BANK OF MAURITIUS

Annual Report on Banking Supervision 2003

CONTENTS

Statement from the Governor

The year 2003 witnessed sustained growth and strengthening of our regulatory and supervisory capacity. The Bank of Mauritius issued several new guidelines to assist the banking industry in upgrading and controlling its operations. Simultaneously, the internal infrastructure for conducting financial institutions' inspections and off-site monitoring was significantly enhanced in the form of new manuals and guides for the supervisory staff. The Bank continued to emphasize staff training comprising on-the-job training and attendance at courses and conferences of direct interest.

The normal flow of our supervisory work was unexpectedly disrupted by an unwelcome occurrence, which put our supervisory capacity to a major test. Irregularities entailing hundreds of millions of rupees loss were uncovered at The Mauritius Commercial Bank Limited, perpetrated over several years. This incident not only required a deployment of our supervisory resources to the bank but also required well considered strategic initiatives to maintain public confidence in the bank and the banking sector generally.

Public confidence is critical to the proper functioning of the banking system in a country. Banks have a fiduciary relationship with the public. Loss of confidence in one bank can have a contagion effect on others, thus rocking the entire banking system and the overall economy with undesirable welfare consequences. In our case, the situation became critically urgent when a bank of the size of The Mauritius Commercial Bank Limited, representing around fifty per cent of the banking system of the country, faced a crisis of confidence. We deemed it vitally important to proceed quickly but in a cool and composed manner even at the risk that the stand we might take would not be appreciated in various quarters. The regulator has the responsibility to investigate and take to task the financial institution that strays away from prudential norms. However, it needs to work with the institution and encourage it, as appropriate, to ensure that fundamental changes are brought about in its structure and governance practices to preserve its financial health and prevent any similar occurrences in the future.

The Bank of Mauritius enlisted the services of an independent forensic accounting firm, nTan Corporate Advisory Pte. Ltd. of Singapore, to investigate into the irregularities at The Mauritius Commercial Bank Limited. Several officers worked with the team of nTan forensic experts. At the same time, it provided them with an opportunity to benefit from the experts in methodologies used in the investigative work.

The Bank of Mauritius views corporate governance as a factor of critical importance in ensuring safety and soundness of financial institutions. To foster good governance, it has issued a network of Guidelines, dealing with the overall issue of governance as well as the specifically targeted areas of related party transactions, public disclosure of information and the role of external auditors. In 2003, we further extended the network by issuing Guidance Notes on Fit and Proper Person Criteria, which place the responsibility for implementation of the criteria squarely in the hands of an institution's Board of Directors. These Guidance Notes were issued in recognition of the fact that an institution cannot be run on sound governance principles unless its management is adequately skilled, competent, honest and ethical. Market participants and the public need assurance that the persons at the helm are and are perceived to be fit and proper at all times.

Credit constitutes by far the biggest part of the banking industry's business in Mauritius and its mismanagement has been responsible for serious problems in certain institutions. Right from the first meeting held with banks' Chief Executive Officers in July 1999, I have impressed upon them the need to have in place a sound credit risk policy to minimize and manage credit risk. Over the years, our on-site inspection teams have uncovered instances where either no credit risk policy existed or, if it did, was not applied consistently and effectively. In 2003, the Bank decided to deal with this critical subject by issuing the Guideline on Credit Risk Management. The Guideline outlines, in very clear terms, the accountability of the Board of Directors and, through it, the Chief Executive Officer, in managing the credit risk activity of the financial institution with integrity, using strictly and exclusively prudential credit criteria. It also insists on the establishment of effective internal controls, covering the entire credit spectrum and their fullest implementation.

We are now coming to the stage where our network of guidelines to assist financial institutions in prudential management of their operations, is becoming increasingly wide ranging. We fully expect them to diligently implement those guidelines. We look forward to receiving assurances through our monitoring work and otherwise, that they are indeed being implemented in their true spirit.

We want our financial institutions to remain in the forefront of the economic development of the country. To this end, we have always taken a long term, futuristic view of the development of the financial industry. The Bank of Mauritius is currently working on certain important new initiatives. These pertain to the establishment of a credit bureau and seeking changes to the existing legislative framework to obtain expeditious realization on collaterals taken against credits granted.

Financial institutions need up-to-date and accurate information on creditworthiness of borrowers in order to carry out their credit appraisal. For some time now, an urgent need has been identified for the establishment of a credit bureau which will collect, consolidate, store and disseminate credit information on borrowers. Further to the report of the sub-committee of the Banking Committee on this subject, a delegation led by the Managing Director of the Bank of Mauritius visited the National Bank of Belgium, which has a modern and efficient credit bureau. The visit was highly enlightening and will help in moving forward the project.

The credit bureau concept will have another application, in the implementation of the Basel II Accord. In order to measure and mitigate credit risk, Pillar I of the Accord requires borrowers to be rated according to their creditworthiness. The rating can be done by external credit rating agencies or such other agencies, as may be approved by the supervisory authority. In this project, the experience of the Banque De France, which has operated a credit bureau since 1946, and of the National Bank of Belgium, is of considerable interest and will be drawn upon as we proceed.

Financial institutions in Mauritius experience lengthy delays in the liquidation of securities taken against credits that become impaired. Some borrowers, having the capacity to repay their loans, deliberately go into arrears because they know that the loan recovery process prescribed in the existing legislation is prolonged and cumbersome. Usually the course available to banks is to foreclose the security and dispose of the assets involved, by levy. But this is a very lengthy process and the proceeds realized are frequently grossly insufficient to discharge the loan liability. As a result, banks are reluctant to embark on the process and the recalcitrant borrowers continue to pay little heed to any notices to settle the outstanding accounts. At the Banking Committee meetings, bankers have raised the issue on various occasions. I have asked them to put forward their proposals to resolve the problem. I have also brought to their attention the approach recently adopted in India through the passing of a new legislation, The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Act 2002. In the meantime, work is progressing at the Bank on legislative amendments.

The constantly emerging challenges in the realm of regulation and supervision necessitate regular upgrading of skills and solid teamwork for the maintenance of monetary and financial stability. The Bank of Mauritius has made considerable headway in capacity building in recent years. The benefits from all the initiatives undertaken by the Bank can only crystallize in the years to come.

Rameswurlall Basant Roi, G.C.S.K.

1. Overview of Supervisory Developments

INTERNATIONAL DEVELOPMENTS

International initiatives on the supervisory front were directed to promote transparency and market discipline. Financial institutions are being urged to adopt best risk management practices and maintain the combat against money laundering and financing of terrorism. Continued efforts to ensure that international supervisory standards are consistently applied and that banking supervision is carried out evenly at the global level, were reflected in the development of norms establishing the responsibilities of home country and host country supervisors and the release of standards pertaining to cross-border initiatives. The following paragraphs briefly outline such initiatives.

In order to provide a framework for the effective management and supervision of operational risk for use by banks and by supervisory authorities when assessing operational risk management policies and practices, the Risk Management Group of the Basel Committee on Banking Supervision (the Committee) issued, in February 2003, a paper entitled 'Sound Practices for the Management and Supervision of Operational Risk'. The paper lays down the ground rules for a framework for effective management and supervision of operational risk for use by banks and by supervisory authorities when appraising the operational risk management policies and practices. The innovative part of the paper is that it formalizes the concept that operational risk management should form part of the comprehensive risk management strategy in the same way as credit and market risk management.

In May 2003, the Committee published the results of the 2001 disclosure survey as part of its sustained effort to promote transparency and effective market discipline in the banking and capital markets. The survey revealed that many banks have continued to expand the extent of their disclosures. Disclosures on accounting and presentation policies, other risks and capital structure were noteworthy, while a need for more disclosures on credit risk modeling and credit derivatives was felt. In this respect, the Committee has urged the few banks that do not disclose the most commonly provided information to improve their disclosures. It is, however, expected that with the forthcoming implementation of the New Capital Accord with its Third Pillar based on Market Discipline, there will be further expansion in the extent of banks' disclosure practices.

The combat against money laundering and the financing of terrorism is on-going. This item remained high on the agenda of international supervisory bodies such as the Basel Committee on Banking Supervision, International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO) during the year 2002/03. These institutions issued a joint note in June 2003 describing the initiatives taken by each institution to combat money laundering and the financing of terrorism.

Whilst reckoning that each organization's sector of oversight has its particularities and that a uniform set of supervisory efforts cannot be applied to all three segments, they stated their commitment to ensuring that the standards of supervision applied are consistent and coherent and that no particular segment would offer the opportunity of arbitraging as a result of less stringent anti-money laundering and terrorism financing norms.

The 'Customer Due Diligence for Banks' publication released in October 2001 was endorsed by banking supervisors from about 120 countries at the International Conference of Banking Supervisors in Cape Town in September 2002. As a supplement to the publication, a Consultative paper entitled 'Consolidated know-your customer (KYC) risk management' was made available to the banking industry in August 2003. The paper analyses the essential components for effective management of KYC policies. One of the requirements of the paper is that jurisdictions should facilitate consolidated KYC risk management by providing an appropriate legal framework that permits the cross-border sharing of information and removes the legal restrictions impeding effective consolidated KYC risk management processes.

Another issue dealt with by the Committee was the management and supervision of cross-border electronic banking activities. A paper on this issue was prepared by the Electronic Banking Group of the Committee and released in July 2003. The paper lays down supervisory expectations and provides guidance to banks carrying out cross-border electronic banking activities as well as to their home and host supervisors. It aims at supplementing the publication on Risk Management Principles for Electronic Banking by emphasizing the need for banks to incorporate their cross-border e-banking risks into their overall risk management framework. It also highlights the need for effective home country supervision of cross-border e-banking activities and for continued international cooperation between banking supervisors respecting such activities.

Evolution of the Core Principles for Effective Banking Supervision

It is now six years since the Core Principles for Effective Banking Supervision were issued in September 1997. This document serves as the international yardstick for the evaluation of the overall quality of supervision in individual countries.

The Core Principles Methodology which provides the necessary criteria for evaluating and judging compliance with the individual principles, has revealed to be an important and effective tool in assessment exercises. The Financial Sector Assessment Programmes (FSAPs) carried out jointly by the IMF and the World Bank to test the robustness of the financial system of individual countries, have been based to a large extent on the compliance with the Core Principles.

In order to keep the Core Principles as comprehensive, relevant and up-to-date as possible, the Committee will commence a thorough review of the Principles probably later this year. The exercise will help determine whether additional Principles are needed or some essential criteria need to be revised or new criteria added. Already, it has been decided in the course of the International Conference of Banking Supervisors that the principles of the 'Customer Due Diligence for Banks' will be incorporated in the Core Principles.

Combat against Money Laundering and Terrorism Financing

The Financial Action Task Force, an international agency established by the G-7 in July 1989 to examine measures to combat money laundering, adopted its revised Forty Recommendations in June 2003. Together with the Eight Special Recommendations on Terrorist Financing, they provide a coherent and comprehensive framework of measures for anti-money laundering and combating terrorist financing.

New Accord on Capital Adequacy

On 29 April 2003, the Committee issued a third consultative paper on the New Basel Capital Accord. Banks and other interested parties were requested to send their comments by 31 July 2003. All comments received during the third consultative period by the Committee were published and posted on its website. Comments made by banks in Mauritius are also available in the Committee's website (*http://www.bis.org*). The Committee is expected to finalise its proposal for a new capital adequacy framework in the light of the comments received, with the objective to release the New Accord in final form by December 2003, for implementation by member countries by the end of 2006.

In view of the forthcoming finalisation of the New Capital Adequacy Accord in December this year and its proposed implementation by year-end 2006, the Bank of Mauritius has set up a working group with the objective of developing an implementation plan for the Accord. The proposals put up by the working group include, inter alia, the preparation of a draft Guideline to be issued to the banking institutions and the active involvement of banks in the process.

DOMESTIC DEVELOPMENTS

Actions taken to combat Money Laundering and Terrorism Financing

The Financial Intelligence and Anti-Money Laundering Regulations 2003 made under section 35 of the Financial Intelligence and Anti-Money Laundering Act 2002 became effective during the second half of June 2003. The Regulations prescribe the customer identification and due diligence requirements to be observed by banks, financial institutions and cash dealers when forming business relationships with clients. The Regulations also require banks, financial institutions and cash dealers to implement internal controls and procedures to combat money laundering and financing of terrorism. Those financial institutions are henceforth required to appoint a Money Laundering Reporting Officer whose responsibilities are clearly laid down in the Regulations.

The Mutual Assistance in Criminal and Related Matters Act was adopted by the National Assembly in August 2003. This legislation permits the country to have and to provide, as well, the widest possible measure of international co-operation promptly and to the fullest extent possible, in investigations, prosecutions or proceedings concerning serious offences and related civil matters.

A Convention for the Suppression of the Financing of Terrorism Act was also enacted by the National Assembly in August 2003. The Act lays down the basis for the ratification by the Republic of Mauritius of the International Convention for the Suppression of the Financing of Terrorism. The ratification of the International Convention signed by the Government on 11 November 2001 is therefore imminent.

The Anti-Money Laundering (Miscellaneous Provisions) Act was enacted in August 2003. The main object is to amend the Banking Act 1988, The Financial Intelligence and Anti-Money Laundering Act 2002 and the Financial Services Development Act 2001 in order to permit the setting up of a National Committee for Anti-Money Laundering and Combating the Financing of Terrorism and the replacement of the Review Committee of the Financial Intelligence Unit by a board. The Act removes the existing ambiguity as to whether the Bank of Mauritius was empowered to issue Guidance Notes on Anti-Money Laundering.

The Bank of Mauritius has reviewed and updated its Guidance Notes on Anti-Money Laundering and Combating the Financing of Terrorism. The Guidance Notes have been reviewed in the light of the regulations made under section 35 of the Financial Intelligence and Anti-Money Laundering Act 2002 which came into force on 21 June 2003. The Guidance Notes encompass all the principles set out in the Eight Special Recommendations of the FATF on combating the financing of terrorism.

Other Legislative Changes in the Banking Sector

During the year under review, the Banking Act 1988 was amended by the Finance Act 2003 to include a new section providing for derogation from articles 1659, 1660, 1661, 1673, 2087 and 2088 of the Code Civil Mauricien for the purposes of conducting repurchase transactions among banks and other financial institutions.

Guidelines issued by Bank of Mauritius

In June 2003, the Bank of Mauritius issued on a consultative basis to banks and non-bank deposit taking institutions a draft Guideline on Credit Impairment Measurement and Income Recognition to render explicit the requirements of the International Accounting Standard 39 (IAS 39) which deals with the impairment and uncollectability of financial assets. This Guideline would supersede the existing Guideline on Credit Classification for Provisioning Purposes and Income Recognition. The need for the new Guideline derives from the fact that the Companies Act 2001 requires all companies to prepare their financial statements in accordance with International Accounting Standards issued by the International Accounting Standards Board. Banks have forwarded to the Bank of Mauritius their representations on the draft Guideline. The representations have been duly considered and another version is contemplated for issue on consultation. It is expected that the final version would be issued before the end of the year.

As from June 2003, the Bank started to implement the new framework for the compilation and reporting of monetary data by requiring all financial institutions falling under its purview to adopt a uniform reporting system along the lines of the Monetary and Financial Statistics Manual of the IMF. Accordingly, all financial institutions submit a standardised set of statements of assets and liabilities on a monthly basis, effective 30 June 2003.

The Bank has constantly impressed upon financial institutions the need for a sound credit policy in managing and mitigating credit risk. Uneven levels of treatment of processes for credit risk policy were observed across financial institutions. In order to bring the credit processes within the institutions to a comparable level, the Bank has issued a Guideline on Credit Risk

Management. The Guideline was finalised after taking into consideration the comments and suggestions of the industry. It is not meant to be a comprehensive framework and only outlines the essentials for a well designed credit risk management framework.

The Bank is presently working on other guidelines, notably, on Operational risk, Market Risk and Sovereign Risk. As usual, these will be issued to the industry on a consultation basis prior to their implementation.

In the wake of recent scandals which rocked financial institutions, both locally and abroad, the need for financial institutions to employ officers who are fit and proper is receiving increased attention. Market participants as well as the public in general need to be assured that officers holding senior positions in financial institutions are competent, honest and financially sound and enjoy total integrity. With a view to providing some basic guidance to assess that their officers are fit and proper, the Bank issued to financial institutions on 4 November 2003, Guidance Notes on Fit and Proper Person Criteria.

Memorandum of Understanding

The Memorandum of Understanding entered into by the Bank of Mauritius with the Financial Services Commission on 5 December 2002 has set the stage for the exchange of supervisory information and for promoting cooperation between the two regulatory bodies. It is expected that in the near future teams comprising officers of both the Financial Services Commission and the Bank of Mauritius would be jointly carrying out on-site inspections of conglomerates.

Financial Sector Assessment Program

The final report of the Financial Sector Assessment Program in which Mauritius participated during 2002 was delivered to the authorities in August 2003.

According to the report, banking supervision is of a good standard, reflecting significant progress made in building the capacity of the Bank of Mauritius in recent years. Certain legal deficiencies were, however, identified. The report expressed the views that those legal deficiencies would be addressed if the current drafts of the new Banking Bill and Bank of Mauritius Bill were enacted and that this should be done as a matter of priority.

The mission is of the view that the prudential guidelines are all of a commendable standard and the capacity of the Bank of Mauritius to enforce guidelines has substantially increased in recent years. However, the need is felt for additional guidelines to address country and market risks and credit policy and there is scope for further strengthening in the areas of consolidated supervision and problem bank resolution.

The Bank of Mauritius is currently addressing those issues. During the year 2002/03, various Guides on supervisory issues such as Guide on Consolidated Supervision and Guide on Intervention by the Bank of Mauritius in Financial Institutions were developed for internal use by the Supervision Department.

The MCB/NPF Case

In February 2003, a fraud in hundreds of million of rupees was discovered at The Mauritius Commercial Bank Ltd (The MCB Ltd). On 14 February 2003, a Communiqué was issued by The MCB Ltd relating to the fraud which was committed at the expense of one of its clients, namely the National Pension Fund (NPF). The Bank of Mauritius issued a Communiqué reassuring depositors that their interests are positively safeguarded.

