business day. The Bank of Mauritius will keep a steady watch on the practices of banks to ensure that they do not engage in "window-dressing" by significantly reducing their market risk exposure on reporting dates. Also, banks would be required to ensure that their intra-day exposures are not excessive.

CONCLUSION

There is no doubt that risk management has become increasingly complex not only in relation to financial trading activities but also in relation to the risk inherent on traditional bank balance sheets. Risk management is therefore becoming a much more skilled activity than in the past. Banks need to manage all their risks comprehensively. Although market risk does not pose a significant risk to banks at present, it is set to assume greater importance as banks engage more and more in instruments linked to interest rate changes.

APPENDIX I

Guidelines

1. List of Guidelines/Guidance Notes

1. Guidance Notes on Risk Weighted Capital Adequacy Ratio
2. Guidance Notes on General Principles for Maintenance of Accounting and Other Records and Internal Control Systems
3. Guidelines for Calculation and Reporting of Foreign Exchange Exposures of Banks, Foreign Exchange Dealers and Money-Changers
4. Guideline on Credit Concentration Limits
5. Guideline on Liquidity
6. Guideline on Internet Banking
7. Guideline on Corporate Governance
8. Guideline on Related Party Transactions
9. Guideline on Public Disclosure of Information
10. Guideline on Transactions or Conditions Respecting Well-Being of a Financial Institution Reportable by the External Auditor to the Bank of Mauritius
11. Guidance Notes on Fit and Proper Person Criteria
12. Guideline on Credit Risk Management
13. Guidance Notes on Anti-Money Laundering and Combating the Financing of Terrorism
14. Guideline on Credit Impairment Measurement and Income Recognition
15. Draft Guideline on Operational Risk Management and Capital Adequacy Determination

2. Guideline on Credit Impairment Measurement and Income Recognition

1.0 Introduction

This Guideline is issued to all deposit-taking financial institutions regulated by the Bank of Mauritius. The Companies Act 2001, which came into effect on 1 December 2001, requires all companies to prepare their financial statements in accordance with International Accounting Standards issued by the International Accounting Standards Board (IASB). A prime focus of this Guideline is the International Accounting Standard 39 (IAS 39), entitled 'Financial Instruments: Recognition and Measurement'. This Standard deals with, among other things, the impairment and uncollectability of financial assets. The Standard was undergoing revisions recently and the revised Standard applies to annual periods beginning on or after 1 January 2005.

The objective of this Guideline is to ensure that financial institutions have adequate processes for determining allowance for credit losses, the carrying amounts of credit portfolio represent recoverable values, and there is timely recognition of identified losses.

The Guideline also applies to the leasing operations of financial institutions. In defining the scope of IAS 39, its paragraph 2 (b) states that the derecognition and impairment provisions of the Standard apply to lease receivables recognised by a lessor.

The Bank of Mauritius subscribes to the application of International Accounting Standards to financial institutions, which together with any additional prudential requirements of the Bank for their safety and soundness, provide a sound basis for determining the results of their credit operations, and provide meaningful public disclosure of information.

The Guideline is not intended to deal with each and every provision of IAS 39 pertaining to impairment and uncollectability of financial assets. Financial institutions are advised to refer directly to the Standard for complete treatment of the subject. The use of the word 'loan' in the Guideline should be interpreted in the broader sense of 'credit', defined in paragraph 2, unless indicated otherwise.

The Guideline is issued under the authority of the Bank of Mauritius Act 2004 and the Banking Act 2004, in particular section 50 of the former and section 100 of the latter. It supersedes the existing Guideline on Credit Classification for Provisioning Purposes and Income Recognition.

2.0 Interpretation

In this Guideline,

"allowance for credit losses" is a cumulative account maintained by a financial institution, representing the estimated credit-related losses existing in its entire portfolio of on and off-balance sheet items, in accordance with this Guideline. For credit and finance leases, it represents the excess of the recorded investment in them over their estimated realisable value. In the balance sheet of a financial institution, the allowance is (i) deducted from the applicable asset for balance sheet items, and (ii) included in the liabilities for off-balance sheet items.

"carrying value" of a credit asset or group of credit assets is its (their) recorded investment less related allowances for credit losses and write-offs.

"credit" means loans and advances by whatever instrument granted and includes customers' lines of credit, overdrafts, bills purchased and discounted, bills receivable, and finance leases.

"effective interest rate" means the contractual interest rate on a loan adjusted for (i) fees and related costs recognised as an adjustment of yield on the loan and (ii) any discount or premium on the loan.

"financial institution" means any deposit-taking body or person regulated by the Bank of Mauritius.

"foreclosed loan" means assets acquired in full or partial settlement of a loan through realisation of collateral or repossession of leased property.

"independent appraiser" means an appraiser who

- is a Chartered Valuation Surveyor certified by the Mauritius Institute of Surveyors, or equivalent as approved by the Bank of Mauritius, or a surveyor certified by an appropriate foreign authority for appraisal of a property located in a foreign country;
- has no direct or indirect financial interest in the property being appraised, or in the transaction involving the financial institution in respect of that property; and
- has no credit granting or investment decision-making authority within the financial institution.

"large credit" is a credit of

- Rs5 million or over for a bank that has a capital base in excess of Rs750 million or equivalent if the amount is stated in U.S dollars,
- Rs2 million or over for a bank that has a capital base of less than Rs750 million or equivalent if the amount is stated in U.S dollars.

"loan" is a financial asset of a financial institution resulting from commitment of the borrower to repay the amount borrowed on a specified date or dates, or on demand, usually with interest. Loans include:

- consumer instalment and credit card loans;
- residential mortgages;
- non-personal loans, such as commercial mortgages and loans to businesses, financial institutions, government and its agencies;
- loan substitutes, such as debentures that are, in substance, loans; and
- direct financing leases and other financing arrangements that are, in substance, loans.