According to the audited interim accounts of The MCB Ltd, the bank's accumulated reserves stood at Rs 5.7 billion as at 31 December 2002. In March 2003, an amount of Rs 881.6 million representing the estimated amount of the fraud was reimbursed to the NPF.

The Bank of Mauritius hired the services of nTan Corporate Advisory Pte Ltd (nTan), Forensic Accountants from Singapore to investigate into the fraud. Inspectors from the Bank of Mauritius participated in the nTan investigation.

On 17 March 2003, the Governor of the Bank of Mauritius met with the Chief Executive Officers and the Board of Directors of Category 1 banks with a view to critically appraising their management practices and their compliance with the ethos of corporate governance as stipulated in the Central Bank's directives. The main issues raised during those meetings were the need for the Board of Directors to carry out a fundamental review of the organizational structure and in particular the top management of their respective banks, the need to review fundamentally the professional standards of bank officers and management staff, that bankers should comply with the Central Bank's directives and adopt an uncompromising focus on the issue of corporate governance. The Governor also urged the Board of Directors to ensure that their audit committees were operationally efficient and fully independent of the office of the Chief Executive.

Proposed Establishment of a Credit Bureau

The assistance of the National Bank of Belgium was solicited for guidance on the proposed establishment of a credit information bureau in Mauritius. In this connection, a delegation headed by the Managing Director of the Bank and comprising commercial bankers proceeded to the National Bank of Belgium for a prospecting visit in November 2003.

Other Developments

In November 2002, Barclays Bank Plc acquired the banking activities of Banque Nationale de Paris Intercontinentale which surrendered its Category 1 and Category 2 banking licences to the Bank of Mauritius with effect from 5 December 2002.

In February 2003, a Fraud Forum was set up by the Category 1 banks with a view to combating fraudulent transactions involving credit cards. The Fraud Forum comprises six Category 1 banks, namely, The Mauritius Commercial Bank Ltd, State Bank of Mauritius Ltd, Barclays Bank Plc, Hongkong and Shanghai Banking Corporation Ltd, Bank of Baroda and First City Bank Ltd.

In May 2003, the undertakings of the New Co-operative Bank Ltd and Mauritius Post Office Savings Bank were transferred to the Mauritius Post and Cooperative Bank Ltd. Approval was granted by the Bank of Mauritius under section 10(1)(a) of the Banking Act 1988.

The African Asian Bank Limited has, pursuant to section 7(2) of the Banking Act 1988, has applied to the Bank of Mauritius for the surrender of its Category 2 Banking Licence and has ceased to conduct banking business with effect from 16 June 2003.

2. A Review of the Performance of Banks

2.1 INTRODUCTION

The banking sector is constituted of the Category 1 banking sector comprising ten banks holding a Category 1 Banking Licence (Category 1 banks) and Category 2 banking sector comprising twelve banks holding a Category 2 Banking Licence (Category 2 banks).

Six Category 1 banks are locally incorporated. Of these, one is foreign owned. The remaining four Category 1 banks operate as branches of foreign banks. Two locally incorporated Category 1 banks account for 68 per cent of the total assets of the Category 1 banking sector.

Out of the twelve Category 2 banks, four are branches of foreign banks, seven are subsidiaries of foreign banks and one is a joint venture between a Category 1 bank and a foreign bank.

A list of the Category 1 and Category 2 banks as at 30 June 2003 is shown in Appendix II.

2.1.1 Surrender of Banking Licences by Banque Nationale de Paris Intercontinentale

In November 2002, following its decision to dispose of its Category 1 and Category 2 banking businesses to Barclays Bank Plc, Banque Nationale de Paris Intercontinentale (BNPI) applied for permission from the Bank of Mauritius for the surrender of its Category 1 and Category 2 Banking Licences under the provisions of section 7(2) of the Banking Act 1988.

The Bank of Mauritius made the necessary inquiries into the conditions of the takeover of the banking businesses of BNPI by Barclays Bank Plc. After being satisfied that the interests of depositors and of the public were preserved and that Barclays Bank Plc would be responsible for safekeeping all the records of the activities of BNPI in Mauritius after the takeover, the Bank of Mauritius accepted the surrender of the Category 1 and Category 2 Banking Licences of BNPI with effect from 5 December 2002. Accordingly, BNPI ceased to conduct banking business in Mauritius as from that date.

2.1.2 Surrender of Category 2 Banking Licence by African Asian Bank Limited

In June 2003, African Asian Bank Limited applied to the Bank of Mauritius for permission to surrender its Category 2 Banking Licence under the provisions of section 7(2) of the Banking Act 1988.

The Bank of Mauritius has given permission for African Asian Bank Limited to surrender its Category 2 Banking Licence with effect from the close of business on 16 June 2003 after completion of certain requirements to its satisfaction.

Accordingly, African Asian Bank Limited ceased to conduct banking business as from 16 June 2003.

2.1.3 Merger of the New Co-operative Bank Ltd with Mauritius Post Office Savings Bank

In April 2003, following the decision of the Government of Mauritius to merge the operations of the New Co-operative Bank Ltd with those of the Mauritius Post Office Savings Bank, the New Co-operative Bank Ltd applied to the Bank of Mauritius for permission for the merger and to operate thereafter under the name of Mauritius Post and Cooperative Bank Ltd.

In May 2003, the Bank of Mauritius gave its approval for the merger and for the change of the bank's name to Mauritius Post and Cooperative Bank Ltd. A Category 1 Banking Licence was issued in the name of Mauritius Post and Cooperative Bank Ltd on 3 June 2003.

On 4 June 2003, the Mauritius Post and Cooperative Bank Ltd was granted an authorisation to carry on the business of foreign exchange dealer in Mauritius under section 3(1) of the Foreign Exchange Dealers Act 1995.

On 19 June 2003, the Savings Bank (Transfer of Undertaking) Act 2003 was enacted to provide for the transfer of the business of the Mauritius Post Office Savings Bank to the Mauritius Post and Cooperative Bank Ltd.

2.2 PERFORMANCE OF CATEGORY 1 BANKS

The activities of Category 1 banks continued to expand during the year 2002-03. On-balance sheet assets of Category 1 banks, inclusive of the assets of BNPI taken over by Barclays Bank Plc during the year, rose by Rs19,880 million or 14.8 per cent from Rs134,680 million at end-June 2002 to Rs154,560 million at end-June 2003, compared to a growth rate of 13.9 per cent in the preceding year. On an individual basis, asset growth of Category 1 banks for the year 2002-03 ranged between 1.4 per cent and 89.6 per cent.

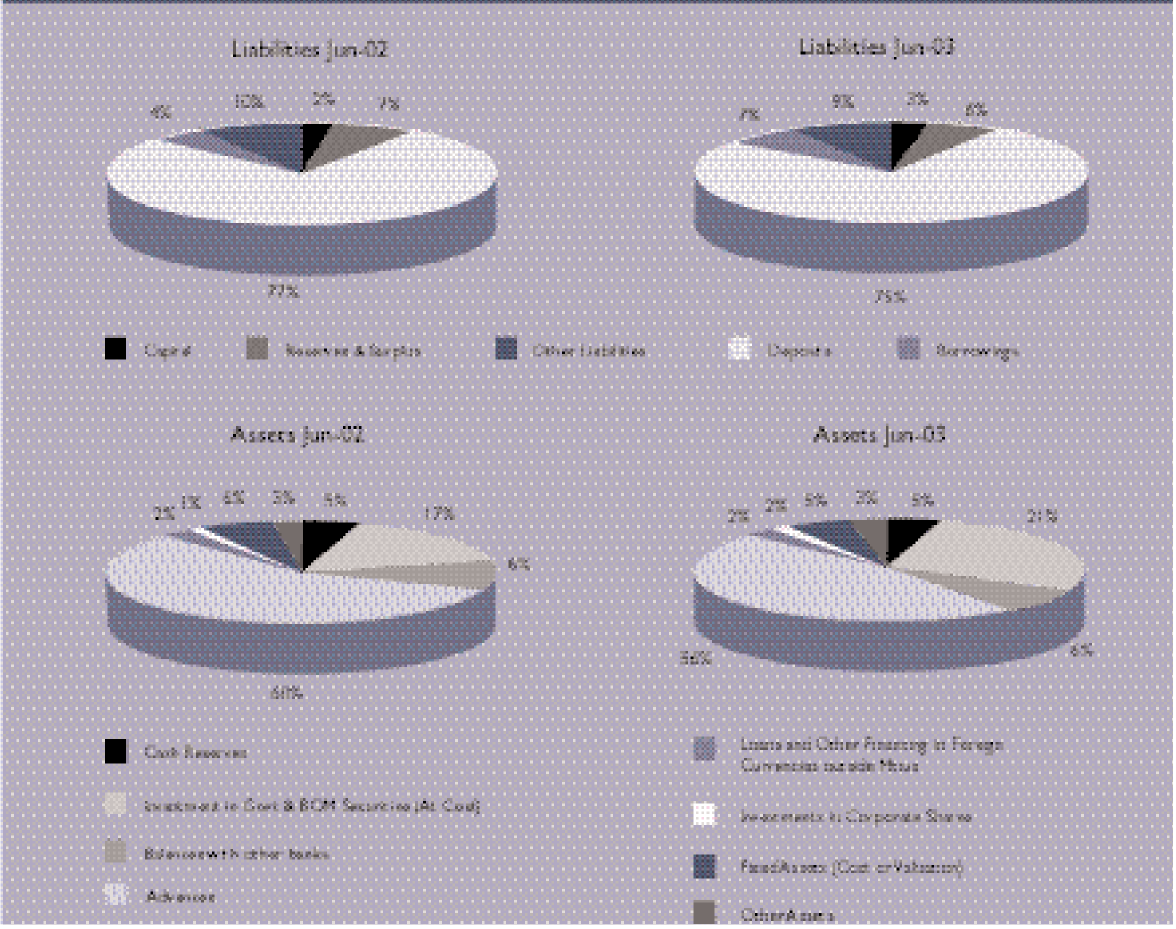
During the year under review, foreign currency assets of Category 1 banks posted a 14.4 per cent increase, rising from Rs18,796 million at end-June 2002 to Rs21,511 million at end-June 2003. The share of foreign currency assets in total assets of Category 1 banks declined marginally from 14.0 per cent at end-June 2002 to 13.9 per cent at end-June 2003. Category 1 banks had an overall short foreign exchange position of Rs1,169 million at end-June 2003 as compared to an overall long position of Rs1,366 million at end-June 2002.

Off-balance sheet assets comprising acceptances, guarantees and documentary credits amounted to Rs17,052 million at end-June 2003, up from Rs15,081 million at end-June 2002.

Chart 1 gives the year-on-year comparison of assets and liabilities of Category 1 banks. At end-June 2003, the bulk of the assets of Category 1 banks consisted of advances and investment in Treasury Bills and Government securities, which, respectively, made up 55.6 per cent and 21.5 per sent of the total, compared to 60.3 per cent and 16.7 per cent, respectively, a year earlier. Lesser demand for credit translated into a shift towards investment in Treasury Bills and Government securities. Deposits constituted 74.9 per cent of Category 1 banks' total resources.

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

Chart 1: Balance Sheet Structure



2.2.1 CAPITAL ADEQUACY

The balance sheet structure of banks is unique as they have a relatively high gearing of outside creditors, mostly depositors, to shareholders' funds. This structure makes banks vulnerable to various risks. In order to carry out a prudent management of those risks, bank regulators have adopted minimum capital adequacy requirements in line with the Basel Capital Accord 1988.

An adequate capital base serves as a safety net for a variety of risks as it provides a cushion against losses, which should be borne by shareholders rather than depositors. Hence, the level of capital maintained by a bank should be consistent with its overall risk profile and business strategy. Board of directors should ensure that at all times banks hold capital which commensurate with their risk profile. Strong capital also reassures creditors and helps to maintain confidence in a bank. Adequate capital, however, cannot by itself provide a safeguard against failure of banks that are not properly managed.

The Basel Capital Accord 1988 was adopted by the Bank of Mauritius in December 1993 and the minimum capital adequacy ratio to be observed by banks was initially set at 8 per cent. It was subsequently increased to 10 per cent as from July 1997 in line with the increase in the minimum paid up/assigned capital to be maintained by banks.

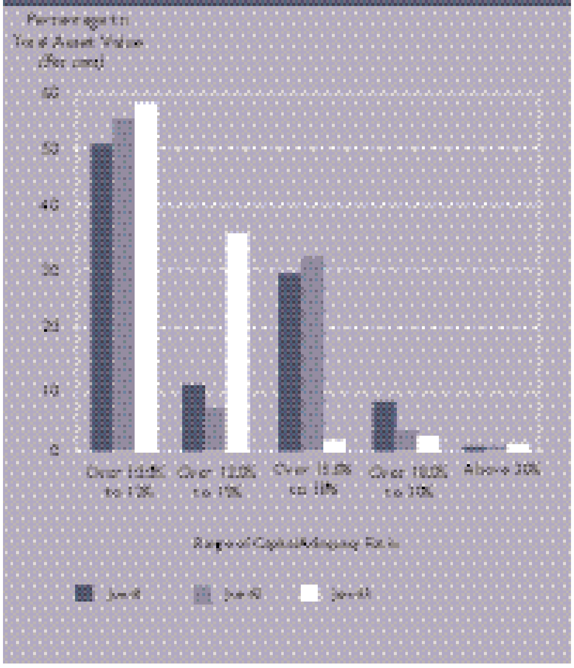
Capital, for supervisory purposes, is considered in two tiers. Tier 1 or permanent capital comprises the highest quality capital elements. Tier 2, or supplementary capital represents other elements which do not satisfy all the characteristics of Tier 1 capital but contribute to the overall strength of a bank as a going concern. A bank's capital base is the sum of its Tier 1 capital and Tier 2 capital net of any deductions. On the other hand, the different broad categories of assets of the bank are assigned different risk weights. The capital base is then expressed as a percentage to total risk-weighted assets.

On average, the risk weighted capital adequacy ratio maintained by Category 1 banks fluctuated between a low of 12.3 per cent in December 2002 to a high of 13.5 per cent in September 2002 during the year ended 30 June 2003. Individual banks' ratio varied widely mainly on account of differences in the attitude of banks to risk management.

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

Chart 2 shows the capital adequacy ratio maintained by Category 1 banks in terms of their total asset value. Category 1 banks that reported ratios between 10 per cent and 12 per cent held in aggregate the biggest share of the banking sector's total on- and off-balance sheet assets at 55.6 per cent and 58.2 per cent in June 2002 and June 2003, respectively. Although this may indicate that some banks are making an optimum use of their capital, this ratio should, however, not be interpreted in isolation. Other ratios such as the ratio of non-performing loans to total capital base would indicate the extent to which a bank's capital base is either being properly managed or is subject to risk of erosion as a result of loan losses.

Chart 2: Banks' Capital Adequacy Ratio in terms of Total Assets Value



At end-June 2003, banks with capital adequacy ratios ranging between 12 per cent and 15 per cent held the next biggest portion of the banking sector's total on- and off-balance sheet assets at 36.7 per cent, as opposed to only 7.3 per cent within the same category for June 2002. Banks with capital adequacy ratios of between 15 per cent and 18 per cent recorded a sharp decline in their aggregate share of the banking sector's total on- and off-balance sheets assets, which fell from 32.8 per cent in June 2002 to 1.9 per cent in June 2003.

2.2.1.2 Capital Base

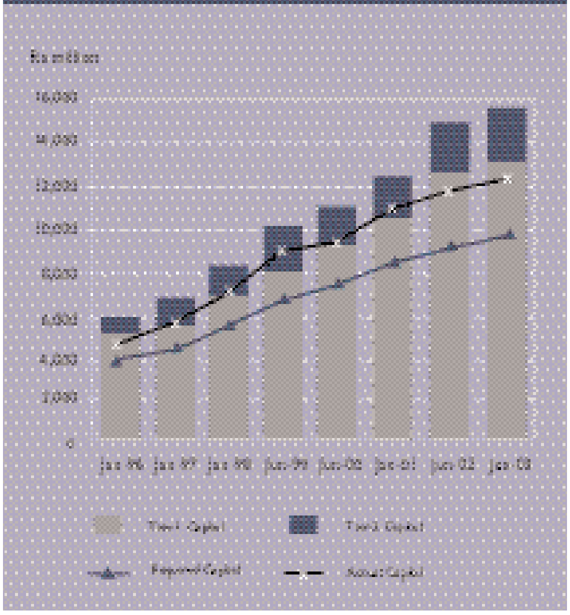
The aggregate capital base of Category 1 banks increased by Rs589 million, from Rs11,954 million at end-June 2002 to Rs12,543 million at end-June 2003. The average capital adequacy ratio of banks at end-June 2003 stood at 12.6 per cent, down from 13.1 per cent at end-June 2002.

During the year under review, the aggregate capital base growth of 4.9 per cent was lower than the growth of the total risk weighted assets of banks at 9.6 per cent, thus resulting in a decrease in the overall capital adequacy ratio of the Category 1 banking sector.

At end-June 2003, Tier 1 capital, which comprises the bulk of total capital accounted for 83.4 per cent of total gross capital (Tier 1 and Tier 2) of Category 1 banks. During the year under review, it grew slightly by 1.5 per cent from Rs12,717 million at end-June 2002 to Rs12,905 million at end-June 2003. On the other hand, Tier 2 capital representing 16.6 per cent of total gross capital at end-June 2003, grew by 13.9 per cent from Rs2,251 million to Rs2,563 million during the year. At end-June 2003, Tier 2 capital represented 19.9 per cent of Tier 1 capital, up from 17.7 per cent in June 2002.

Chart 3 reflects the split between Tier 1 and Tier 2 capital over the period of end-June 1996 through 2003. A comparison of the actual capital base maintained by Category 1 banks with their minimum required capital base, given their total risk-weighted assets, as shown in the chart indicates that, on average, the buffer of capital maintained by the banking sector is increasing over the years. This may indicate banks' prudent attitude towards risk or insufficient demand for more risky assets.

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 grew by 14.3 per cent from Rs128,954 million at end-June 2002 to Rs147,338 million at end-June 2003 while the corresponding risk weighted value rose by a lower percentage of 6.8 per cent from Rs82,879 million to Rs88,546 million.

Table 1 shows the comparative movement in the riskiness of Category 1 banks' total on-balance sheet assets as between end-June 2002 and end-June 2003. The 100 per cent risk-weighted assets represented the bulk of Category 1 banks' total

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

	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
Risk Weights (%)	**June 2003**		**June 2002**	
0	46,471	31.5	34,844	27.0
20	11,588	7.9	10,826	8.4
50	6,102	4.1	5,140	4.0
100	83,177	56.5	78,144	60.6
	147,338	**100.0**	**128,954**	**100.0**

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

		June 98	June 99	June 00	June 01	June 02	June 03
A	Total On- and Off-Balance Sheet Assets (Rs million)	97,186	111,064	125,884	133,244	153,023	174,731
B	Total Risk-Weighted Assets (Rs million)	56,772	68,403	75,264	81,986	90,927	99,607
C*	Average Combined Risk Weighting (Per cent) B/A	58.4	61.6	59.8	61.5	59.4	57.0
D	Capital Adequacy Ratio (Per cent)	12.5	12.9	12.2	13.1	13.1	12.6

*B/A

assets at 60.6 per cent and 56.5 per cent at end-June 2002 and end-June 2003, respectively. During the year under review, high risk assets continued to maintain a downward trend, with assets weighted at 100 per cent and 20 per cent, respectively, being shifted to low risk assets (zero-risk rated). This is mirrored in the substantial increase in banks' investment in Government securities and Treasury Bills, zero-risk rated assets, which rose by 56 per cent from Rs22,046 million at end-June 2002 to Rs34,388 million at end-June 2003.

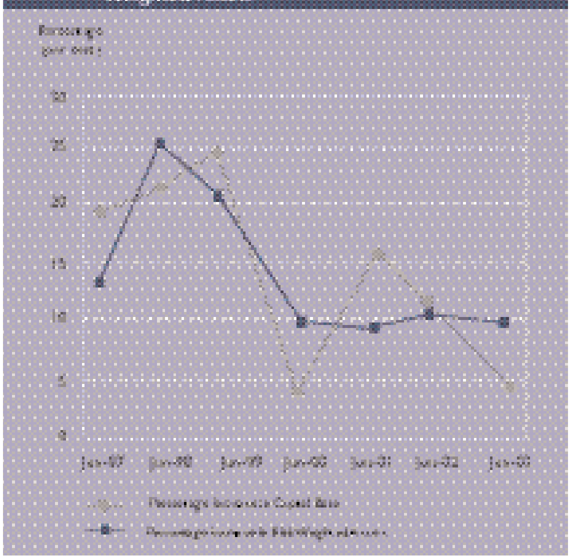
A comparison of the total on- and off-balance sheet assets of Category 1 banks together with their corresponding risk-weighted value and their average combined risk weighting over the period June 1998 to June 2003 is given in Table 2.

As shown in Table 2, from June 2002 to June 2003, total on- and off-balance sheet assets of Category 1 banks rose by Rs21,708 million or 14.2 per cent while the corresponding total risk-weighted value grew by Rs8,680 million at a lower rate of 9.6 per cent. The corresponding growth rates for the preceding year were 14.8 per cent and 10.9 per cent, respectively.

As illustrated in Table 2, the average combined risk weighting (which is the ratio of the risk-weighted assets to the total on- and off-balance sheet assets) recorded a decline from 59.4 per cent in June 2002 to 57.0 per cent in June 2003, indicating, on average, a slight shift to less risky assets. Despite this overall decrease in the riskiness of banks' total on- and off-balance sheet assets, the aggregate capital adequacy ratio of banks nevertheless fell from 13.1 per cent to 12.6 per cent. This is mainly on account of a lower percentage growth of the capital base of the banking sector resulting from a share 'buy back' carried out by two banks during the year ended June 2003. This trend clearly indicates that some banks do not wish to be over capitalised as capital involves a cost which indirectly impacts on the pricing of banks' products.

Chart 4 compares the percentage increase in capital base and risk-weighted assets over the period June 1997 to June 2003.

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



2.2.2 ASSET QUALITY

Banking business by its very nature is subjected to a wide array of risks, which if not controlled properly, can undermine the stability of the whole financial sector.

Banks lie at the heart of the payment and settlement system and are highly leveraged institutions with the bulk of their resources raised by way of deposits from the public. They are entrusted with the fiduciary responsibility of managing public funds and safeguarding depositors' interests. On the other hand, banks' shareholders expect a reasonable return on their equity. Banks are therefore faced with the challenges of remaining safe and sound as well as engaging in risky productive operations.

Asset structure building is the first step towards ensuring good performance of banks. At the very outset, banks should measure the risks inherent to each asset item and have in place good risk management systems. The share of each asset component reflects the risk levels and types of risk to which the bank is exposed. Chart 1 compares the asset composition of banks' balance sheets at end-June 2002 and end-June 2003. The Bank of Mauritius has issued several guidelines and guidance notes to the sector with a view to guiding banks to take risks which are commensurate with their resources.

An analysis of the asset structure of Category 1 banks, the risks inherent to each type of asset and the relative risk mitigation tools are given below.

Risk Weighted Assets

There is a strong relationship between risk management and banks' performance. Improving risk management enhances both qualitative and quantitative performance of banks. The parameters set out in the Guidance Notes on Risk Weighted Capital Adequacy Ratio issued in accordance with Basel Capital Accord 1988, limit the riskiness of banks' activities in relation to capital held by them and call for proper balance sheet management. Banks should strike a balance between high earnings from very risky operations and safe and sound operations.

The riskiness of non-fund based and other off-balance sheet operations are also included in the computation of the risk-weighted assets ratio as they represent potential risk for banks and carry a capital requirement.

Earning Assets

The soundness of a bank depends largely on the management of its balance sheet structure. The ratio of earning assets to total assets gives an insight into the management of funds towards productive assets, comprising advances, investment in Treasury Bills and Government securities, placement with other banks and other interest earning assets. Although a high ratio is desirable, banks should adopt a reward versus risk policy and build a well-planned asset mix taking into consideration inherent risks for individual types of assets.

The proportion of earning assets in total assets remained unchanged at 83.0 per cent at end-June 2002 and end-June 2003.

2.2.2.1 Advances

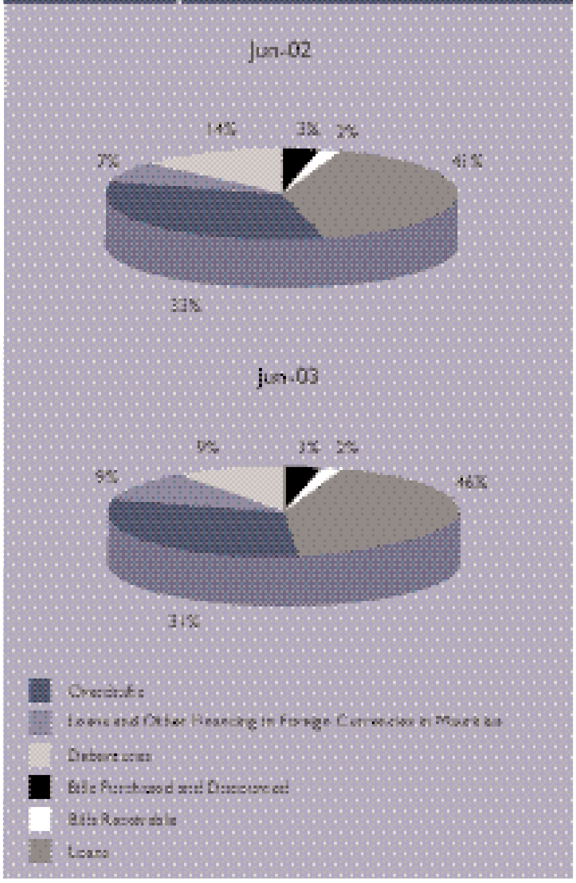
Banks' performance is dependent to quite an extent on quality of their advance portfolio, the more so as intermediation business remains their major income generating activity. Advances (including investment in debentures) constituted the single most important asset item of Category 1 banks. The proportion of advances in total assets dropped from 60.3 per cent at end-June 2002 to 55.6 per cent at end-June 2003. Nevertheless, banks continued to derive the major part of their total income, about 62.7 per cent in 2002/03, from advances.

Total advances extended by Category 1 banks increased by Rs4,643 million or 5.7 per cent, from Rs81,242 million at end-June 2002 to Rs85,885 million at end-June 2003, compared to a higher growth of Rs5,656 million or 7.5 per cent in the preceding year.

Chart 5 compares the composition of advances at end-June 2002 and 2003. During the year ended 30 June 2003, there has been a shift from debentures and overdrafts in favour of loans in local currency and loans and other financing in foreign currency in Mauritius.

Investment in debentures dropped substantially by Rs3,498 million or 32.1 per cent from Rs10,890 million at end-June 2002 to Rs7,392 million at end-June 2003 as these instruments were redeemed at maturity.

Chart 5: Composition of Advances



Advances, unless they are cash collateralised or extended as mortgage loans, are, for capital adequacy purposes, considered among the riskiest assets held by banks. These assets are exposed to credit risk, inherent to banks' lending activities due to potential inability of debtors to repay their debts in a timely manner. The high proportion of advances in banks' balance sheet makes credit risk an area of concern for supervisors, the more so as credit risk has been the root cause of many bank failures at the international level.

Banks transform their liabilities into assets of different maturities. Their projected cash flows based on maturities of their assets and liabilities provide a baseline for liquidity management. The untimely or non-repayment of advances may, thus, affect the liquidity position of banks and also their earnings.

The Bank of Mauritius has issued several guidelines to the industry setting out basic standards for banks' lending activities. Banks are expected to have in place sound credit management tools comprising policies and procedures for credit risk mitigation, asset classification and provisioning. Policies to limit or reduce credit risk are meant to address the various factors which may increase the level of normal credit risk associated with lending activities.

Concentration of Risks

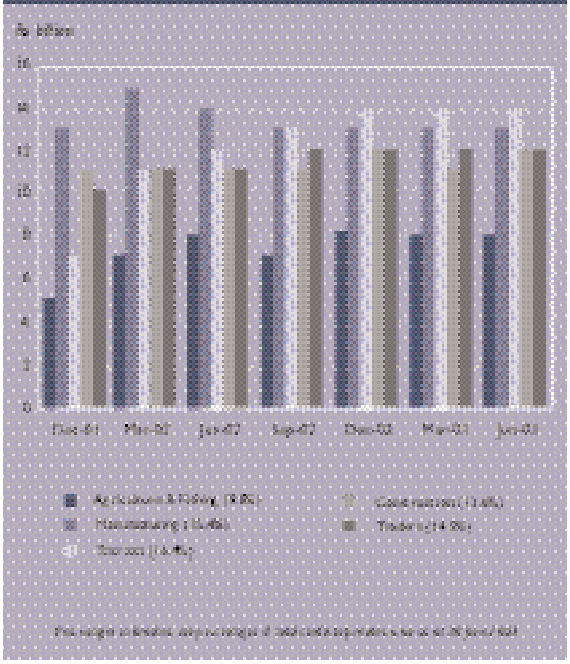
Portfolio diversification is a pre-emptive measure towards management of large exposures to single borrowers or group of closely-related borrowers or related parties, an industry sector or a particular activity. Such circumstances increase the complexity and the degree of risk to which banks are exposed. The incapacity of debtors, with large exposures or operating in the same sector, to repay their debts in a timely manner may additionally expose banks to cash flow problems which may lead to liquidity problems. The Bank of Mauritius has set down the parameters for large exposures in its Guideline on Credit Concentration Limits with a view to limiting banks’ exposure to risks inherent in such advances.

Total credit facilities extended to any one customer/group of closely-related customers for amounts aggregating 15 per cent or more of individual banks’ capital base totalled Rs40,447 million at end-June 2003, up from Rs36,283 million at end-June 2002. At end-June 2003, they represented 39 per cent of the overall on- and off-balance sheet commitments of banks. Overall banks' large exposures in terms of capital base increased from 228 per cent at end-June 2002 to 257 per cent at end-June 2003.

In addition to the normal risk of loss, excessive concentration by industry or particular activity exposes banks to business risk linked to unanticipated cyclomatic economic downturns. Such situations make banks vulnerable to simultaneous failures of customers operating in the same sector. The Bank of Mauritius closely monitors lendings of banks by industry sector through reports submitted by banks on a monthly basis.

As can be seen from Chart 6, the 'Tourism' sector accounted for the highest share or 16.4 per cent of total credit to private sector at end-June 2003. The share of credit to 'Manufacturing' sector which includes the EPZ sector, 'Trade' sector and 'Construction' sector stood at 15.4 per cent, 14.5 per cent and 13.6 per cent, respectively. The high concentration of advances in these four sectors which are very much exposed to macroeconomic factors calls for a close scrutiny of those sectors by the Bank of Mauritius.

Chart 6: Sectorwise Distribution of Credit to Private Sector



Related Party Transactions

Related parties, comprising mainly subsidiaries, affiliates, major shareholders, executive and non-executive directors and senior executives, have a direct influence on banks' policies and decision-making. Related party lending may, therefore, be subjected to pressure regarding the terms and conditions of the facilities. To guard against such situations, the Bank of Mauritius issued a guideline requiring all transactions with related parties to be carried out on terms and conditions that are as favorable to the financial institution as the market terms and conditions. Banks are also required to set up a Conduct Review Committee from their board members with the responsibility of monitoring and reviewing related party transactions.

Furthermore, the Guideline on Public Disclosure of Information requires banks to provide aggregated data on their on-and off-balance sheet credit exposures to related parties relative to the banks' exposure to all customers, stating also the proportions. The institution should also indicate the proportion of credit exposure to related parties that has become non-performing.

Asset Classification

Quality of advances is a determinant factor affecting the performance of banks. Deterioration of asset quality not only reduces the earning capacity of banks but also exposes them to the complexity of higher risks. Banks are expected to have in place a well-defined procedure relating to credit granting, review and monitoring for the continuous assessment of their asset portfolio for the timely recognition of any impairment in assets and appropriate corrective measures.

Asset classification, the grading of assets with respect to the associated level of credit risk, is yet another step towards ensuring soundness and sustainability of banks. Although banks have their own grading system, they are expected to satisfy the minimum requirements laid down in the guideline issued by the Bank of Mauritius regarding asset classification. The guideline considers the time during which advances remain in arrears as a criterion but, nevertheless, stress is laid on counterparties' financial condition as the guiding factor for classification. Banks should regularly review their advance portfolio in relation to debt servicing and the counterparties' continuous repayment capacity.

The level of non-performing advances reflects the quality of assets held by banks and ultimately their credit culture. Non-performing advances of Category 1 banks increased from Rs6,675 million at end-June 2002 to Rs7,269 million at end-June 2003. Expressed as a percentage of total advances, the ratio increased from 8.2 per cent to 8.5 per cent.

Credit classification is also used as an underlying factor for recognition of interest in banks' income. Non-performing assets are those assets which have stopped generating income. Interest accrued thereon should not be recognised to the institutions' profits. Proper classification of assets therefore reflects the integrity of income figures.

Allowance for Loan Losses

Allowance for loan losses consists of specific provision set aside in respect of identified impaired advances and general provision. The general provision is prudential in nature and equivalent to not less than one per cent of a bank's standard advances. Asset classification is used as a basis for determining the level of provision which represents a bank's capacity to absorb future loan losses.

The Guideline on Credit Classification for Provisioning Purposes and Income Recognition sets out the factors to be considered for the establishment of the level of provisioning in respect of impaired advances. The collectibility of debt which is largely dependant on underlying collateral, is the major determinant for the level of provision. Assessment of collateral could turn out to be a very subjective exercise when it comes to the statement of collateral value. The Guideline accordingly prescribes conditions in which the assessment of collateral value should be carried out.

Specific provisions for bad and doubtful debts on delinquent advances went up from Rs1,656 million at end-June 2002 to Rs2,222 million at end-June 2003. As a proportion of total non-performing advances, these provisions increased from 24.8 per cent to 30.6 per cent.

The 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 2001 to end-June 2003.

2.2.2.2 Investments in Securities

This category of assets comprises holdings of Treasury Bills and Government securities.

Treasury Bills and Government securities, the second most important aggregate assets of Category 1 banks, are the most easily convertible non-cash liquid assets. Although there is no mandatory requirement to maintain non-cash liquid assets, banks are encouraged to maintain their own threshold as part of their liquidity risk management program. Such investments, which are risk-free and zero-rated for capital adequacy purposes, also represent a stable source of interest earnings for banks. The past three years have witnessed an increase in the share of banks' holdings of Treasury

Table 3: Provision for Loan Losses by Industry Sector

	End-June 2001		End-June 2002		End-June 2003	
	Non-performing Advances	Specific Provision	Non-performing Advances	Specific Provision	Non-performing Advances	Specific Provision
	(Rs million)					
Agriculture and Fishing	234	42	103	20	96	16
Manufacturing *(including EPZ)*	2,073	474	2,560	722	2,481	970
Tourism	160	15	202	25	278	30
Transport	50	7	68	17	63	12
Construction	1,169	121	1,171	195	1,680	356
Traders	1,345	364	1,288	378	1,197	431
Financial and Business Services	93	7	68	9	146	21
Personal *(including credit card advances)*	606	141	735	150	939	216
Professional *(including credit card advances)*	37	2	118	28	58	17
Others	394	45	362	112	331	153
	6,161	**1,218**	**6,675**	**1,656**	**7,269**	**2,222**

Bills and Government securities in total assets from 13.2 per cent at end-June 2001 to 21.5 per cent at end-June 2003. This is mirrored in the decrease of the proportion of advances in total assets falling from 63.9 per cent to 55.6 per cent during this period and a corresponding concentration of assets in the category of claims on government.