"provision for credit losses" is an expense account for credit related losses recognised during the year, based on a financial institution's estimate of such losses in respect of on and off-balance sheet items that are assessed to be impaired during the year, in accordance with this Guideline.

3.0 Impairment Recognition and Measurement Policy

A financial institution must implement an effective credit risk management and control policy, supplemented by effective credit impairment recognition and measurement policy. The policies must be supported by appropriate accounting and documentation processes, information systems, and internal controls to ensure their integrity.

3.1 Formulation of Policy

The recognition and valuation of credit instruments, individually or in groups, will involve implementation of appropriate rules for the purpose, and the exercise of prudential judgment by management of a financial institution. In formulating and implementing its loan impairment recognition and measurement policy, the institution must:

- establish properly documented analytical framework and procedures for assessing loan quality, which are applied consistently and contain a proviso that loan quality assessment shall be carried out and reflected in financial statements no less frequently than quarterly or a shorter interval, if warranted, to ensure the adequacy of allowance for credit losses;
- ensure that all estimates of cash flows in realisation of loans assessed individually, are reasonable, based on supportable assumptions, and backed by effective internal controls, including a second review of estimates on large credits, and supported by proper documentation;
- for loans assessed on a 'portfolio' basis, ensure that it has in place a rational process for aggregating loans in the portfolio into individual groups having similar characteristics, and the

application of effective methodology for determining loss estimates;

- ensure that any impact of changes in general economic activity or sectoral conditions is based on sound assumptions to produce conservative results;

- establish a program of periodic monitoring and analysis of collateral taken in loans to ensure that their appraised values and estimated realisation values in the event of loan foreclosure, are realistic and supported by proper documentation;

- employ suitably qualified staff to assess the loan recovery prospects and subsequent follow-up, with appropriate segregation of duties between those responsible for original analysis and approval of credit and the ones engaged in impairment assessment; and

- ensure that all analytical work carried out, methodology applied and any changes thereto, and management's judgment exercised, are properly documented and duly validated by signatures of individuals responsible.

3.2 Role of the Board of Directors

Taking account of the factors listed in paragraph 3.1, the board of directors of a financial institution must:

- establish credit risk management policy, including credit impairment recognition and measurement policy, the associated internal controls, documentation processes, and information systems;

- review at least once a year the policies and the associated controls and systems;

- ensure through audit and inspection, adherence to the policies; and

- review, either itself or through a board committee, valuations of all impaired credits of the size that could individually affect adversely the financial well-being of the bank.

In the case of the branch operation of a foreign bank, the above responsibilities of the board shall be ascribed to the head office or to a committee in Mauritius designated for the purpose by the head office.

4.0 Application of IAS 39 in Assessing Credit Impairment

The part of IAS 39 dealing with Impairment and Uncollectability of Financial Assets is reproduced in Appendix A. Paragraph 58 of the Standard states

> "An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss."

The two operative concepts in the above paragraph are to have 'objective' evidence that an asset may be impaired, and to determine the amount of any impairment loss.

4.1 'Objective' evidence

'Objective' evidence provides the trigger point for launching an investigation into the impairment of the financial asset to assess the degree of its impairment. The Standard lists the following items of 'objective' evidence:

- "significant financial difficulty of the borrower;

- an actual breach of contract, such as a default or delinquency in interest or principal payments;

- granting by the lender to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, of a concession that the lender would not otherwise consider;

- a high probability of bankruptcy or other financial reorganisation of the issuer;

- recognition of an impairment loss on that asset in a prior financial reporting period;
- the disappearance of an active market for that financial asset due to financial difficulties; or
- a historical pattern of collections of accounts receivable that indicates that the entire face amount of a portfolio of accounts receivable will not be collected."

It should be underlined that according to the above criteria, when a borrower misses a contractual instalment payment on interest or principal, his loan is forthwith designated for an **assessment** of the degree of impairment. This assessment must be completed within 60 days of the first indication of impairment.

Additional sources of evidence of impairment that should merit investigation and assessment, include:

- Funds obtained under the loan agreement were not used for the purpose for which they were loaned;
- The project financed by the loan has become non-viable e.g. a failing restaurant;
- The borrower is about to default and the lender advances it funds to meet its current payment obligations;
- The borrower belongs to a group of entities that has credits outstanding from the financial institution or other financial institutions and one or more members of the group have defaulted;
- The borrower is engaged in a large number of undertakings leading to over-extension of its resources. It has begun shifting support from one undertaking to another, which may lead to potential delinquency of the loan under review;
- In case of an overdraft, further elements to be considered are the expiry of the approved overdraft limit, and the customer exceeding the approved limit frequently;
- The underlying collateral, which was heavily relied upon in granting the loan, has lost value significantly; or
- There is a loss of confidence in the borrower's integrity.

4.2 Estimation of Recoverable Value

Estimated recoverable value of loans shall be determined either individually or on a 'portfolio' basis. All credits designated for assessment of impairment, using the tests outlined in Paragraph 4.1, shall be assessed individually for estimation of recoverable amounts. All other credits shall be assessed on a 'portfolio' basis.