During the period end-June 2002 to end-June 2003, banks' investments in Treasury Bills and Government securities increased substantially by Rs10,652 million or 47.3 per cent from Rs22,519 million to Rs33,171 million.

2.2.2.3 Balances with Banks

Balances with banks consist of balances on nostro accounts which banks maintain with their correspondents, assigned capital of the overseas branch of one bank, placements with banks abroad and Category 2 banks. Balances with banks, except for those with banks incorporated in Group B countries and having a residual maturity exceeding one year, are considered as low risk assets and weighted at 20 per cent for capital adequacy purposes.

Balances with banks registered a 2.6 per cent growth from Rs8,218 million at end-June 2002 to Rs8,432 million at end-June 2003. At end-June 2003, balances with banks constituted 5.5 per cent of banks' total assets, down from 6.1 per cent at end-June 2002.

2.2.2.4 Investment in Corporate Shares

Investment in corporate shares consists essentially of investments in equity of subsidiaries and associates and other quoted and unquoted companies. Even though these assets contribute to the profitability of banks, they are not classified as earning assets as these investments do not provide a stable and predictable source of income or asset value. Banks derive income from investment in corporate shares either in the form of dividends and/or capital gains. While trading securities provide potential for capital gain, they also expose banks to higher risk of unfavourable market price movements. Section 22(1)(b)(iv) of the Banking Act 1988 limits a bank's investments in undertakings whose objects are other than insurance of deposits or promotion of the development of a money or securities market in Mauritius and economic development of Mauritius, to 30 per cent of its capital base.

Investment in equity of other companies which are among the least liquid assets of banks increased by Rs751 million, from Rs1,985 million at end-June 2002 to Rs2,736 million at end-June 2003, mainly on account of a change in the accounting policy of one bank in relation to its equity investments in its subsidiaries and associates following the adoption by it of IAS 27 and IAS 28. The bank's investment in its subsidiaries and associates, which was previously stated at cost, is now accounted using the equity accounting method.

2.2.2.5 Fixed Assets

Fixed assets comprise mainly banks' premises from which they operate, other immovable properties, vehicles, furniture and equipment. These assets, although essential for the operations of banks, are not earning assets. Section 22(1)(c) of the Banking Act 1988 limits the purposes of banks' acquisition or purchase of immovable properties to conducting of their operations and housing or providing amenities for their staff. These assets which are considered amongst the least liquid assets of banks, should not be financed by depositors' money but instead out of banks' capital and reserves. Banks' capital being a buffer against potential losses, cannot be tightly tied up in unnecessary fixed assets. An analysis of the ratio of fixed assets to core capital gives an insight of the amount of capital tied up in such assets. Some jurisdictions set a limit to the ratio of fixed assets to core capital. The ratio stood at 63.4 per cent at end-June 2003, up from 60.0 per cent a year earlier.

Some banks acquire immovable properties during the course of realisation of collateral held against advances. Banks are expected to dispose of such assets within a reasonable delay, as stipulated in section 22(2) of the Banking Act 1988, to prevent them from indulging in speculative transactions thus exposing themselves to undue market risk. Lack of marketability of such assets also results in banks' funds being tied up and hinders their smooth operations.

The ratio of fixed assets to total assets gives an indication of the amount of banks' funds tied in non-earning assets. The ratio fell from 5.7 per cent at end-June 2002 to 5.3 per cent at end-June 2003.

2.2.2.6 Cash Reserves

Cash reserves consist of cash in hand and balance with Bank of Mauritius. They are the most liquid assets held by banks and are classified as risk free assets for capital adequacy purposes. Cash reserves act as a buffer against balance sheet fluctuations and also serve as a monetary tool as they are used to control the amount of money banks can lend. Category 1 banks are required to maintain a minimum cash ratio equivalent to 5.5 per cent of their deposit liabilities inclusive of foreign currency deposits, averaged on a weekly basis.

The monthly average cash ratio maintained by Category 1 banks in 2002-03 ranged from 5.6 per cent to 6.1 per cent compared to a monthly average cash ratio varying between 5.6 per cent and 5.9 per cent in 2001-02.

2.3 MANAGEMENT

The quality of management is one of the most important elements in the successful operation of a bank. The financial soundness and performance of a bank depend largely on the quality of both the management team and the directors' oversight of the bank. Global experience has shown that banking failures are more to be attributed to poor quality of management than to economic and financial crises. Hence, the experience, capability, judgement and integrity of both its senior executives and board of directors are sine qua non conditions for the success of a bank.

To that effect, the Banking Act 1988 lays much emphasis on the necessity for banks' directors to have the skills, knowledge and experience to enable them to perform their duties effectively and efficiently. Section 3(4) stipulates that no licence shall be granted by the central bank unless it is satisfied as to the technical knowledge and experience of the applicant. The Bank's Guideline on Corporate Governance outlines the benefits for a financial institution to have some board members who possess demonstrated expertise and experience relevant to the principal issues that face a bank, such as matters relating to financial controls, capital management, banking risks and corporate planning. Section 30 of the Act furthermore insists on the probity and competence of any person who is to be appointed as the Chief Executive Officer of a bank. In accordance with section 31 of the Act, a director, a chief executive officer, a manager or any officer concerned with the management of a bank is disqualified to hold office if he is convicted of an offence involving fraud or other dishonesty. Both the bank's directors and the executive management must consequently adhere to high ethical standards and be fit and proper to serve. A Guidance Note on Fit and Proper Criteria has already been issued by the Bank of Mauritius. The objective of the Guidance Note is to set a framework for fit and proper criteria to be observed by regulated institutions when appointing officers at the senior management level. The integrity and competence of senior management are vital conditions for a strong and sound institution.

The responsibility of the board is clearly spelt out in the Bank's Guideline on Corporate Governance where it is stressed that the board is ultimately responsible for the financial soundness of the bank though it can entrust the management of the day-to-day operations of the bank to management. The same guideline sets out a clear delineation of responsibilities of the board and management in the interest of an effective accountability regime. While management is accountable to the board for day-to-day administration of the business and for the performance of the bank, it is the board which is answerable to shareholders for the safeguarding of their interests through the lawful, informed, efficient and able administration of the institution.

Transparency of information relating to existing conditions, decisions and actions enables market participants to judge the efficiency of management of a bank. It is difficult to assess the actions and performance of the board of directors and senior management when there is a lack of transparency. This happens in situations where the stakeholders, market participants and general public do not receive sufficient information on the structure, objectives and performance of the bank with which to judge the effectiveness of the board and senior management in governing the bank. The Guideline on Public Disclosure of Information has been issued with a view to enhancing market discipline through comprehensive, meaningful and accurate information provided in a timely manner to market participants. The Guideline on Corporate Governance also requires the board of directors to ensure that the bank is satisfying its disclosure obligations and that the information disseminated is true and accurate. According to the same guideline, every bank is requested to disclose on an annual basis its approach to corporate governance. Transparency is also dealt with in the Guideline on Related Party Transactions which makes it an obligation for a related party as defined in the guideline to disclose his interests or relationships to the institution in a proactive manner. The same obligation of disclosure of interests applies in the case of a director of a bank at section 32(1) of the Banking Act. A director of a bank who is interested in an advance, loan or credit facility from the bank has the duty to declare the nature of his interest to the board of directors of the bank before such facility is sanctioned by the Board in the absence of the interested director.

The ability of the board to make independent decisions flexibly and effectively, its self-government and independence from executive management are also indicative of a sound administration. The Guideline on Corporate Governance emphasises the importance for the board to function independently of management. In this respect, the board should set up the appropriate structure to reflect its independence. An adequate number of independent directors should form part of the board. A governance committee emanating from the board should be constituted to manage the processes of the board in view of ensuring its independence from management. One of the processes would involve the holding of board meetings which would not be attended by members of management. The ultimate objective is to create the public perception that the board is independent and operates at a level higher than management. Section 30(2) of the Banking Act safeguards the independence of not only the chief executive officer of a bank but also the board of directors against any external influence which, if exercised, may be detrimental to the interests of depositors.

Risk taking is an integral part of the banking business. As the environment in which financial institutions are evolving is becoming more complex and fast-paced, risk management should grow in sophistication. The soundness of a financial institution depends on the aptitude of management to establish an all-inclusive risk management policy, system and process for identifying, monitoring and controlling different types of risks. The Guideline on Corporate Governance emphasises the importance for the board to ensure that the risk management policies proposed by management are adequate and effective enough to strike a prudential balance between the risks and potential returns to shareholders. In order to fulfill this responsibility, the board should be very familiar with all the risks involved in banking activities. If it deems it necessary, the board can even have recourse to professional support from outside the bank. A dedicated risk management committee can also be set up to appraise the adequacy of risk management policies and systems.

Risk management cannot be effective within an institution if the basics of internal control are ignored. In many of the recent corporate failures that have received public attention, basic principles of internal control, particularly those pertaining to operating risks, were not followed. Recent events should remind boards of directors, managements, and auditors that internal controls and sound governance become even more important when banks' operations move into higher risk areas. The Guidance Note on General Principles for Maintenance of Accounting and Other Records and Internal Control Systems stipulates that the internal control systems of an institution should provide reasonable assurance regarding the achievement of the effectiveness and efficiency of operations, the reliability of financial reporting and compliance with applicable laws and regulations. Directors and management are responsible for regularly assessing, monitoring and testing the institutions' internal control systems in order to warrant for their effectiveness, efficiency, and their ongoing relevance to the business. Internal auditors should conduct a regular review of the internal control systems. In accordance with the Guidance Note, the banks' external auditors are also expected to express their opinion on the effectiveness of the internal control systems. The Guideline on

Transactions or Conditions respecting Well-Being of a Financial Institution Reportable by the External Auditor to the Bank of Mauritius underlines the heavy reliance placed on the work carried out by external auditors. The guideline elaborates on the reporting requirements of external auditors as laid out in section 25(11) of the Banking Act 1988 and sets out the broad categories of reportable transactions or conditions that may affect the well-being of financial institutions, amongst which transactions which indicate that the financial institution has significant weaknesses in its internal control and management processes that render it vulnerable to material risks and exposures. The Bank of Mauritius is empowered under section 26(12) of the Banking Act to arrange trilateral meetings with each bank and its external auditor to discuss matters of supervisory concerns. These legal provisions result in the convergence of interests of the external auditor and the supervisor who must monitor the present and future viability of the financial institution.

In keeping with the objective of maintaining a safe and sound financial system, the Banking Act (sections 26 and 27) confers powers on the central bank to carry out regular inspections and examinations of banks. Section 29(3) empowers the central bank to take appropriate actions in line with matters of supervisory concerns highlighted during an inspection or an examination.

The Bank of Mauritius has set up a Banking Committee under the chairmanship of the Governor and comprising the chief executive officers of all banks. This committee acts as a consultative forum on financial sector issues with the overall objective of enhancing the efficient functioning of the banking system.

The need for alertness, initiation of timely corrective action and ongoing consultation among all interested parties cannot be overemphasized.

2.4 PROFITABILITY

Earnings represent a key source of fund for internal capital growth and affect banks' ability to raise external capital. They also provide a buffer for absorbing losses.

However, the level of earnings in itself does not give an insight of the risks taken by banks. High profits, though desirable, must be interpreted with caution. Banks are profit-making institutions and

Table 4: Category 1 Banks - Consolidated Profit Performance

	2000/01	2001/02 (Rs million)	2002/03
Interest Income from Advances	8,010	7,958	8,076
Interest Income from Investment in Treasury Bills and Government securities	1,858	1,730	2,184
Other interest income	406	405	312
Less: Interest Expense on Deposits	6,710	6,083	6,111
Other Interest Expense	215	329	260
Net Interest Income	**3,349**	**3,681**	**4,201**
Add: Non-interest income	2,022	1,927	2,104
Operating Income	**5,371**	**5,608**	**6,305**
Less: Staff Costs	1,222	1,275	1,350
Other Operating Expenses	1,321	1,287	1,602
Operating Profit before Bad and Doubtful Debts and Taxation	**2,828**	**3,046**	**3,353**
Less: Charge for Bad and Doubtful Debts	407	685	903
Exceptional Items	21	6	37
Operating Profit	**2,400**	**2,355**	**2,413**
Share of profits in subsidiaries and associates	–	184	201
Profit before Tax	**2,400**	**2,539**	**2,614**

Chart 7: Category 1 Banks - Components of Income

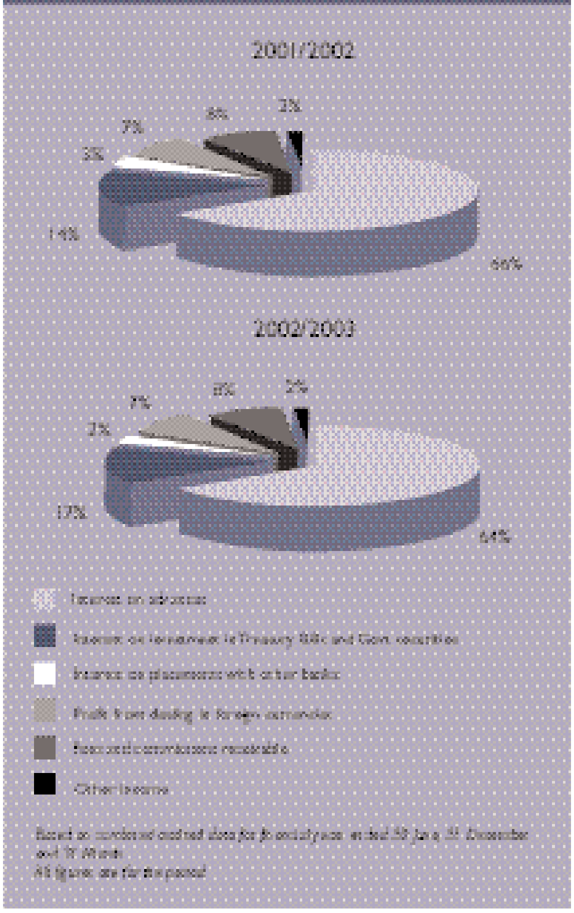
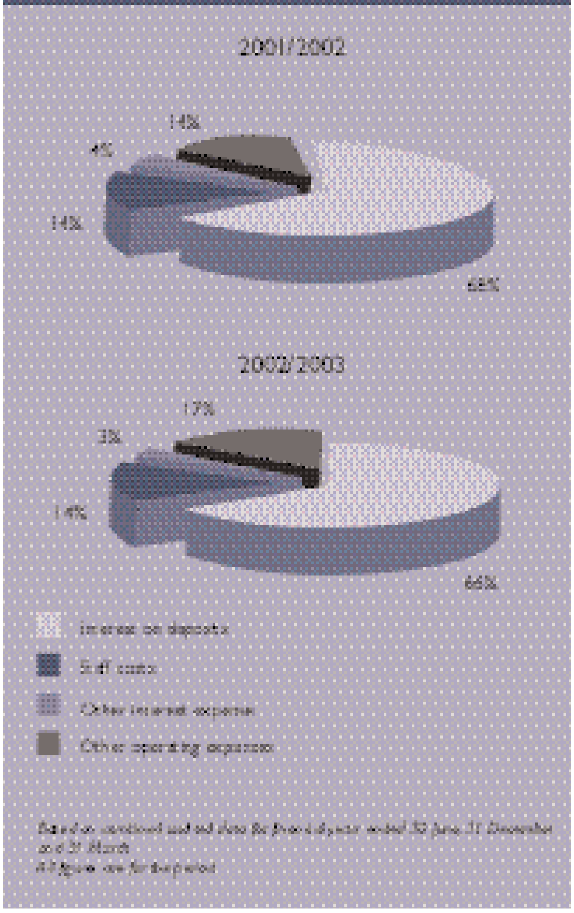


Chart 8: Category 1 Banks - Components of Expenses



may indulge in excessive risk taking to achieve high profitability. Supervisors expect banks to strike a balance between risks and rewards to ensure quality and stability of earnings.

The profitability figures are based on the audited results of the banks for the financial years ended 30 June, 31 December and 31 March. Category 1 banks posted an overall pre-tax profit of Rs2,614 million in 2002/03 as compared to Rs2,539 million in 2001/02.

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 2001/02 and 2002/03.

2.4.1 Income

Total income of Category 1 banks increased by Rs656 million during the year under review to stand at Rs12,676 million. Both interest income and non-interest income were higher than in the previous year. Category 1 banks continued to channel the major part of their resources into advances and investment in Treasury Bills and Government securities. Interest income derived from these sources accounted for an average of 80 per cent of the total income of Category 1 banks through the years 1998/99 to 2002/03.

Table 5 compares the growth rate of interest to non-interest income over the past three years. During the year 2002/03, interest income increased by Rs479 million while non-interest income grew by Rs177 million.

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

	2000/01	2001/02	2002/03
Growth in Interest Income (%)	13.7	-1.8	4.7
Growth in Non-interest Income (%)	19.1	-4.7	9.2

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

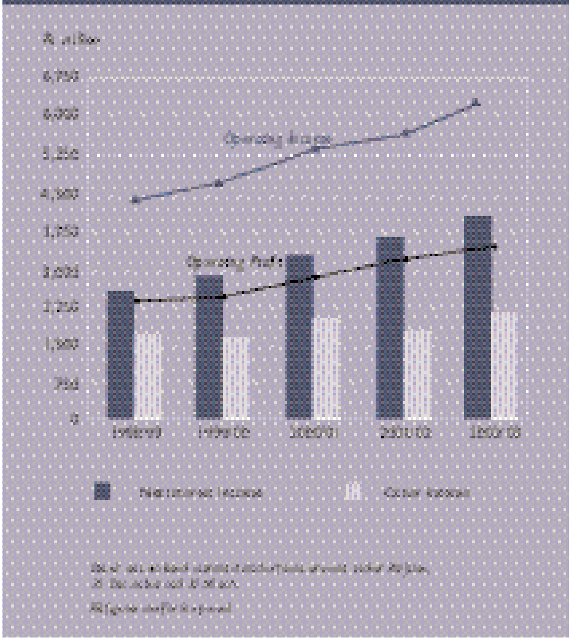
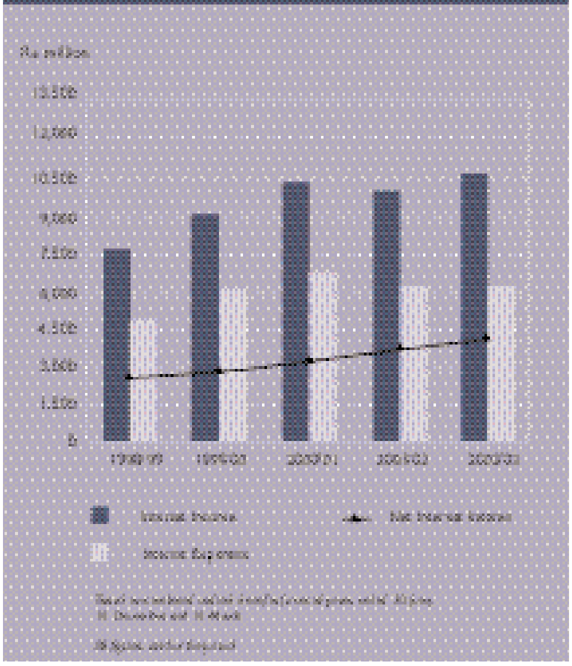


Chart 10: Category 1 Banks - Components of Net Interest Income



The impact of the various components of income on operating profit over the past five years is displayed in Chart 9.

2.4.2 Net Interest Income

Chart 10 shows the increasing trend in net interest income for Category 1 banks from 1998/99 through 2002/03. Advances remained the main source of interest income for Category 1 banks with the interest received thereon growing by Rs118 million during the year under review. However, a slight shift in the composition of interest income was observed with the income from investment in Treasury Bills and Government securities component rising from 17.1 per cent to 20.7 per cent while the interest income contribution from advances fell by 2.4 percentage points to 76.4 per cent. The growth rate in the main components of interest income of Category 1 banks is given in Table 6.

Interest expense fell by 0.6 per cent from Rs6,412 million in 2001/02 to Rs6,371 million in 2002/03. Interest expense on deposits went up by Rs28 million as opposed to a decrease of Rs66 million observed in the cost of borrowings from other banks. The combined effect of the fall of Rs41 million in interest expense and the increase of

Table 6: Category 1 Banks - Growth in Interest on Advances v/s Growth in Interest on Treasury Bills and Government Securities

	2000/01	2001/02	2002/03
Growth in Interest on Advances (%)	12.5	-0.6	1.5
Growth in Interest on Treasury Bills and Government Securities (%)	19.5	-6.9	26.2

Table 7: Category 1 Banks - Interest Spread

	2000/01	2001/02 Rs	2002/03
Interest earned on Rs100 of Advances	11.90	10.97	9.97
Cost per Rs100 of Deposits	8.05	7.02	6.23
Interest Spread	3.85	3.95	3.74

Rs479 million in interest income resulted in an overall increase of Rs520 million in net interest income of Category 1 banks in 2002/03 compared to a lower growth of Rs332 million in 2001/02.

As can be seen from Table 7, interest earned on Rs100 of advances and the cost per Rs100 of deposits fell by Re1.00 and Re0.79, respectively, during the year under review. As a result, the interest spread fell by Re0.21 during the year.

2.4.3 Non-interest Income

Total non-interest income rose from Rs1,927 million in 2001/02 to Rs2,104 million in 2002/03. Net fees and commissions and profit from dealing in foreign currencies remained the major components of non-interest income, and together accounted for 87.2 per cent thereof in 2002/03.

2.4.4 Non-interest Expenses

Non-interest expenses, comprising staff costs and other operating expenses, stood at Rs2,952 million in 2002/03, up from Rs2,562 million in 2001/02.

Staff costs maintained an upward trend and increased from Rs1,275 million in 2001/02 to Rs1,350 million in 2002/03, representing a growth of 5.9 per cent.

Other operating expenses also rose sharply from Rs1,287 million in 2001/02 to Rs1,602 million in 2002/03 as banks continued to invest in state-of-the-art technologies with a view to improving services to their customers.

The cost to income ratio, that is, the ratio of staff costs and other operating expenses to gross operating income (net of charge for bad and doubtful debts), went up from 52.0 per cent in 2001/02 to 54.7 per cent in 2002/03.

2.4.5 Operating Profit

Category 1 banks realised operating profit before bad and doubtful debts of Rs3,353 million for 2002/03, representing an increase of Rs307 million or 10.1 per cent over the figures of 2001/02. The increase of Rs307 million was, however, partly absorbed by an additional charge of Rs218 million in respect of bad and doubtful debts. Category 1 banks together achieved operating profit before tax amounting to Rs2,413 million in 2002/03, Rs58 million higher than Rs2,355 million realised in 2001/02.

2.4.6 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 also reflect the quality of management.

Return on average assets dropped from 2.26 per cent in 2001/02 to 2.04 in 2002/03 partly due to a larger asset base of Category 1 banks. Individual banks' return on average assets in 2002/03 ranged from negative 2.56 per cent to 3.20 per cent, compared to a range of negative 2.06 per cent to 3.33 per cent in 2001/02. Two Category 1 banks recorded negative returns on account of significant additional provisions made for bad and doubtful debts, while three banks achieved ratios above 2 per cent.

The return on equity must be analysed in relation to profitability and capitalisation. A high ratio may indicate high profitability as well as a low capitalisation while a low ratio can mean low profitability as well as high capitalisation.

Return on equity dropped from 17.5 per cent in 2001/02 to 15.7 per cent in 2002/03. Such return for individual banks ranged from negative 25.9 per cent to 20.5 per cent in 2002/03, compared to negative 21.1 per cent to 24.3 per cent in 2001/02, with four banks achieving ratios of over 15 per cent.

Chart 11 reflects the evolution of banks' profit for the years 1998/99 through 2002/03 while Chart 12 shows the variations in returns on average assets and equity for the same period.

2.5 LIQUIDITY

Liquidity refers to the ability of banks to fund increases in assets and meet their obligations as they fall due. Shortfalls in liquidity and protracted failure of banks to accommodate expected and unexpected fluctuations in their balance sheet are likely to impact on their earnings, depositors'

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

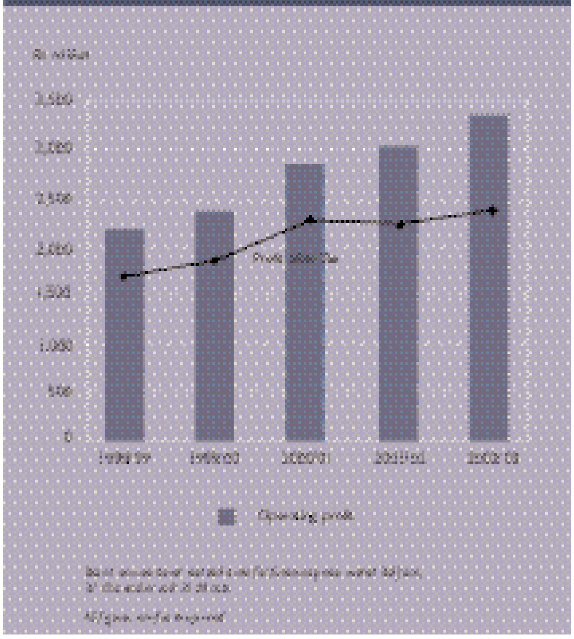


Chart 12: Category 1 Banks - Return on Equity and on Average Assets

confidence in them and ultimately their solvency. Banks are therefore required to adopt a sound liquidity management framework. The liquidity management framework should include, among others, a strategy for the ongoing management, measurement and monitoring of net funding requirements with a view to reducing liquidity risk, and the development of contingency plans for liquidity crises.

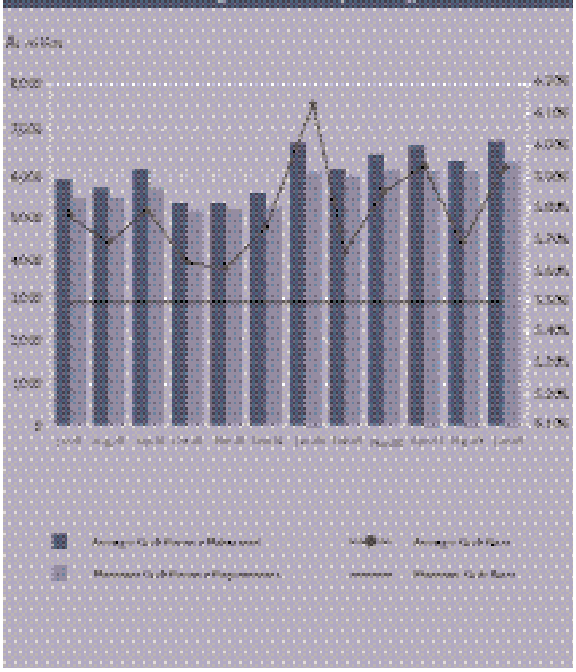
The level of liquidity risk of the individual banks is evaluated on a continuous basis by assessing their degree of compliance with the statutory cash ratio requirement, the composition of their assets and liabilities, the marketability of their assets and on-site review of their liquidity management processes in place. As from June 2000, banks are required to submit a status report on their liquidity policy every six months, based on the framework prescribed in the Guideline on Liquidity. The adequacy and effective implementation of the policy is monitored by the Bank of Mauritius.

2.5.1 Cash Ratio

Category 1 banks in Mauritius are required to maintain a minimum weekly average cash reserve consisting of cash in hand and balance with Bank of Mauritius, of 5.5 per cent with respect to their total deposit liabilities inclusive of foreign currency deposits. The degree of compliance with the prescribed limit gives an indication of the liquidity position of individual Category 1 banks and management's effectiveness in forecasting its cash flows.

The monthly average cash ratio maintained by Category 1 banks in 2002-03 ranged from 5.6 per cent to 6.1 per cent as compared to a monthly average cash ratio varying between 5.6 per cent and 5.9 per cent in 2001-02. The fluctuations in the monthly average cash holdings of banks against the regulatory limit over the last year is depicted in Chart 13.

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



2.5.2 Non-Cash Liquid Assets Ratio

There is no mandatory requirement for the maintenance of non-cash liquid assets but banks are advised to establish their own thresholds for controlling liquidity as part of prudential management.

Investment in Treasury Bills and Government securities represents the most readily liquifiable non-cash assets available to banks. Such investments expressed as a percentage of total deposits went up from 21.7 per cent as at end-June 2002 to 28.6 per cent as at end-June 2003, as banks directed a higher proportion of their funds towards those risk-free assets. During the year under review, Category 1 banks' holdings of Treasury Bills and Government securities posted a 47.3 per cent increase to stand at Rs33,171 million or 21.5 per cent of total assets at end-June 2003, as compared to 16.7 per cent a year earlier.

2.5.3 Deposits

Deposits constitute the primary source of funding of Category 1 banks, comprising the highest proportion of banks' total liabilities and thus are a key factor in liquidity management. The structure and stability of deposit base are of prime importance as liquidity issues can also stem from a larger-than-normal reliance on short-term non-core deposits.

At end-June 2003, deposits accounted for 74.9 per cent of total resources of Category 1 banks, down from 77.1 per cent at end-June 2002. During the year under review, total deposits went up by 11.6 per cent, as against a 12.8 per cent growth in the previous year, rising from Rs103,773 million to Rs115,823 million. Savings and time deposits together made up for Rs9,752 million of the total increase of Rs12,050 million.

As may be seen from Table 8, savings and time deposits remained the major components of the deposit mix and represented around 86 per cent of total deposits over the past three years. However, the proportion of term deposits in total deposits showed a gradual decline during that period following higher growth rate in demand deposits. The foreign currency deposit component accounted for 12.3 per cent of total deposits at end-June 2003 as compared to 12.5 per cent at end-June 2002.

Concentration of Deposits

A high concentration of deposits from a few customers may expose banks to liquidity risk as unexpected withdrawal of bulk deposits may erode banks' deposit base and destabilise their liquidity position.

Table 9 reflects the degree of concentration of banking sector's deposits according to their value range as at end-June 2003. It may be observed therefrom that the banks' deposit base comprised largely of low value range accounts thus providing the banking sector with a cushion against potential erosion through abrupt withdrawals from large

Table 8: Deposit Structure

	2001	End of June 2002 (Rs million)	2003
Demand	12,041	13,617	15,915
	(13.1)	*(13.1)*	*(13.8)*
Savings	39,221	46,528	51,573
	(42.6)	*(44.9)*	*(44.5)*
Time	40,734	43,628	48,335
	(44.3)	*(42.0)*	*(41.7)*
	91,996	**103,773**	**115,823**
	(100.0)	***(100.0)***	***(100.0)***

Figures in brackets are percentages to total

Table 9: Value Range of Deposits			
	End of June 2003		
	No of Accounts	Amount (Rs million)	Percentage of Total Deposits
Up to Rs1 million	1,623,696	66,224	57.2
Over Rs2 million to Rs5 million	11,917	22,371	19.3
Over Rs5 million	1,426	27,228	23.5

Table 10: Maturity Structure of Time Deposits				
	June - 2002		June - 2003	
	Amount (Rs million)	% of Time Deposits	Amount (Rs million)	% of Time Deposits
Up to 12 months	22,759	52.2	26,506	54.9
Over 12 months to 48 months	16,178	37.1	16,305	33.7
Over 48 months	4,691	10.7	5,524	11.4
	43,628	**100.0**	**48,335**	**100.0**

deposit accounts. Moreover, the main source of deposits remained 'Personal' deposits. These deposits, which dissipate withdrawal risk associated with corporate deposits, averaged 70 per cent of total deposits over the period.

Maturity of Time Deposits

Maturity of time deposits is relevant for financial stability from a liquidity viewpoint as it gives the value of liabilities falling due in the short-term and thus an indication to banks of their liquidity needs for that period.

Time deposits inclusive of foreign currency deposits represented 42 per cent of total deposits at end-June 2003 and had a wide-ranging maturity from 7 days' notice to over 48 months. The maturity configuration of time deposits given in Table 10 points to a slightly higher liquidity risk profile. As at end-June 2003, fixed deposits maturing within 12 months represented 54.9 per cent of the total term deposits compared to 52.2 per cent a year earlier.

Advances/Deposits Ratio

Advances to deposits ratio, which describes the extent to which banks' lending has been financed from their deposits, is an important indicator of liquidity management by banks. The advance portfolio carries an element of liquidity risk, both from the fact that it is amongst the least liquid of assets and that the level of non-performing loans therein will entail lower cash inflow than forecast. The ratio showed a gradual decline from 82.2 per cent at end-June 2001 to 78.3 per cent at end-June 2002 and further down to 74.2 per cent at end-June 2003. This partly reflects the general slowdown in demand for credit, which impelled banks to invest their excess funds in Treasury Bills and Government securities.

2.5.4 Interbank Transactions

An important aspect of liquidity management entails banks' access to funding options and reliance on those lines of funding to bridge short-term fluctuations in their resources. Interbank market operations provide for an efficient channelling of liquidity from banks with excess cash to banks in liquidity needs through short term lending and borrowings and also give an indication of the liquidity position of individual banks. Depending on the seriousness of the liquidity problems, Category 1 banks may resort to repurchase transactions or to the Lombard facility which is a stand-by overnight facility provided by the Bank of Mauritius.

The daily average funds transacted on the interbank market increased from Rs195 million in 2001-02 to Rs213 million in 2002-03 and varied between Rs80 million and Rs580 million during the year under review.

In order to effectively manage and monitor their net funding requirements, banks should have in place an adequate management information system, which provides timely and accurate information to the Board of Directors and senior management. In addition, banks should also be aware of any information that could impact on public perceptions about their soundness. With a view to enhancing market discipline, the Guideline on Public Disclosure, which has become effective as from 3 January 2003, requires banks to make information publicly available on the risks related to their activities, including among others, liquidity risk.

2.6 ELECTRONIC BANKING TRANSACTIONS

Electronic banking services are presently being provided by six Category 1 banks. Transactions using electronic delivery channels recorded considerable growth during the past years, crowning principally during the month of December. Between end-June 2002 and end-June 2003, the number of Automated Teller Machines (ATMs) in operation in Mauritius, inclusive of Rodrigues, increased by 15 from 242 to 257 and the number of cards in circulation went up by 102,807 from 750,260 to 853,067. The number of credit cards and debit cards in circulation grew by 6.5 per cent and 15.6 per cent, respectively.

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 1.8 million for a monthly average amount of Rs2,853 million in 2001-02 to a monthly average of 2.0 million for a monthly average amount of Rs3,290 million in 2002-03.

At the end of June 2003, outstanding advances on 164,030 credit cards in circulation amounted to Rs807 million, indicating an average outstanding amount of Rs4,920 per card.

Table 11 shows the quarterly positions of Category 1 banks' electronic banking transactions from end-June 2002 to end-June 2003.

Table 11: Electronic Banking Transactions

	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03
At end of Month **No. of ATMs in Operation**	**242**	**255**	**261**	**258**	**257**
During the Month **No. of Transactions**	1,706,705	1,964,339	2,534,785	2,115,284	2,134,469
Value of transactions (Rs mn) (Involving the use of Credit Cards and Debit Cards at ATMs and Merchant Points of Sale)	2,594	3,065	4,572	3,418	3,384
At end of Month **No of Cards in Circulation**					
Credit Cards	154,063	156,658	159,674	161,034	164,030
Debit Cards and others	596,197	630,809	650,037	663,649	689,037
Total	**750,260**	**787,467**	**809,711**	**824,683**	**853,067**
At end of Month **Outstanding Advances on Credit Cards (Rs mn)**	732	776	827	763	807

2.7 PERFORMANCE OF CATEGORY 2 BANKS

From the very outset, the objective of Government of Mauritius has been to promote Mauritius as a reputable financial centre. Hence, section 14(4)(b) of the Banking Act 1988 which embodies the legal framework for Category 2 banks, requires Category 2 banks to be branches or related corporations of foreign banks of established reputation or banks incorporated locally. The Bank of Mauritius, the licensing authority as empowered by the Bank of Mauritius Act and the Banking Act 1988, has a policy of quality versus quantity and is very selective in the granting of licence. Only banks having a physical presence in Mauritius and meeting the licensing criteria laid down in section 3 of the Banking Act have been granted a Category 2 Banking Licence.