4.2.1 Individually Assessed Credits

The estimation of recoverable amount of individually assessed credits shall be carried out in the context of broad principles enunciated in paragraph 63 of IAS 39. Future cash flows on credit shall be based on reliable evidence for determining amounts recoverable. The estimation process shall be based on the following factors:

- Assessment of the financial condition of the borrower and the group to which it belongs;
- Assessment of the debt service capacity of the borrower (adequate generation of cash flow) to discharge its contractual obligations on a continuing basis;
- evaluation of any up-to-date business plan of the borrower;
- Regularity of the borrower's past payment record;
- Lender's confidence in the integrity of the borrower;
- In case of a loan to a related party, an evaluation of all factors impinging on the timely recovery of the loan, including seriousness of efforts made by the bank for the recovery;
- In case of a foreign borrower, an assessment of all practical aspects of achieving recovery,

including the legal enforceability of loan and related instruments;

- Evaluation of the continued viability of the project financed by the loan;
- Current economic and other conditions, including emerging trends, affecting the industry sector relevant to the borrower;
- Evaluation of country risk applicable to the loan project;
- Length of timeframe for achieving recovery; longer the time period, lesser is the certainty of obtaining recovery;
- Any down-grade of the borrower's credit rating by a reputable rating system or agency;
- Further default occurring in a restructured loan;
- Assessment of value of any personal guarantee of the borrower or guarantee of another party;
- Assessment of the net realisable value of the collateral for the loan.

In assessing future cash flows emanating from an impaired loan, it is not necessary that several of the above factors must be present before it is judged that the flows will be substantially reduced or non-existent. A single factor, such as vulnerable financial condition of the borrower, may justify making an appropriate provision for the loan.

A critical element in the estimation of future cash flows in respect of large credits to businesses that are past due 180 days or more is the existence of a reliable business plan, with attributes outlined in paragraph 4.2.1.1 below. Similarly, large credits to retail clients must be supported by a reliable repayment plan, as outlined in paragraph 4.2.1.2. Retail credits that are not large must also be supported by a repayment plan, which may not be as formal as for large credits. Future cash flows not supported by an acceptable business plan or a repayment plan shall be construed as unrealistic and inappropriate for determining the recoverable value of a credit. In such a case, the recoverable value of the credit shall be limited to the net realisable value of any collateral securing the credit. For business credits other than large credits, it would be appropriate to accept a less formal business plan, but which provides a reasonable indication of cash flows to be generated by the borrower to honour his credit obligations.

In case of a large overdraft facility (meeting the definition of 'large credit'), if a client's approved limit has expired or does not exist or if it does exist, the client has exceeded it by 10 per cent for a period of 30 days and the excess has not been approved by the financial institution's board of directors or a designated board committee, the excess amount shall be viewed as unrecoverable for the purposes of assessing credit impairment and making a provision for credit losses. In the calculation of the excess amount, any deposit of the customer held by the financial institution may be netted off, providing that it is legally permissible and there is a formal agreement with the customer permitting such offset. Any approval of the excess by the board or board committee shall require effective application of prudential assessment criteria as if the overdraft was a new loan. Any such assessment shall be properly documented. Financial institutions must also rigorously monitor overdraft facilities that do not meet the definition of 'large credit' and establish appropriate criteria for assessing impairment and making a provision for credit losses.

In determining the net realisable value of loans, it would be appropriate to first calculate the difference between the carrying amount of the loan and present value of expected future cash flows as required by IAS 39 and then deduct the discounted net realisable value of the collateral. The ultimate amount will determine the provision for credit losses, to be charged to profit and loss.

All work done, accounting for the applicable criteria in paragraph 4.2.1, in the estimation of the recoverable amount of an individual loan, including judgments made by management, shall be properly documented and validated.

4.2.1.1 Business Plan

An important element in the calculation of the recoverable amount of an impaired large credit to a

business customer is the existence of its up-to-date business plan. Reliance placed on the plan will depend on several factors, including whether the plan

- is prepared in a professional manner;
- is sufficiently comprehensive to cover all essential elements;
- uses realistic assumptions;
- uses market and other projections that are soundly based and reasonable;
- envisages use of qualified management resources for implementation of the plan; and
- clearly outlines a realistic strategy for achieving the plan's objectives.

In their regular audit of impaired loans of a financial institution, the auditors must review the adequacy of a borrower's approaches to developing its business plan and the plan's scope, as contained in the bank's files, to ensure that it provides a reasonable basis for loan recovery and that the extent of the impairment has accordingly been fairly recognised in the books of the financial institution.

4.2.1.2 Repayment Plan of a Personal Loan

The repayment plan in respect of an impaired personal loan mentioned in paragraph 4.2.1, must have adequate attributes to demonstrate its soundness. These will include:

- the borrower's analysis of the causes of loan impairment and specific changes envisaged to make the loan performing again;
- delinquencies of any previous credits of the bank or any other bank to the borrower and an explanation of why the circumstances surrounding those delinquencies do not apply to the present credit;
- a clear identification of sources of funds, which will generate sufficient flows on a continuing basis to honour the loan obligations;
- control of the borrower over such sources and identification of risks that might impair their availability; and
- other information supporting the bonafides of the borrower.

4.2.1.3 Collateral

Another important factor in the calculation of the credit loss provision is the value of collateral. The following pre-conditions must be met in determining the appraised value of collateral:

- Appraised value of collateral is based on a conservative view of current market prices, suitably discounted for price volatility and the lack of ready market for assets. All realisation costs, including legal costs, must be taken into account.
- Realisable value of collateral is supported by a written opinion of an independent and qualified appraiser. Management of the financial institution must ensure that the appraisal is reasonably comprehensive, up-to-date and based on assumptions acceptable to it. If the Bank of Mauritius deems it necessary, it may require the institution to have the appraisal carried out, at the institution's expense, by another independent appraiser.
- For any loans past due 360 days or more, proper legal action in the court for the realisation of collateral has been commenced.