The Bank of Mauritius, with a view to preserving the reputation of Mauritius as a soundly regulated financial centre, continuously improves its regulatory and supervisory framework in order to meet international standards. The activities of Category 2 banks are closely monitored through both off-site surveillance and on-site inspections. Category 2 banks are subject to the same level of strict regulations as Category 1 banks. As part of its continuous programme of consolidating its supervisory and regulatory framework, the Bank of Mauritius issued, during the year under review, two guidelines which were addressed to both Category 1 banks and Category 2 banks. With a view to fostering more transparency and market discipline, a Guideline on Public Disclosure, which became effective on 3 January 2003, requires banks to prepare and publicise quarterly comprehensive reports on their financial condition and performance. A Guideline on Transactions or Conditions respecting Well-Being of a Financial Institution Reportable by the External Auditor to the Bank of Mauritius, effective 24 February 2003, requires external auditors to report to the Bank of Mauritius transactions or conditions that may affect the well-being of banks.

The Mauritian authorities have committed themselves to combat money laundering and financing of terrorism. Without proper checks, the wide array of services provided by Category 2 banks increases their exposure to money laundering. In November 2003, the Bank of Mauritius issued Guidance Notes on Anti-Money Laundering and Combating the Financing of Terrorism, in replacement of the previous Guidance Notes on Anti-Money Laundering issued in 2001, which require Category 2 banks to have in place 'Know Your Customer' procedures for proper monitoring of customer activities. The Bank of Mauritius keeps a close watch on banks' cash transactions reported on a monthly basis. Transactions other than money market operations are also monitored for any suspicious fund movement in and out of the country. Category 2 banks are also subject to the provisions of the Financial Intelligence and Anti-Money Laundering Act 2002 and Prevention of Terrorism Act 2002 and have to report suspicious transactions to the Financial Intelligence Unit.

Asset protection and asset growth are among the main objectives of many high networth individuals who are in quest of places of business which allow flow of funds free from exchange control restrictions and provide tax planning opportunities. Mauritius offers an attractive destination with its network of double taxation avoidance treaties signed with 26 countries. Tax planning opportunities supported by modern communication facilities and availability of highly professional services are the underpinning factors responsible for the success of the Global Business sector. The promotion of Mauritius as a cyber island with the potentials of a high standard back-office administration centre and business process outsourcing possibilities paves the way for further development of this sector.

2.7.1 ASSETS

The activities of Category 2 banks show a commendable improvement during the year under review in spite of a sluggish international market. The overall asset base of these banks grew by USD369 million or 8.5 per cent from USD4,320 million at end-June 2002 to USD4,689 million at end-June 2003 compared to a higher growth rate of 14.0 per cent recorded in the previous year.

Placements with banks and loans and advances to non-bank customers are the main earning assets of Category 2 banks. At end-June 2003, 94 per cent of total resources of Category 2 banks were deployed in these two assets. The growing demand for credit by non-bank customers over the past four years has resulted in a major change in Category 2

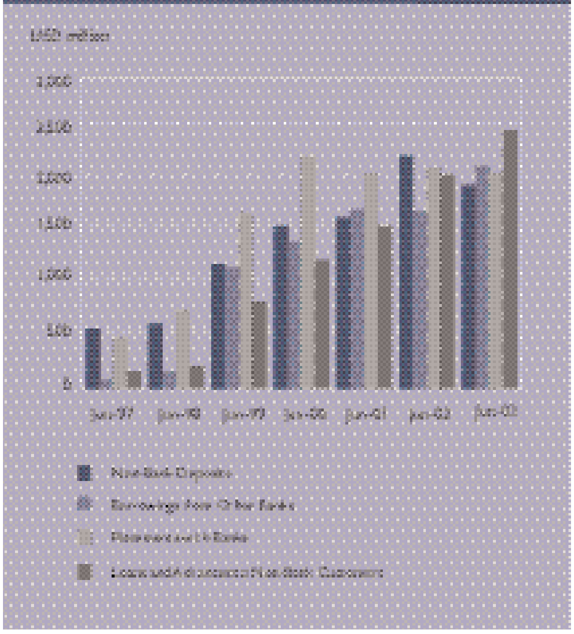


Chart 14: Category 2 Banks - Non-Bank Deposits, Borrowings from Other Banks, Placements with Banks and Loans and Advances to Non-Bank Customers

banks' asset structure as can be seen in Chart 14. Placements with banks, which made up 60 per cent of total assets at end-June 2000, held a proportion of only 43 per cent at end-June 2003.

2.7.1.1 Placements with Banks

Placements with head office, parent bank, subsidiaries, fellow subsidiaries and other banks constituted 43.1 per cent of their total assets at end-June 2003, compared to 47.9 per cent a year earlier and are banks' second largest assets.

Placements with banks decreased by USD52 million or 2.5 per cent from USD2,071 million at end-June 2002 to USD2,019 million at end-June 2003.

2.7.1.2 Advances to Non-Bank Customers

At end-June 2003, advances to non-bank customers constituted 51.1 per cent of total assets of Category 2 banks compared to 47.0 per cent a year earlier and were the banks' main earning assets. Advances to non-bank customers grew by USD374 million, or 18.5 per cent, from USD2,024 million at end-June 2002 to USD2,398 million at end-June 2003, compared to a more significant growth of USD531 million or 35.6 per cent during the preceding year.

At end-June 2003, an 81.2 per cent share of total advances of Category 2 banks was granted to residents outside Mauritius compared to 87.0 per cent a year earlier. Lending to Global Business companies domiciled in Mauritius doubled during the year to USD341 million and accounted for 14.2 per cent of Category 2 banks' total advances at end-June 2003, up from 8.4 per cent a year earlier. Advances to residents in Mauritius grew by 17.1 per cent, from USD94 million at end-June 2002 to USD110 million at end-June 2003, with its proportion in total advances remaining unchanged at 4.6 per cent. These facilities are mainly extended to certain public sector enterprises.

2.7.1.3 Investments

During the year under review, Category 2 banks' investments comprising mainly investments in bonds outside Mauritius picked up by USD53 million or 29.0 per cent from USD183 million at end-June 2002 to USD236 million at end-June 2003. The share of investments in total assets stood at 5.0 per cent at end-June 2003 as compared to 4.2 per cent at end-June 2002.

2.7.2 FUNDING

Category 2 banks continued to raise the bulk of their funds by way of deposits from non-bank customers and borrowings from banks which together made up 86.7 per cent of their total resources at end-June 2003. Deposits from non-bank customers accounted for 41.3 per cent of total resources of Category 2 banks, down from 50.6 per cent at end-June 2002 while the proportion of borrowings from banks in total resources increased from 38.4 per cent to 45.4 per cent. However, during the year ended 30 June 2003, banks relied more on deposits from non-bank depositors rather than borrowings from banks for financing their activities. This is reflected by the higher average monthly non-bank deposits of USD2,032 million reported by banks compared to the average monthly borrowing figure of USD1,801 million. The corresponding figures for the preceding year stood at USD1,750 million and USD1,642 million, respectively.

2.7.2.1 Non-Bank Deposits

Total deposits from non-bank customers showed a drop of USD250 million or 11.4 per cent from USD2,187 million at end-June 2002 to USD1,937 million at end-June 2003 as compared to a rise of USD552 million or 33.8 per cent in the preceding year. Fixed deposits constituting 65.2 per cent of total deposits at end-June 2003, dropped by USD212 million and accounted for 84.8 per cent of the total decrease in deposits in 2002-03.

2.7.2.2 Borrowings from International Money Market

Borrowings from the international money market by Category 2 banks recorded a significant 28.3 per cent rise from USD1,658 million at end-June 2002 to USD2,127 million at end-June 2003 compared to a lesser growth of USD8 million in the preceding year.

Funds borrowed from outside Mauritius accounted for 98.6 per cent of total borrowings. During the year under review, Category 2 banks continued to rely mainly on their head office, parent bank, subsidiaries and fellow subsidiaries for their borrowings and at end-June 2003, 87.4 per cent of their total borrowings emanated from these sources. However, a marked increase of USD126 million to USD239 million, was registered in borrowings from other banks outside Mauritius while borrowings from banks in Mauritius dropped from USD48 million to USD28 million.

2.7.3 LIQUIDITY

Liquidity risk arises when banks cannot raise adequate funds at a reasonable cost to meet their foreseeable and unforeseeable commitments. This risk by itself can have immediate consequences on the financial health of banks. Banks' inability to meet their commitments may cause reputational damage which may result into massive erosion and eventual failure.

Since Category 2 banks do not impact directly on the domestic money supply and are not subject to maintenance of a minimum cash reserve ratio in relation to their deposit base, the Bank of Mauritius exercises close scrutiny on banks' maturity pattern transformation on a monthly basis. The fact that Category 2 banks undertake the bulk of their activities on short-term rollover basis except for some specific long-term borrowings toward lending of equal maturities reduces the risk of major maturity mismatch and potential liquidity crisis.

The Guideline on Liquidity requires Category 2 banks to establish and implement prudent liquidity management policies providing for measures and controls for their funding requirements. Banks are also required to submit, every six months, a report on the status on their liquidity policy and the implementation thereof.

2.7.4 PROFITABILITY

Nine Category 2 banks close their accounts on 31 December and the remaining three on 31 March. 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 is referred to as 2002/03. Eleven Category 2 banks recorded net profits while one bank which has virtually ceased operation and was yet to surrender its banking licence as at 30 June 2003, incurred a loss.

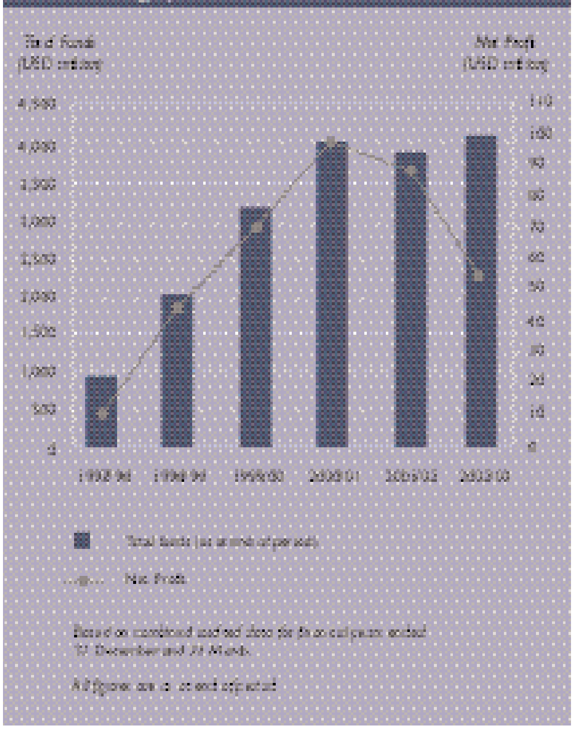
Aggregate net pre-tax profits of Category 2 banks dropped substantially from USD98.0 million in 2001/02 to USD55.0 million in 2002/03. This decline was mainly attributable to a significant reduction registered by one major bank in the profit from translation of foreign currencies and substantial additional provision for bad and doubtful debts made by banks in 2002/03. Individually, the banks' profits ranged from USD0.03 million to USD29.7 million in 2002/03 compared to a range of USD0.2 million to USD61.8 million in 2001/02.

Table 12 gives the profit performance of Category 2 banks from 2000/01 to 2002/03.

Chart 15 shows net profits of Category 2 banks in relation to their total funds for the years ended December 1995 through 2001/02.

Table 12: Category 2 Banks - Profit Performance		2000/01	2001/02	2002/03
			(USD million)	
	Interest Income	284.7	216.6	192.5
Less	Interest Expense on Deposits & Borrowings	205.1	151.8	132.3
Net Interest Income		**79.6**	**64.8**	**60.2**
Add	Non-interest Income	34.4	46.0	17.8
Operating Income		**114.0**	**110.8**	**78.0**
Less	Total Operating Costs	8.9	10.0	10.5
	Staff Expenses	*3.1*	*3.7*	*3.8*
	Provision for Depreciation	*0.4*	-	-
	Other Expenses	*5.4*	*6.3*	*6.7*
Operating Profit		**105.1**	**100.8**	**67.5**
Less	Charge for Bad and Doubtful Debts	8.5	2.8	12.5
Net Profit		**96.6**	**98.0**	**55.0**
Interest Income as a Percentage of Total Income (Per cent)		89.2	82.5	91.5
Cost to Income Ratio (Per cent)		8.4	9.3	16.0
Return on Average Assets (Per cent)		2.7	2.6	1.5
Return on Equity (Per cent)		32.2	40.7	21.5

Chart 15: Category 2 Banks - Total Funds and Net Profits



2.7.4.1 Net Interest Income

Despite a rise in total assets, net interest income continued to decline for the second consecutive year and registered a drop of USD4.6 million or 7.1 per cent, from USD64.8 million in 2001/02 to USD60.2 million in 2002/03 as compared to a fall of USD14.8 million in the previous year. Category 2 banks operate in an environment of global competition and are faced with a narrowing operating margin.

Total interest earnings maintained a downward path reflecting the general trend of falling interest rates on the international market. During the year 2002/03, interest income decreased by a lesser amount of USD24.1 million or 11.1 per cent compared to USD68.1 million or 23.9 per cent in the preceding year. However, the proportion of interest income in total income picked up from 82.5 per cent in 2001/02 to 91.5 per cent in 2002/03 on account of a higher percentage fall in non-interest income.

Placements with banks and advances to non-bank customers continued to be the main interest earning assets of Category 2 banks and together contributed 85.6 per cent of banks' total income compared to the lower proportion of 79.5 per cent in 2001/02. The share of interest from placements with banks in total interest earnings fell further by 9.9 percentage point to 41.2 per cent in 2002/03 after a decline from 58.4 per cent in 2000/01 to 51.1 per cent in 2001/02. Earnings from placements dropped substantially from USD110.7 million in 2001/02 to USD79.4 million in 2002/03 while earnings from loans and advances to non-bank customers edged up from USD98.1 million to USD100.6 million.

Total interest expenses went down by USD19.5 million or 12.8 per cent, from USD151.8 million in 2001/02 to USD132.3 million in 2002/03 as against a fall of USD53.3 million or 26.0 per cent a year earlier. During the year 2002/03, interest paid on borrowings from the international money market rose by USD12.1 million or 14.4 per cent, from USD83.8 million to USD95.9 million, in contrast to the preceding year when the cost of borrowings fell sharply by USD42.6 million or 33.7 per cent. Interest paid on deposits from non-bank customers which went down by USD10.7 million in 2001/02, dipped further by USD31.6 million to USD36.4 million in 2002/03.

2.7.4.2 Non-Interest Income

Non-interest income comprises mainly profit from translation of currencies and fees and commissions. After having recorded a steady rise from USD8.6 million in 1998/99 to USD46.1 million in 2001/02, Category 2 banks suffered a setback in terms of their non-interest income which fell sharply from USD46.0 million in 2001/02 to USD17.8 million in 2002/03. This was mainly attributable to adverse effects of exchange rates on the profit on translation of currencies of one major bank which maintains its books in a currency other than US Dollar, the reporting currency.

Non-interest income accounted for only 8.5 per cent of total income in 2002/03 as compared to 17.5 per cent in 2001/02.

2.7.4.3 Non-Interest Expenses

Non-interest expenses consisting of staff expenses and other operating expenses were well contained in 2002/03 and edged up by only USD0.5 million to USD10.5 million compared to an increase of USD1.1 million in 2001/02. Staff expenses went up by USD0.1 million to USD3.8 million while other operating expenses which made up 63.8 per cent of non-interest expenses, rose by USD0.4 million to USD6.7 million.

Cost to income ratio is an indicator of banks' efficiency at operational level. After a moderate increase of 0.9 percentage point in 2001/02, cost to income ratio recorded a significant rise from 9.3 per cent in 2001/02 to 16.0 per cent in 2002/03 on account of the low operating income realised by banks coupled with a higher charge for bad and doubtful debts.

2.7.4.4 Return On Average Assets And Equity

Table 12 outlines the financial performance of Category 2 banks in terms of their returns on average assets and equity in 2000/01, 2001/02 and 2002/03. It can be seen from the table that profitability indicators were dragged lower in 2002/03 by the declining profits realised by the banks.

The overall return on average assets of Category 2 banks lost 110 basis points from 2.6 per cent in 2001/02 to a low of 1.5 per cent in 2002/03. Individual banks' returns on average assets ranged between negative 0.2 per cent and 2.6 per cent in 2002/03 compared to negative 1.0 per cent and 5.8 per cent a year earlier. Return on average assets of four Category 2 banks stood above 1.5 per cent in 2002/03 compared to similar performance achieved by five Category 2 banks in 2001/02.

The overall return on equity of Category 2 banks rose from 32.2 per cent in 2000/01 to 40.7 per cent in 2001/02 but dropped substantially to 21.5 per cent in 2002/03. In 2002/03, individual banks' returns on equity ranged from negative 1.0 per cent to 66.4 per cent compared to a range of negative

Table 13: Category 2 Banks - Total Advances, Non-performing Advances and Provision for Bad and Doubtful Debts*	2000/01	2001/02 (USD million)	2002/03
General Provision	13.3	13.4	20.1
Specific Provision	5.9	6.3	15.5
Total Provision for Bad and Doubtful Debts	**19.2**	**19.7**	**35.6**
Total Advances	1,430.9	1,532.6	1,522.3
Non-performing Advances	9.0	6.9	52.2
Ratio of Non-performing Advances to total Advances (Per cent)	0.6	0.5	3.4
Ratio of Specific Provision for Bad and Doubtful Debts to Non-performing Advances (Per cent)	65.6	91.3	29.7

** based on audited accounts*

4.0 per cent to 82.8 per cent in the previous year. Only three banks achieved a return on equity of over 20 per cent in 2002/03 compared to four banks in 2001/02.