The past experience with foreclosed loans indicates that the net realisable value of collateral has not generally exceeded 50 per cent of its appraised value. Unless the financial institution presents reasons to the contrary acceptable to the Bank of Mauritius, the value to be considered in determining the recoverable amount of an impaired loan shall not exceed 50 per cent of the appraised value of collateral, discounted to its present value using the loan's effective interest rate. The above limit will not apply to collateral of liquid assets.

Where a financial institution is convinced that it is not going to recover the outstanding amount of

the loan, in part or in full, it must take steps to write-off the unrecoverable amount.

Appendix B contains an example of the accounting entries required for an individually assessed impaired loan.

4.2.2 'Portfolio' Assessed Loans

Loans that have not been individually assessed for impairment, will be assessed on a 'portfolio' basis. Although there is no current evidence that loans in the 'portfolio' are impaired, past loan loss experience indicates that some of them will become non-performing over time.

'Portfolio' loans will be divided into groups with similar characteristics and loss attributes, and evaluated for impairment. In determining provision for credit losses for the groups, factors such as past loan loss experience and current economic and other relevant conditions, including known adverse economic conditions likely to affect sectoral financial performance, will be taken into account.

Provision for credit losses on such loans may be assessed using cash flow process envisaged in IAS 39, applying weighted average of effective interest rates. The Bank of Mauritius has not been able to identify any convincing reasons that the use of a more direct approach of applying past loan loss experience adjusted for current economic and credit conditions in Mauritius, will produce results materially different from those attained in the discounted cash flow approach. The Guideline requires that all loans, regardless of size, meeting the criteria of objective evidence of impairment outlined in paragraph 4.1, will be assessed individually for impairment loss.

Financial institutions shall classify loans in the 'portfolio' into groups with similar credit risk characteristics, for calculating credit loss provisions. They may use the discounted cash flow approach or the more direct approach mentioned above in assessing the loan loss provisions. However, unless a financial institution makes a case acceptable to the Bank of Mauritius that its loan loss experience has been different, the percentage of loan loss provision to aggregate amount of loans in the entire 'portfolio' shall be no less than 1 per cent. If a loan is supported by a collateral of liquid assets, the amount of the liquid collateral will be offset against the amount of the loan for 'portfolio' based provisioning. The requirement of the 1 per cent shall not apply to credits extended directly to the Government of Mauritius or to public sector enterprises backed by Government of Mauritius guarantees.

The credit impairment provision for the 'portfolio' will be charged to profit and loss for the year in accordance with paragraph 63 of IAS 39. If a loan in the portfolio becomes impaired (according to paragraph 4.1), it will be withdrawn from the 'portfolio' and assessed individually for determining the extent of impairment.

4.3 General Provision

IAS 30 (paragraph 44) sets out the circumstances under which a general provision may be established. It states that "Any amounts set aside in respect of losses on loans and advances in addition to those losses that have been specifically identified or potential losses which experience indicates are present in the portfolio of loans and advances should be accounted for as appropriations of retained earnings." The general provision is over and above the provision made on loans assessed individually, or on a 'portfolio' basis where judgment is made on the basis of past experience.

In line with IAS 30, the Guideline envisages the establishment of a general provision to ensure the adequacy of the overall allowance for credit losses. It will be designed to cover potential losses that are not captured in the allowances for individually assessed loans and 'portfolio' loans. Factors in support of a general provision are normally future-oriented and may include:

- potential financial crises giving rise to credit losses that were not previously anticipated;
- emerging changes in lending policies of the bank, its loan review system, ability and depth of its credit department, estimation of risks, and quality of oversight exercised by the board of directors;

- further changes in general economic and business conditions, recent loan loss experience, trends in credit quality and credit concentrations;
- changes in competition faced by the bank and legal and regulatory requirements; and
- emerging changes in the risk profile of the overall credit portfolio.

Management of a bank shall exercise its best prudential judgment in the light of the above factors to determine the amount of the general provision. The provision so determined shall be established as an appropriation of retained earnings of the bank.

5.0 Income Recognition

Financial institutions may accrue income on the present value of the recoverable amount of an individually assessed impaired loan, using the effective interest rate. However, appropriate adjustments shall be made if at the next review of the loan, it is determined that cash flows will not be in accord with the flows originally estimated.

6.0 Role of External Auditors

Financial institutions shall require their auditors to attest to the adequacy of processes used in determining credit loss allowances and the adequacy of total allowance. Any deficiencies in the allowance or the processes used shall be duly recorded in the auditors' 'opinion' or management letter, depending on their materiality.

7.0 Returns

The Bank of Mauritius may require such data from financial institutions as it deems fit to ensure compliance with the requirements of the Guideline.

8.0 Commencement

This Guideline shall come into effect forthwith.

Bank of Mauritius
November 2004

Appendix A
Excerpts from IAS 39 on Impairment and Uncollectibility of Financial Assets

Impairment and Uncollectibility of Financial Assets

58. An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss.

59. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of event that occurred after the initial recognition of the asset (a 'loss event') and that loss event has impact on the estimated future cash flows of the financial asset or group of financial assets. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events: (a) significant financial difficulty of the issuer or obligor; (b) a breach of contract, such as a default or delinquency in interest or principal payments; (c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider; (d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation; (e) the disappearance of an active market for that financial asset because of financial difficulties; or (f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including: (i) adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or (ii) national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

60. The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

61. In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

62. In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical

data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Financial Assets Carried at Amortised Cost

63. If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (ie the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss.

64. An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 59). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

65. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal shall be recognised in profit or loss.

Financial Assets Carried at Cost

66. If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 46(c) and paragraphs AG80 and AG81). Such impairment losses shall not be reversed.

Available-for-Sale Financial Assets

67. When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that had been recognised directly in equity shall be removed from equity and recognised in profit or loss even though the financial asset has not been derecognised.

68. The amount of the cumulative loss that is removed from equity and recognised in profit or loss under paragraph 67 shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss.

69. Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss.

70. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment

loss was recognised in profit or loss, the impairment loss shall be reversed, with the amount of the reversal recognised in profit or loss.

No Active Market: Equity Instruments

AG80. The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

AG81. There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

AG84. Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

AG89. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Interest Income After Impairment Recognition

AG93. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Appendix B
Example of Accounting for impaired loan

This example is intended to be illustrative only. Any matters of principle should be decided in the context of IAS 39 and this Guideline.

Scenario

ABC Bank Ltd (ABL) grants a loan of Rs1,200,000 to XYZ Co Ltd on 1st January 2002, under the following terms:

Loan amount: Rs1,200,000
Interest rate: 1% per month
Repayment: Rs106,618.55 at the end of each month.
Security: Lien on two lorries belonging to the company

	Opening Balance	Interest	Total	Repayment	Closing Balance
31-Jan-02	1,200,000.00	12,000.00	1,212,000.00	106,618.55	1,105,381.45
28-Feb-02	1,105,381.45	11,053.81	1,116,435.26	106,618.55	1,009,816.71
31-Mar-02	1,009,816.71	10,098.17	1,019,914.88	106,618.55	913,296.33
30-Apr-02	913,296.33	9,132.96	922,429.29	106,618.55	815,810.74
31-May-02	815,810.74	8,158.11	823,968.85	106,618.55	717,350.30
30-Jun-02	717,350.30	7,173.50	724,523.81	106,618.55	617,905.26
31-Jul-02	617,905.26	6,179.05	624,084.31	106,618.55	517,465.76
31-Aug-02	517,465.76	5,174.66	522,640.42	106,618.55	416,021.87
30-Sep-02	416,021.87	4,160.22	420,182.08	106,618.55	313,563.53
31-Oct-02	313,563.53	3,135.64	316,699.17	106,618.55	210,080.62
30-Nov-02	210,080.62	2,100.81	212,181.43	106,618.55	105,562.88
31-Dec-02	105,562.88	1,055.63	106,618.50	106,618.55	–

The repayment schedule was given as follows:
The bank has a capital base of less than Rs750 million.

On inception (1 January 2002)

Dr Loans	Rs1,200,000	
Cr Cash		Rs1,200,000

(To record disbursement of the loan)

At the end of first quarter of 2002 (31 March 2002)

At 31st March 2002, the bank received payments for the months of January and February on their respective due dates. However, the payment for March has still not been received.

The bank has learned that XYZ Co Ltd is in financial difficulty because one of its clients has gone bankrupt. However, the bank believes that the problem is only temporary and that the company will soon honour its commitment.

Dr Cash	Rs23,054	
Dr Accrued interest receivable	Rs10,098	
Cr Interest income		Rs33,152
(To record interest received/accrued during the quarter)		

Dr Cash	Rs190,183	
Cr Loan Account		Rs190,183
(To record capital repayment during the quarter)		

	Quarter ended 31 March 2002 Rs
Income Statement (Extract)	
Interest Income	33,152
Provision for credit loss	–
Balance Sheet (Extract)	
Accrued interest receivable	10,098
Loan to XYZ Co Ltd	1,009,817

At the end of second quarter of 2002 (30 June 2002)

At 30 June 2002, XYZ Co Ltd has not met any of its obligations with the bank since February. However, during a meeting with one of the directors of XYZ Co Ltd, it was explained that the current financial condition is due to the bankruptcy of one of the company's major clients, but the director is confident that the company will soon get new clients to make good the shortfall. He promised to pay the whole outstanding amount along with interest by 31 December 2002. The bank has requested XYZ Co Ltd to submit a business plan along with a cash flow projection for the period to 31 December 2002. It has also requested him to have the business plan and cash flow projections vetted by his auditors / business advisors. However, this has not been received.

After assessing the prevailing economic conditions ABL expects that XYZ Co Ltd will be able to repay only Rs1,000,000 on 31 December 2002. It is unlikely that the bank will receive other payments. In view of the expected repayment of Rs1,000,000 on 31 December 2002, the bank has decided not to enforce the security.

The accounting entries for the quarter to 30 June 2002 are:

Dr Accrued interest receivable	Rs30,904	
Cr Interest income		Rs30,904
(To record interest accrued during the quarter – 1% p.m. over 3 month on the outstanding balance of Rs1,019,915 (Rs1,009,817 + Rs10,098). Interest is accrued on the carrying amount prior to the decision to write down the loan to its recoverable amount)		

At 30 June 2002, carrying amount of loan is Rs1,050,819 (capital Rs1,009,817 + interest accrued at 31 March Rs10,098 + interest accrued during the quarter Rs30,904). Recoverable amount is Rs942,045 (discounting Rs1,000,000 over 6 month by 1% per month), with the result that there is an impairment loss of Rs108,774 (i.e Rs1,050,819 – Rs942,045).

Dr Provision for credit loss (Profit and Loss)	Rs108,774	
Cr Allowance for credit loss		Rs108,774

(To reduce carrying amount of loan to its estimated realisable value)

	Quarter ended 30 June 2002 Rs	Six month ended 30 June 2002 Rs
Income Statement (Extract)		
Interest Income	30,904	64,056
Provision for credit loss	(108,774)	(108,774)
Balance Sheet (Extract)		
Accrued interest receivable	41,002	41,002
Loan to XYZ Co Ltd	1,009,817	1,009,817
Allowance for credit loss	(108,774)	(108,774)

At the end of the third quarter of 2002 (30 September 2002)

On 30 September 2002, XYZ Co Ltd has still not yet submitted any business plan or cash flow projection.