2.7.5 Provision for Bad and Doubtful Debts

The Guideline on Credit Classification for Provisioning Purposes and Income Recognition requires Category 2 banks to hold a general provision equivalent to at least one per cent of their standard advances (net of advances collateralised by cash deposits) and specific provisions for losses in respect of individual impaired credits.

Table 13 shows the trend of the provisions for bad and doubtful debts with respect to non-performing advances and total advances of banks from 2000/01 through 2002/03. Non-performing advances increased significantly from USD6.9 million in 2001/02 to USD52.2 million in 2002/03 and likewise, the ratio of non-performing advances to total advances went up from 0.5 per cent in 2001/02 to 3.4 per cent in 2002/03. Specific provisions for bad and doubtful debts, on the other hand, rose by only USD9.2 million to USD15.5 million in 2002/03. As a result, the ratio of specific provisions to non-performing advances fell substantially from 91.3 per cent to 29.7 per cent.

3. The Proposed New Capital Adequacy Framework

Capital is one of the key factors to assess the safety and soundness of a bank and provides a benchmark against which its financial condition can be measured. Capital also serves as an important internal insurance fund to cover on-balance sheet and off-balance sheet risks. A bank's attitude towards risks will therefore determine the amount of capital it needs to support those risks.

In 1988, the Basel Committee on Banking Supervision (BCBS) made a major step in capital regulation by introducing the concept of a risk-based capital adequacy standard. The proposals which were made in a document known as the 1988 Capital Adequacy Framework (hereafter referred to as Basel 1) brought a dramatic change in banking capital requirement rules. Basel 1 aimed at establishing a level playing field among the banking systems of the major industrialized countries and at improving the safety and soundness of banks worldwide.

The business of banking has undergone tremendous changes over the past decade and the integration of the global financial markets has led to increased risk taking by large banks. With increasing concentration of the banking system and the evolution of risk management techniques in the largest banks, Basel 1 started presenting serious shortcomings, which are becoming more evident over time. The limited number of risk categories in Basel 1 creates incentives for banks to game the system through capital arbitrage. The development of a new framework thus became imperative for the small number of large internationally active banking organisations.

In 1999, the BCBS issued a Proposed New Capital Adequacy Framework (hereafter referred to as Basel II). Basel II is founded on three pillars, namely,

- Pillar 1: Minimum Capital Requirements,
- Pillar 2: Supervisory Review Process, and
- Pillar 3: Market Discipline.

The first pillar proposes three options to deal with credit risk. They are

(i) The Standardized Approach

(ii) The Foundation Internal Ratings Based (IRB) Approach

(iii) The Advanced Internal Ratings Based Approach.

Pillar 2 deals with supervisory reviews that aim at ensuring that a bank's capital level is adequate to cover its overall risk.

Pillar 3 relates to market discipline and details the minimum levels of public disclosure that are expected from banks.

The main objectives of Basel II are

- to continue promoting the safety and soundness of the financial system,
- to improve risk measurement and management both domestically and internationally,
- to align the amount of required capital to the amount of risk taken,
- to further focus the supervisory bank dialogue on the measurement and management of risk and the risk-capital nexus,
- to make all of the above transparent to the counterparties that ultimately fund and share those risk positions.

The BCBS has issued three consultative documents since 1999 and conducted three Quantitative Impact Studies (QIS). During each consultative round, the views of the banking community around the world were sought. The suggestions received were, as far as possible, taken into account by the BCBS, in improving and refining the proposals. The last Consultative Paper (CP3) on the Proposed New Capital Adequacy Framework was issued in April 2003 and comments and suggestions were received by the BIS by 31 July 2003. The BCBS envisages the final publication of the new proposals by end 2003 and member countries of the BCBS intend a common implementation of Basel II for their internationally active banks by year-end 2006.

• CHANGES BROUGHT ABOUT IN CP3

One major innovation of CP3 is the development of a Simplified Standardised Approach (SSA) for computing credit risk. This new methodology assigns a flat risk weight of 100% to all corporate exposures instead of relying on ratings generated by External Credit Assessment Institutions (ECAIs). National supervisors are thus relieved of the burden of setting up processes to select eligible ECAIs. Concerns raised by banks regarding the cost of rating their corporate customers by ECAIs have also been addressed.

An important improvement in CP3 relates to the preferential treatment defined for fully collateralized mortgage loans. The SSA now proposes a lower capital requirement of 35% on lending which is fully collateralized by mortgages on residential property that is or will be occupied by the borrower. However, supervisors may impose higher risk weights if they believe that the preferential risk weight is not adequately prudential.

Under the Internal Ratings Based Approach, CP3 brings greater risk sensitivity by introducing three subclasses under retail exposures and five subclasses under corporate exposures. Each of the subclasses has been tied to distinct risk weight functions with a view to reflecting its different risk characteristics and eventually to varying levels of minimum capital requirements. Retail exposures have been subdivided into exposures secured by residential properties, qualifying revolving retail exposures and other retail exposures while commercial exposures have been categorized into project finance, object finance, commodities finance, income producing real estate and high volatility commercial real estate. Additional refinement has been introduced to allow banks using the IRB Approach to distinguish between loans to Small and Medium-sized Entity (SME) borrowers and those to larger firms. Small business-related exposures will be treated as a "retail exposure". In addition, CP3 categorizes purchased receivables into retail and corporate receivables and prescribes distinct capital requirement to each class.

CP3 has also introduced two specific approaches for computing capital requirement for equity exposures. The first one builds on the IRB treatment for corporate exposures while the second one allows banks to model the potential decrease in the market value of their holdings. Guarantees and credit derivatives in the IRB risk inputs are now recognised as credit risk mitigation instruments.

Under the IRB treatment for securitization, banks may base the capital requirement on the external rating of a securitization exposure or the capital requirement for the pool of assets underlying a given securitization.

Further, the computation of a minimum capital for operational risk no longer requires a separate floor on the capital charges. Greater flexibility has been introduced through the setting up of an Advanced Measurement Approach (AMA) for computing operational risk capital. This method allows banks to use their own methods for assessing their exposure to operational risk as long as they satisfy a set of qualifying criteria. Risk mitigation is also recognized under the AMA.

Stress testing has also been introduced with respect to credit risk capital. Banks adopting an IRB approach to credit risk will be required to set up conservative stress testing processes to estimate the extent to which their IRB capital requirements could increase during a stress scenario. The outcome of the stress test would enable both banks and supervisors to assess whether capital buffer is sufficient.

Under CP2, banks were required to hold five-year data on the loss characteristics defined under the IRB approaches. CP3 has now defined a three-year transitional period starting from the implementation date at year end 2006. Banks are thus eligible for the IRB approach provided they have at least two years of historical data at the implementation date. The historical data is expected to increase by one year for each transition year.

MAJOR CHALLENGES OF THE NEW BASEL CAPITAL ACCORD

Complexity

One of the major concerns that have been raised regarding Basel II is that it is extremely complex. Unlike the 1988 Accord, which is a one-size-fits-all approach, the new proposals provide a wide range of options for setting minimum capital requirements based on complex statistical and mathematical assessment of risks. These techniques have evolved with the broader direction that banking and risk management has taken over the past decade. Further, to achieve greater risk sensitivity in the measurement of capital ratios, Basel II makes a number of distinctions between exposures and transactions. The trade off between greater risk sensitivity and complexity has been widely discussed by industry participants around the world.

Cost and Transparency

The increased complexity, scope and flexibility of the new proposals could lead to reduced transparency and obscure the evaluation of capital adequacy. The simplicity of Basel 1 has favoured its worldwide applicability and has over the years provided a consistent and relatively robust system that was less open to subjective interpretation by regulators around the world. The wide range of approaches open for calculating risk capital under Basel II can thus undermine transparency.

The new proposals also call for the development and implementation of new risk management systems, the cost of which can be significant. The benefit resulting from a lower capital charge is unlikely to be sufficient to warrant the expenditure, especially for emerging economies. However, large and complex financial institutions with existing comprehensive risk management systems are likely to utilize the most sophisticated approaches while most of the other banks are likely to opt for cost-effective simplicity. The twin factors of complexity and cost will limit, at least in the short term, the application of all the basic aspects of the proposed Accord to large and sophisticated financial institutions with well developed risk management systems.

Competitive inequality

According to the third quantitative impact study carried by the BCBS, which saw the participation of 365 banks from 43 countries, it was found that the capital requirement of banks using the standardized approach would increase while risk capital calculated under IRB would fall considerably. The results also showed that the new operational charges would outweigh capital reduction in credit risk under the standardized approach. Banks using the advanced approach would thus, experience a significant fall in capital requirement as the reduction in capital requirement for credit risk will outweigh the charge for operational risk. Smaller banks, which are managing their credit risks and capital prudently, may be unfairly imposed with a higher capital charge.

Basel II also creates a higher barrier to entry especially in banking industries where banks are faced with competition from non-bank deposit taking institutions. The new proposals will impose constraints on banks that are not imposed on their non-bank competitors especially in markets where non-banks are allowed to operate with less capital.

In developing countries (DCs), most banks have straightforward balance sheets, and do not require sophisticated risk management systems to calculate risk capital. These banks would therefore use the standardized approach to measure credit risk while branches of foreign banks may, with the approval of the local supervisory authority, use the IRB approach. This will pose serious challenges to domestic and cross border supervisory cooperation. Moreover, foreign entities using the IRB approach could enjoy capital savings as they can achieve lower risk capital while domestic banks using the standardized approach would suffer from unfair competition while operating in the same environment.

Although banks in developing countries have expressed their appreciation of the advantages of the IRB approach, they believe that its introduction will be more difficult for developing country banks owing to weaker managerial and supervisory capacity and the non-availability of historical data.

Unfair disadvantage

The new proposals provide an incentive for banks to increase lending to borrowers that have a rating above BBB. The majority of these borrowers, which are found in developing countries, may be viewed as less desirable customers by internationally active banks. These banks will favour highly rated sovereigns, corporates and banks. With the reduced capital inflows in developing countries, the economic performance of such countries will be seriously and unfairly affected.

Pro-cyclicality

There are serious concerns that Basel II will exacerbate pro-cyclical tendencies within the banking system. This aspect will reflect itself in the loss characteristics of the IRB approach whereby, the probability that a borrower will default (defined under the IRB as PD, Probability of Default) will decrease during an economic upturn and increase during an economic downturn due to stressed economic conditions. During deteriorating economic conditions, existing loans would "migrate" to higher risk categories, thereby raising overall capital requirements. As raising capital is expensive for banks especially in downturns, the cost of bank funding increases leading to a credit crunch. This in turn exacerbates the recession and further deepens the non-performing loan problem.

Credit Rating Agencies

Under the standardized approach of the new proposals, risk weight would be dependent on the ratings provided by the credit rating agencies. There are serious reservations as to whether rating agencies would be able to measure risk associated with bank loans as rating agencies do not have much experience with regard to risk rating borrowers. Furthermore, experience shows that rating agencies are more reactive than proactive. The downgrade of Enron and Worldcom came only after the frauds in those companies were disclosed publicly. Further, the use of credit rating agencies for the purpose of determining required capital may result in "biased" ratings of borrowers. The fundamental reason is that credit rating agencies will be "hired" by companies needing to borrow from banks. With the exception of the large corporations (which may already be rated), corporations selecting the rating agency will stand to gain by selecting the one that is willing to provide the desired rating. This problem known as ' the race to the bottom' would imply credit risk assessments that do not reflect the true credit risk profile of the borrower. In its attempt to improve on credit assessments by introducing external rating agencies, the proposed accord may actually result in a more distorted computation of banks' individual risks.

Banks in developing countries will be further affected by ECAIs in that such agencies are almost non-existent in these countries. In seeking the services of internationally recognized ratings agencies which meet the eligibility criteria set out by Basel II, banks in DCs will have to price their assets based on the additional costs incurred in obtaining the ratings for each group of borrowers. This would exacerbate the already stressed conditions of banks in DCs.

Further, supervisors in DCs do not have sufficient expertise to accredit ECAIs. Both the supervisors and banks in DCs would face serious difficulties with ECAIs. Reliance on credit ratings presents additional difficulties to DCs, namely, the limited coverage of most rating agencies, the possibility that new, less reliable agencies will emerge and the problem of unsolicited ratings. Many DCs have suggested in their responses during the consultative rounds that dependence on rating agencies is so unsatisfactory that a different way of setting risk weights needs to be defined.

Risk Weights

To bring regulatory capital more in line with economic capital, Basel II proposes to widen the range of risk weights and to introduce weights greater than 100%. Banks adopting the IRB approach would be allowed to develop their own risk analysis, management and control systems. Since the range of risk weights is considerably wider in the IRB Approach than in the Standardized approach, banks with loan portfolio concentrated on lower risk borrowers may have the strongest incentives to use the IRB Approach as it generates a lower capital requirement. Banks with higher risk loans portfolio may opt for the Standardized Approach. Banks may also design rating systems which underestimate credit risk and hence settle for a lower regulatory capital requirement. This could seriously threaten the stability of the financial system.

It is also questionable as to whether the risk weights applied to different categories of assets under Basel II reflect the true risk profiles or whether risk categories are well defined under the new proposals. The risk weights have also been criticized as being set on an arbitrary basis and that the BCBS would not be in a position to justify the risk weights set. Moreover, certain proposed weights are considered to be too high or not particularly suited for the local context, resulting into the initial objective of creating a level playing field being undermined.

- **OPERATIONAL RISK**

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Basel II proposes three methods for setting capital charges for operational risk, namely,

- The Basic Indicator Approach
- The Standardized Approach
- The Advanced Methodology Approach

Although there is a general consensus that banks worldwide are faced with significant operational risk due to increased sophistication in their activities such as e-commerce, new complex financial products, highly automated technology, increased globalisation of their activities, the quantification of operational risk remains difficult. Credit risk capital calculated under Basel 1 is set high enough to cover implicitly other types of risks including operational risks. Consequently, the need for an explicit capital charge for operational risk is not felt by industry participants.

The methodology for calculating operational risk capital charge is viewed by some participants as being set on an arbitrary basis. In the simplest approach, i.e the Basic Indicator Approach, the operational risk capital has been set at 15 percent of gross income. This may not truly reflect the operational risk faced by a bank. Under the Standardized Approach, which is a more sophisticated approach for calculating capital charge, operational risk capital is determined on a Beta Factor supplied by the BCBS. This Beta Factor may differ between countries and therefore the need has been expressed to adapt the Beta Factor to local contexts.

Banks are spending much time and resources to improve risk management practices as their financial interest lies in better measuring and managing risks. The objective of a reasonable, flexible and comparable approach to operational risk is achievable and banks believe that they have already catered for such risks by applying formal techniques to their measurement and management. But there are some concerns as to whether a bank which is already managing its operational risks perfectly should set aside a capital charge for such risks. A bank having risk management processes to calculate its operational risk capital under the simplest approach would still be unable to accurately calculate the capital to be set aside as the operational loss cannot be quantified until the loss actually occurs. The Barings Bank and Allfirst failures clearly demonstrate that they would have failed to cope with operational risk even if they had set aside a capital charge calculated under the Basic Indicator Approach. Banks should therefore focus on robust risk management practices rather than setting capital charge under the simplest approaches proposed by Basel II.

Developing countries have serious concerns with regard to the proposed methods for calculating operational risk capital. The capital charge that would result under the Basic Indicator Approach would be too high given the less complex nature of banking in developing countries. For most emerging economies, there is a more complex (less direct) relationship between gross income and risks. This could create some imbalance in the quantification of operational risks and hence penalize banks by over-estimating risk and the relevant capital charges.

Standardization of risk management practices

Most sophisticated banks already have advanced risk management systems in place, to cater for the calculation of risk capital for their complex products. The new proposals may not be desirable and may result in additional costs for those banks having to change their systems. Excessive reliance on risk management processes mandated by supervisors may cause banks to follow those processes blindly and reduce their responsibility as to the adequacy of those processes. Basel II may thus drive diversity out of the market as holding the same views and using similar models may lead to systemic consequences.

Competitive disadvantage

The implementation of the Basel II proposals involves significant resources in the process of data management and credit modelling. Most banks around the world are not sophisticated enough to qualify for the advanced methodologies and are still in the early stages of developing firm wide data. These banks as well as those in the G10 countries, are more likely to adopt the simplest approach for calculating operational risk capital. Thus banks using the advanced approach will enjoy unfair competitive advantage against other banks with less sophisticated systems. Further, smaller banks are not necessarily more exposed to operational risk. The increased capital charge would simply be transferred to customers through pricing, putting banks at competitive disadvantage.

Under Basel II, banks do not have the incentive to shift from the less sophisticated approach to the advanced approach in respect of operational risk. To graduate from the Standardized Approach to the AMA, banks would be required to deploy significant effort and resources in data collection, scenario development and benchmarking which would result in a maximum reduction of 25% in capital charge.

• PILLAR 2 CONCERNS

Basel II imposes a heavy burden on supervisors in that it would require a substantial upgrade in supervisory resources and supervisory capabilities in most countries. Supervisors will have to participate in model building as well as assess their adequacy and validate the advanced approaches.

In developing countries, the unavailability of sufficiently experienced regulators and trained personnel in commercial banks is likely to be a key hurdle. On account of this, it is questionable whether banks will be able to properly implement the new risk management techniques set out in Basel II. Improper risk management practices, if implemented, are less likely to be discovered and resolved in a timely fashion.

Supervisors could also divert their attention away from banks with weaker risk analysis and management systems by focussing excessively on the use of sophisticated models. This could pose a serious threat to systemic stability. Furthermore, the deep involvement of supervisors in risk management decisions implies that any bank failure may be viewed as the failure of the supervisors. Consequently, supervisors will be more reluctant to allow banks to fail. As a result, the risk attitude of banks will not be in line with the new proposals, which encourages banks to take calculated risk.