According to the Guideline, since the loan is overdue by more than 180 days and no reliable business plan exists, the bank cannot anticipate any cash flow from this account. However, it can account up to 50% of the appraised value of collaterals.

The bank intends to commence legal action in March 2003 in case it does not receive the promised sum in December 2002. It is expected that if legal action is initiated in March 2003, it will run through to 30 September 2003, when the bank, as per valuation report received, expects to obtain a net amount of Rs500,000 from the realisation of the lorries.

Thus at 30 September 2002 the deemed recoverable value of the collateral, and in fact, loan is Rs221,862 (discounting 50% of Rs500,000 by 1% p.m. over 12 months).

Dr Accrued Interest Income	Rs28,545	
Cr Interest income		Rs28,545

(To record interest accrued at 1% p.m. on the carrying amount of Rs942,045 during the quarter.)

Dr Provision for credit loss (Profit and Loss)	Rs748,728	
Cr Allowance for credit loss		Rs748,728

(To reduce carrying amount of loan to its estimated realisable value, which is Rs221,862).

	Quarter ended 30 September 2002 Rs	Nine month ended 30 September 2002 Rs
Income Statement (Extract)		
Interest Income	28,545	92,601
Provision for credit loss	(748,728)	(857,502)
Balance Sheet (Extract)		
Accrued interest receivable	69,547	69,547
Loan to XYZ Co Ltd	1,009,817	1,009,817
Allowance for credit loss	(857,502)	(857,502)

At the end of the fourth quarter of 2002 (31 December 2002)

During the fourth quarter of 2002, the bank informed XYZ Co Ltd that it was going to initiate legal action against it if it does not settle its account by 31 December 2002. On 31 December 2002, XYZ Co Ltd made a payment of Rs300,000 and promised to pay the remaining amount during the first quarter of 2003. However, it has not submitted any business plan, including projected cash flows. The bank gave XYZ Co Ltd up to end February to settle the outstanding dues. In the contrary case it will commence legal action in March 2003.

Dr Cash	Rs300,000	
Cr Provision for credit loss (Profit and Loss)		Rs300,000
(To account for the repayment of Rs300,000)		
Dr Allowance for credit loss	Rs300,000	
Cr Accrued interest receivable		Rs69,547
Cr Interest income (1% p.m. on the carrying amount of Rs221,862[1] during the quarter)		Rs6,723
Cr Loan to XYZ Co Ltd		Rs223,730
(To adjust the allowance for credit loss, and in consequence the carrying amount of the recorded loan and accrued interest in respect of the Rs300,000 settled).		

	Quarter ended 30 December 2002 Rs	Year ended 30 December 2002 Rs
Income Statement (Extract)		
Interest Income	6,723	99,324
Provision for credit loss	–	(857,502)
Reversal impact of provision for credit loss	300,000	300,000
Balance Sheet (Extract)		
Accrued interest receivable	–	–
Loan to XYZ Co Ltd (Rs1,009,817 – Rs223,730)	786,087	786,087
Allowance for credit loss	(557,502)	(557,502)

[1] See workings for the quarter ended 30 September 2002 for details.

Note that the carrying amount of the loan outstanding (net of allowance for credit loss) is Rs228,585, which is equal to discounting 50% of Rs500,000 (the appraised realisable value of the lorries) by 1% p.m. over 9 months.

At the end of the first quarter of 2003 (31 March 2003)

At end March 2003 the bank received no further payments from the company. Accordingly in March 2003, the bank initiated legal action in court against XYZ Co Ltd for recovery of the outstanding amount. It is expected that legal action will be completed on 30 September 2003 as originally expected and that the collateral will fetch Rs500,000.

Negotiation is still on with XYZ Co Ltd. The directors of the company have stated that they will pay Rs600,000 at 30 June 2003, provided that the bank writes off the remaining debt and withdraws its case against the company. The bank expects that it will not be able to get more than this amount.

Dr Accrued Interest Income	Rs6,926	
Cr Interest income		Rs6,926
(To record interest accrued at 1% p.m. on the carrying amount of Rs228,585 during the quarter.)		

Dr Allowance for credit loss	Rs210,659	
Cr Loan to XYZ Ltd		Rs210,659
(To write off the amount of the loan by an amount which in management's judgement, is beyond realistic prospect of recovery. Rs786,087 + Rs6,926 – Rs582,354 i.e. Rs600,000 discounted by 1% p.m. over 3 months – April to June)		

	Quarter ended 31 March 2003 Rs
Income Statement (Extract)	
Interest Income	6,926
Provision for credit loss	–
Reversal of provision for credit loss	–
Balance Sheet (Extract)	
Accrued interest receivable	6,926
Loan to XYZ Co Ltd (Rs786,087 – Rs210,659)	575,428
Allowance for credit loss	(346,843)

Note that the carrying amount of the loan (net of allowance for credit loss) is Rs235,511, which is equal to discounting 50% of Rs500,000 by 1% p.m. over 6 months.

APPENDIX II

1. Legislative Changes

THE FINANCE ACT 2003

The Finance Act 2003, which was enacted on 21 July 2003, brought the following amendments to the Banking Act 1988, the Bank of Mauritius Act and the Stock Exchange Act.

The Banking Act 1988

A new section (section 33A) has been included in Part VII and inserted immediately before section 34. By virtue of this new section

(i) articles 1659, 1660, 1661 and 1673 of the Code Civil Mauricien will not apply to commercial contracts involving purchases made with a provision for repurchase of Treasury Bills, Bank of Mauritius Bills or such other instruments as the central bank may specify, among banks and such other financial institutions as the central bank may specify; and

(ii) articles 2087 and 2088 of the Code Civil Mauricien will not apply to securities given for the repurchase of instruments referred to in paragraph (i).

The repurchase transactions entered into will be subject to the terms and conditions specified, by direction, by the central bank.

The Bank of Mauritius Act

A new subsection (subsection (na)) has been added in section 12 to include among the activities of the Bank of Mauritius the issue of Bank of Mauritius Bills.

A new section (section 12A) has been inserted immediately after section 12 to permit the Bank to raise, for monetary policy purposes, loans by the issue of Bank of Mauritius Bills.

Every Bank of Mauritius Bill will be issued by the Bank in such form, multiples and currencies as may be determined by the Bank and subject to such conditions as may be determined by the Bank.

The Bill will be payable at par at the Bank and will specify its maturity date.

Provisions have also been made in this new section for the proceeds of the issue of the Bills to be paid to the Bank and for the Bill to be redeemed, before its maturity date, on such terms and conditions as may be agreed. Further, every Bill will, on redemption, be cancelled by the Bank.

The Stock Exchange Act

The Stock Exchange Act has been amended in section 2, in the definition of "securities" to insert immediately after paragraph (b), the following new paragraph “(ba) Bank of Mauritius Bills issued by the Bank of Mauritius”.

THE ANTI-MONEY LAUNDERING (MISCELLANEOUS PROVISIONS) ACT 2003

The Anti-Money Laundering (Miscellaneous Provisions) Act 2003 enacted on 16 September 2003 brought the following amendments to sections 39 and 39A of the Banking Act 1988.

Section 39

A new paragraph (paragraph h) has been added to subsection (2) to provide for a bank to

(i) report a suspicious transaction to the FIU under; or

(ii) supply information to the FIU pursuant to a request made under section 13(2) of,

the Financial Intelligence and Anti-Money Laundering Act 2002.

Subsection (11) has been deleted and replaced by a new subsection. This new subsection states that

nothing in this section shall preclude the disclosure of information by the central bank

(i) under conditions of confidentiality to a central bank in a foreign country for the purpose of assisting it in exercising functions corresponding to those of the central bank under this Act; or

(ii) pursuant to section 22 of the Financial Intelligence and Anti-Money Laundering Act 2002 to the FIU.

The definition of 'FIU' has been inserted in subsection (12) and ascribed to mean the Financial Intelligence Unit established under the Financial Intelligence and Anti-Money Laundering Act 2002.

Section 39A

The words "proof beyond reasonable doubt" in subsection (3) have been deleted and replaced by the words "being satisfied".

A new paragraph (paragraph (c)) has been added to subsection (4) to provide for this section to be without prejudice to the duty of the central bank to pass on information to the FIU established under the Financial Intelligence and Anti-Money Laundering Act 2002, pursuant to section 22 of that Act.

2. Public Notice

Notice is hereby given that **BANQUE DES MASCAREIGNES LTEE** has, effective 8 January 2004, been granted a Category 1 Banking Licence to carry on the business of Category 1 banking in Mauritius under section 3 of the Banking Act 1988, subject to the provisions of the Banking Act 1988 and to such terms and conditions as may be imposed by the Bank of Mauritius from time to time.

The business address of **BANQUE DES MASCAREIGNES LTEE** is Weal House, Avenue de Duc D'Edimbourg, Port Louis.

Bank of Mauritius

14 January 2004

3. Notice

Foreign Exchange Dealers Act 1995 -

Authorisation to carry on the business of foreign exchange dealer

Notice is hereby given that Shibani Finance Co. Ltd which was operating as a money-changer, has now been granted an authorisation to carry on the business of a foreign exchange dealer in Mauritius subject to the provisions of the Foreign Exchange Dealers Act 1995 and to the terms and conditions set out in the Foreign Exchange Dealers Regulations 1995. It has accordingly surrendered its money-changer's licence.

The business address of Shibani Finance Co. Ltd is Victoria Building, Corner Quay & Corderie Streets, Port Louis.

Bank of Mauritius

17 February 2004

4. Communiqué

Report of nTan Corporate Advisory Pte Ltd.
(Investigation into irregularities at The Mauritius Commercial Bank Ltd pursuant to
Section 27 of the Banking Act 1988)

On February 14, 2003 The Mauritius Commercial Bank Ltd issued a communiqué announcing the loss of hundreds of millions of rupees arising out of irregularities at the bank over the past several years.

Following a quick assessment of the impact of the loss on the financial strength of the bank, the Bank of Mauritius in its capacity as the regulatory and supervisory authority of banks reassured the public that depositors' interests were adequately safeguarded and there was no cause for concern regarding the stability of the banking system.

The seriousness of the irregularities and their potential adverse implications for the banking industry as a whole imperatively called for investigation by an independent body. In March 2003, the Bank of Mauritius enlisted the services of a reputed forensic accounting firm, the nTan Corporate Advisory Pte Ltd., to investigate mainly into the various factors that led to the irregularities and to make recommendations. A team of bank examiners from the Supervision Department of the Bank of Mauritius supported the nTan team of investigators.

nTan Corporate Advisory Pte Ltd. has submitted to the Bank of Mauritius a Report on its findings followed by recommendations.

The Report dwells comprehensively on certain practices that date as far back as in the early 1990s when The Mauritius Commercial Bank Finance Corporation was still in operation. The anatomy of the irregularities reveals techniques that have been employed for tampering with fixed deposit accounts and executing transfers of funds. The Report also dwells on the prudential aspects of banking practices at The Mauritius Commercial Bank Ltd. Conclusively, the bank's traditional system of controls has been overridden.

The Report makes wide-ranging recommendations. It recommends, inter alia, that

1. The Mauritius Commercial Bank Ltd should enhance the robustness of its internal control system.

2. The Mauritius Commercial Bank Ltd should thoroughly review the concentration of powers vested in its staff members.

3. The Mauritius Commercial Bank Ltd should ensure that it is equipped with adequately trained and qualified staff members in its key areas of operation.

4. The Mauritius Commercial Bank Ltd should require all staff members, particularly those dealing with customers, assets and liabilities to take compliance leave during which period their supervisors and/or the Internal Audit Department and/or the Compliance Department should carry out appropriate reviews of their work.

The Bank of Mauritius has noted the progress made by The Mauritius Commercial Bank Ltd in raising its corporate governance structure to levels of best practice in the past several months. In the wake of the discovery of the irregularities, The Mauritius Commercial Bank Ltd has overhauled its organisational structure. The bank reorganised all its risk-prone areas of operation with external assistance. The bank has set up systems and established procedures with a view to mitigating as far as possible its operational risks.

The Governor of the Bank of Mauritius had a meeting with the Board of Directors of The Mauritius Commercial Bank Ltd at 4.00 p.m. today. Contents of the Report were highlighted and discussed with the Board of Directors of the bank. The Governor strongly urged the Board of Directors on the need for it to speed up the implementation of recommendations made in the Report.

The Bank of Mauritius will ensure that the recommendations made in the Report are fully implemented by The Mauritius Commercial Bank Ltd.

Bank of Mauritius

26 March 2004

5. Communiqué

The Bank of Mauritius has approved the hours of business of The Mauritius Commercial Bank Ltd (MCB) up to 17.00 hrs on Fridays.

On Friday 4 June 2004, MCB closed its places of business at or around 15.30 hrs instead of 17.00 hrs.

The closure of the bank's places of business before the end of its normal operating hours has caused prejudice to members of the public. The MCB has invited those persons who have been affected by the premature closure to inform it of the nature of their complaint in this respect.

The Bank of Mauritius has required MCB to place a non-interest bearing deposit of Rs500 million with it for a period of 14 days with effect from today 7 June 2004 in view of the bank's non-compliance with the approved opening hours of business.

Bank of Mauritius

7 June 2004

6. Notice

Surrender of Category 2 Banking Licence

by African Asian Bank Limited

African Asian Bank Limited was authorised by the Bank of Mauritius to carry on Category 2 banking business on 17 June 1998.

African Asian Bank Limited applied for permission from the Bank of Mauritius for the surrender of its Category 2 Banking Licence under the provisions of section 7(2) of the Banking Act 1988 with effect from 16 June 2003.

African Asian Bank Limited ceased to conduct banking business since 16 June 2003.

The public is hereby informed that after the completion of the necessary formalities by African Asian Bank Limited, the Bank of Mauritius has accepted under section 7(2) of the Banking Act 1988 the surrender of its Banking Licence for cancellation with effect from 8 October 2004.

Bank of Mauritius

8 October 2004

7. List of Authorised Banks, Non-Bank Deposit-Taking Institutions, Money-Changers and Foreign Exchange Dealers

The following is an official list of banks holding a Category 1 Banking Licence, banks holding a Category 2 Banking Licence, institutions other than banks which are authorised to transact deposit-taking business and authorised money-changers and foreign exchange dealers in Mauritius and Rodrigues as at 30 June 2004.

Banks holding a Category 1 Banking Licence

1. Bank of Baroda
2. Barclays Bank PLC
3. Banque des Mascareignes Ltée
4. First City Bank Ltd
5. Habib Bank Limited
6. Indian Ocean International Bank Limited
7. Mauritius Post and Co-operative Bank Ltd
8. South East Asian Bank Ltd
9. State Bank of Mauritius Ltd
10. The Hongkong and Shanghai Banking Corporation Limited
11. The Mauritius Commercial Bank Ltd

Banks holding a Category 2 Banking Licence

1. Bank of Baroda
2. Barclays Bank PLC
3. Deutsche Bank (Mauritius) Limited
4. Investec Bank (Mauritius) Limited
5. Mascareignes International Bank Ltd
6. P.T Bank Internasional Indonesia
7. RMB (Mauritius) Limited
8. SBI International (Mauritius) Ltd
9. SBM Nedbank International Limited
10. Standard Bank (Mauritius) Offshore Banking Unit Limited
11. Standard Chartered Bank (Mauritius) Limited
12. The Hongkong and Shanghai Banking Corporation Limited

Non-Bank Financial Institutions Authorised to Transact Deposit-Taking Business

1. ABC Finance & Leasing Ltd.
2. Barclays Leasing Company Limited
3. Finlease Company Limited
4. General Leasing Co. Ltd.
5. Global Direct Leasing Ltd
6. GML Leasing Ltd
7. La Prudence Leasing Finance Co. Ltd
8. Mauritian Eagle Leasing Company Limited
9. Mauritius Housing Company Ltd
10. MUA Leasing Company Limited
11. SBM Lease Limited
12. SICOM Financial Services Ltd
13. The Mauritius Civil Service Mutual Aid Association Ltd
14. The Mauritius Leasing Company Limited

Money-Changers (Bureaux de Change)

1. Direct-Plus Ltd.
2. Grand Bay Helipad Co. Ltd
3. Max & Deep Co. Ltd
4. Gowtam Jootun Lotus Ltd

Foreign Exchange Dealers

1. British American Mortgage Finance House Co. Ltd
2. Rogers Investment Finance Ltd
3. Thomas Cook (Mauritius) Operations Company Limited
4. CIEL Finance Ltd
5. Shibani Finance Co. Ltd