• PILLAR 3 CONCERNS

Industry participants have expressed their concern that disclosure of proprietary information could undermine their competitive position if that information is shared with competitors namely banks and non-banks. They also pointed out that Pillar 3 disclosure standards for IRB approach are onerous and counter-productive.

Developing countries also believe that, the initial objectives of improving market transparency through Pillar 3 may be undermined as excessive disclosure of information may confuse market participants who cannot interpret such information properly. For this reason it will be necessary to educate analysts and other market participants concerning the correct interpretation of Pillar 3 disclosures to avoid unexpected and uninformed market reactions to this information.

• CONCLUSION

Although capital is not a substitute for bad corporate and risk management processes in a bank, additional capital requirements are not always the right solution to deal with deficiencies in the risk management processes of banks. It is a widely held view that capital increases should be used as an interim measure while permanent measures should be in place to improve the bank's position.

The proposed Basel II Accord is definitely more complex than its predecessor but it brings additional benefits to banks, supervisors and other market participants namely in terms of better risk assessment by market, stronger relationship between banks and supervisors and better alignment of economic capital and regulatory capital.

As an emerging financial centre, Mauritius has to gear itself to the challenges represented by Basel II. The Bank of Mauritius has created a task force to draw up an implementation plan, after close consultation with other regional supervisors and the home country supervisors of international banks. In Mauritius, a tentative target for the implementation of Basel II has been set at December 2006.

Notwithstanding the merits of Basel II, the Bank of Mauritius is committed to ensuring that banks measure, manage and mitigate risks properly.

As rightly pointed out by Roger W Ferguson, Vice Chairman of the Board of Governors of the US Federal Reserve System, *'Banks exist for the purpose of risk-taking and the objective of supervision is certainly not to eliminate, and perhaps not even to lower risk taking. Rather, the objective of supervision is to assist in the management of risk'.* ❑

4. IAS 39 - The implication of its implementation

INTRODUCTION

The promulgation of Companies Act 2001 (CA 2001) in December 2001, has brought significant changes in the local financial reporting environment. Section 211 of CA 2001 requires all companies to prepare their accounts in full compliance with the International Accounting Standards (IAS). Such a requirement came at the right time when Mauritius was seeking to consolidate its financial sector. Compliance with IASs will help in further increasing transparency and comparability of accounts.

However, the full adoption of IASs also poses a significant challenge to most companies, especially as far as compliance with IAS 39, Financial Instruments – Recognition and Measurement, is concerned. Banks and financial institutions are the ones most concerned as they deal primarily in financial instruments.

IAS 39 is believed to be one of the most complex accounting standards issued by the IASB so far, and a 350-page IAS 39 Implementation Guidance has had to be issued as a complement to the standard. IAS 39 transforms the whole way in which companies report their financial assets and liabilities and introduces the concept of partial fair value[1] reporting.

HISTORICAL DEVELOPMENT OF THE STANDARD

The International Accounting Standard Committee, now International Accounting Standard Board (IASB), began its project to develop a comprehensive set of accounting standards addressing financial instruments in 1989. It was felt that historical cost accounting may not always reflect a realistic picture and that changes in fair value[1] may not always be apparent to users of accounts until impairment or write-down. Also, the sophistication of the financial market and the increasing need for risk control measures have resulted in loads of innovative and complex financial products, which ought to be captured in the accounts, but which were often not the case as there were no specific requirements to that effect. The IASB, through a standard on financial instruments, aimed at addressing these two lacunas.

In 1994, the IASB divided the project into two phases. The first phase addressed disclosure and financial statement presentation, and resulted in the issuance of IAS 32 in 1995. The second phase of the project addressed recognition and measurement and resulted in the issuance of IAS 39 in December 1998, with 1 January 2001 as the effective date.

The standard itself has been issued amidst widespread criticism. Detractors of IAS 39 claim that there has not been adequate consultation prior to its issue and that the standard is basically a political product. Consequently, it lacks the consensus and practicability which a good accounting standard should have.

The IASB is currently working on revising IAS 32 and IAS 39 and a voluminous Exposure Draft on Proposed Amendments to the standards was issued in June 2002 and closed for comments on 14 October 2002. It is reported that significant comments have been received on the Exposure Draft, especially emanating from the banking industry. These are being studied and a new revised standard or an Exposure Draft is expected in the last quarter of 2003 or first quarter of 2004.

Although significant changes to accounting for financial instruments are in the pipeline, it is expected that IAS 32 and IAS 39, in their present form, will remain applicable for several years.

In Europe and most other countries, companies are expected to be compliant with IASs as from 1 January 2005. However, in Mauritius, compliance with IASs, is already mandatory for all accounting periods commencing on or after 1 December 2001. While most IASs already had a Mauritius Accounting Standard (MAS) equivalent, IAS 32 and

[1] Fair value is the amount at which an asset can be exchanged, or a liability settled, between knowledgeable and willing parties in an arm's length transaction.

IAS 39 were relatively new standards and their applicability took most companies by surprise. It is argued that MAS equivalent of these two standards were already in issue well before 1 December 2001, but with the development in the financial sector at that time, the issue had taken the backstage. Besides, it is only in late 2001, when European companies started the process of implementing IAS 32 and IAS 39 that the practical issues and constraint of implementing IAS 32 and IAS 39 came to the limelight.

By that time it was already too late. Studies have revealed that at least two to three years preparation is required for an effective and smooth implementation of IAS 39 – enough time has to be allowed for changes in systems requirements, training, documentation and in parallel run. However, given that the local financial sector is not very sophisticated and that financial products are rather simple, implementation of IAS 39 should not be a major problem for most companies.

Nevertheless, the situation is different for banks and similar financial institutions as they basically deal in financial products.

Given that it would be unworkable for banks to comply with IAS 32 and IAS 39 at such short notice, an application was made to the Registrar of Companies for a deferment of the standards. The Bank of Mauritius resolutely supported this endeavour and on 20 June 2003, the Registrar of Companies granted all companies holding Category 1 and Category 2 banking licences under the Banking Act 1988 the desired deferment. However, this moratorium period is applicable only for accounting periods commencing on or prior to 1 January 2003 and has not been extended to non-bank financial institutions.

REQUIREMENTS OF THE STANDARD

IAS 39 identifies four categories of financial assets[2] and two categories of financial liabilities[3]. The prescribed accounting treatment will be determined based on the categorisation of the financial asset or liability. Table 1 below provides a brief summary of the categories of financial assets and of their respective accounting treatment. Table 2 provides the same information in respect of financial liabilities.

Table 1 : Financial Assets

Category	Defining Characteristics	Prescribed Accounting Treatment
Held-to-maturity	Fixed or determinable payments; Fixed maturity with positive intent and ability to hold to maturity.	Amortised cost. (at the effective interest rate)
Held-for-trading	Purchased with the intention of making a profit from short-term market fluctuations (including all non-hedging derivative assets).	Fair value. Gains and losses on revaluation recognised in income statement.
Originated by the enterprise	Loans and receivables originated by the enterprise by providing money, goods or services directly to a debtor and not for trading.	Amortised cost. (at the effective interest rate)
Available-for-sale	All other financial assets.	Fair value. Gains recognised in income or deferred in equity, depending on one-off enterprise-wide decision.

[2] A financial asset is defined in IAS 39 as: cash, a contractual right to receive cash, a contractual right to exchange financial instruments under potentially favourable conditions or an equity instrument of the enterprise.

[3] A financial liability is defined by IAS 39 as a contractual obligation to: deliver cash, deliver financial assets, or exchange financial instruments under potentially unfavourable conditions.

Table 2: Financial Liabilities		
Category	**Defining Characteristics**	**Prescribed accounting treatment**
Trading	Incurred to make a margin, or a gain from short-term market fluctuations (including all non-hedging derivative liabilities).	Fair value. Adjustment recognised in income.
Other liabilities	All Other Liabilities.	Cost or amortised cost.

HEDGE ACCOUNTING

IAS 39 also introduces the concept of hedge accounting. On its own, IAS 39 may bring significant volatility in the income statement as fair value movements are caught on the income statement. Hedge accounting can reduce this volatility.

Hedging involves entering into transactions that give an offsetting profile to a risk. Ideally the increase or decrease in an underlying hedged item should be matched with the effect of the increase or decrease in the hedging instrument. However, applying normal accounting procedures may not always allow this. At times the underlying hedged item may not be recognised in the accounts (e.g. a forecasted future cash flow), while the corresponding hedging instrument is classified as Held-For-Trading and is recognised on the balance sheet. At other times, there may be measurement mismatches, where the hedged item is recognised at amortised cost and the hedged instrument is recognised at fair value. This invariably results in unwarranted variability in profits. Hedge accounting provides a leeway to avoid such volatility by explicitly requiring that the effect of the hedged item and the hedging instrument be matched in the income statement in those situations where they would not be achieved by applying the normal accounting procedures.

There are strict and onerous conditions that must be fulfilled before hedge accounting can be used. These are:

- Formal documentation identifying the hedged item, the hedge, the nature of the risk, and how hedge effectiveness will be measured;
- Realistic expectation of the hedge effectiveness;
- Hedge to actually be effective;
- For cash flow hedges of an anticipated transaction, such transaction must be probable and must ultimately have a profit or loss effect.

PROBLEMS TO APPLY THE STANDARD

At first sight, the requirements of IAS 39 do not appear overwhelming. However an in-depth analysis will reveal how complex the standard actually is. Banks may have particular problems in the following areas:

- Computing effective interest rates;
- Fair value measurement of financial instruments;
- Debt securities as originated loans and receivables;
- Embedded derivatives;
- Macro hedging.

COMPUTING EFFECTIVE INTEREST RATE

The effective interest rate is the rate that exactly discounts an expected stream of future cash payments through maturity or the next market-based repricing date to the current net carrying amount of a financial asset or financial liability. In simple terms it is the internal rate of return of a cash flow stream.

It is common for banks to provide loans with a fixed interest rate for an initial period of two to three years followed by a variable or a different fixed rate for the remaining period of the loan. In such cases, IAS 39 requires that the effective interest rate be used to accrue interest income. In order to comply with this requirement, banks will have to beef up their system to allow them to compute the effective interest rate and to accrue interest at that rate.

At other times, the bank may allow the borrower to repay the loan earlier. In such a case, computing the effective interest rate means that the bank should not base itself on the contractual stream of cash flows but should also take into account the likely timing of payments.

FAIR VALUE MEASUREMENT OF FINANCIAL INSTRUMENTS

As already mentioned, there are four categories of financial assets. Based on its underlying characteristic, a financial asset should be classified as either Originated Loans and Receivables, Held-to-Maturity, Held-for-Trading or Available-for-Sale.

Financial assets Held-for-Trading should be fair valued with any resulting gain or loss charged directly to the Income Statement. Available-for-Sale financial asset should also be fair valued, but here the company should make a one-time election as to whether the resulting gains or losses are to be charged to the income statement or whether they should go directly to equity. Originated Loans and Receivables and Held-to-Maturity should be reported at amortised cost, subject to impairment tests.

Banks will find themselves having to fair value many types of financial assets, which were up to now stated at cost. In small countries like Mauritius, fair value information may not be readily available and banks will have to devise estimation techniques, such as the discounted cash flow model, to produce the required fair values.

In the case of Available-for-Sale financial assets, where the bank has opted to account gains or losses in equity, IAS 39 requires that such gains and losses should be transferred to the revenue reserve when the asset is impaired, sold, collected or otherwise disposed of. In such a case, the accounting system should be capable of recognising separately each revaluation gain or loss on each financial asset, so that in case of derecognition or impairment, the respective amount can be included in the revenue reserve. This is likely to be a very cumbersome and painstaking exercise.

The audit of fair value is also likely to present a significant challenge to auditors. Auditing fair value is much different from auditing historical cost figures. In the latter case it is relatively easier as historical cost data can be substantiated and are verifiable. However, fair value may not be readily available and management will have to make different assumptions and use various valuation models to compute the fair value. Consequently, to audit the fair values, auditors will have to audit the appropriateness of the assumptions and valuation models utilised. The risk of oversight is higher thereby resulting in higher audit risk. Auditors will have to allocate more time to their audit and to seek more expert advice. As a consequence, they will end up passing the cost to their customers by charging higher audit fees.

DEBT SECURITIES AS ORIGINATED LOANS AND RECEIVABLES

IAS 39 defines loans and receivables as financial assets created by an enterprise by providing money, goods or services directly to a debtor, provided that there is no intent to immediately sell those assets.

Banks that are primarily dealers in Treasury Bills are likely to hold Treasury Bills for investment purposes, for trading or for meeting liquidity requirements. Investment in Treasury Bills, if there is intent and ability to hold to maturity can be classified as Held-to-Maturity. However, there are severe restrictions when classifying an asset as Held-to-Maturity and it is unlikely that banks will opt for such classification.

Most banks will prefer to classify their Treasury Bills, held as investment or for liquidity purposes, as Available-for-Sale and account for the change in fair value through equity. However, under IAS 39, any debt security purchased directly from the issuer should be classified as either Originated Loans and Receivables or Held-for-Trading.

EMBEDDED DERIVATIVES

An embedded derivative[4] is a financial derivative built into a plain financial instrument known as a host contract. Where the economic benefit and risk profile of the embedded derivative is different from the host instrument, the former should be separated from the latter (known as debundling) and accounted for separately as if they are stand-alone instruments.

[4] A derivative is a financial instrument:

* whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the ‘underlying’);
* that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
* that is settled at a future date.

It is generally believed that embedded derivatives exist only in complex financial products. However, a simple product such as loan with an early repayment option may contain an embedded derivative (the option to repay the loan earlier), which has to be separately fair valued and accounted for. This is a major issue for most financial institutions.

MACRO HEDGING

It is common practice for banks to hedge their risks. However, they are more concerned with their net position. As such, up to now they have not been hedging each of their individual risk on a one-to-one basis. Rather they hedge their net position. This is known as macro hedging. As per IAS 39, macro hedging is not eligible for hedge accounting. Such a restriction may result in variability in profits.

To avoid such variability and to enable their hedging to be qualified for hedge accounting, banks may designate their hedged instrument to specific hedged item on a one-to-one basis. But such an exercise is likely to be challenging, painstaking and may require extensive changes in banks' processes and systems.

CONCERN OF REGULATORS

IAS 39 is a major cause of concern to banking supervisors around the world. The main worries are:

- Accounting for credit losses;
- Volatility in profits;
- Capital adequacy.

ACCOUNTING FOR CREDIT LOSSES AND GUIDELINE ON CREDIT IMPAIRMENT MEASUREMENT AND INCOME RECOGNITION

It is imperative that the assets of banks are not overstated and that credit losses are recognised on a timely basis. Under the present system, banks are required to use matrix provisioning to determine allowance for credit losses.

The Bank of Mauritius, through its Guideline on Credit Classification for Provisioning and Income Recognition, prescribed minimum provision based on the number of days the facility is overdue. The calculation was rather simple and there is the shared view that this particular system is yielding acceptable results, with little chances of overstatement of assets.

However, IAS 39 strictly disallows matrix provisioning – it requires companies to calculate loan impairment by comparing the recoverable amount of a loan to the carrying value of the loan. In case the former is lower than the latter, the loan is considered impaired and should be written down to its recoverable amount. The calculation of the recoverable amount is a highly subjective exercise as banks have to make their own estimates of the future expected cash flows on the loan and discount it to the present. It was possible for institutions to abuse of this loophole to overstate their loan assets while understating their loan loss provisions.

To cope with this problem, the Bank of Mauritius has come forward with a Draft Guideline on Credit Impairment Measurement and Income Recognition, which will supersede the previous Guideline on Credit Classification for Provisioning and Income Recognition. Comments received on the Draft Guideline were mostly unfavourable as banks view it as being overly prudent and are of the opinion that it will increase their administrative burden. However, there is a need for a stringent Guideline so as to put accrued objectivity in the determination of impairment losses.

VOLATILITY IN PROFITS

IAS 39 requires some types of financial instruments to be fair valued and the resulting gains and losses be reported directly in the income statement. Market prices are rarely stable. Rather they tend to fluctuate rapidly depending on current market situation and perception. Accordingly, the reported figures will change as price varies on the market.

The IASB is of the view that volatility is a fact of life and that it should be captured in the accounts of companies. However, high volatility may cause erosion of market confidence and thereby weaken the financial sector.

CAPITAL ADEQUACY RATIO

The capital adequacy ratio is a major prudential ratio used by bank regulators around the world. It represents the ratio of a bank's capital base to its total risk weighted assets and it basically defines the minimum capital a bank should have as a buffer against credit and market risks.

The capital base for capital adequacy purposes includes paid up capital and other undistributed reserves. Revaluation reserve is also included in the capital base but is discounted by 25% and should be supported by a valuation prepared by an approved appraiser.

With IAS 39, fair value changes will be booked on the balance sheet with changes in value being recorded in the income statement or directly in equity. Given the nature of a bank's balance sheet, there is likely to be significant unrealised fair value changes being recorded as gain.

In the absence of any specific guidance the resulting gains or losses on fair value changes will affect the capital base of a bank and accordingly will affect its capital adequacy ratio. Given the scope for manipulation of fair value changes, it would be relatively easy for unscrupulous banks to play around with their capital adequacy ratios.

Besides, fair value figures are likely to change rapidly with changes in market confidence and perception. The capital adequacy ratio is likely to fluctuate with changes in the fair values of financial assets and liabilities. This may be wrongly interpreted by the market and may result in erosion of market confidence.

CONCLUSION

The IASB is working on a project to further consolidate the standard and may in some years come forward with fair value requirements for all financial instruments.

In the meantime, banks in Mauritius and abroad will have to modify their systems and procedures to be compliant with IAS 39 by 1 January 2004. This conversion process is a major project and will require much effort, both financial and psychological, from banks.

5. Financial Soundness Indicators

The financial crises of the last decade have affected many countries in varying degrees mainly through their high cost, in particular, by way of loss in output and the fiscal outlay to shore up the economies. They have provoked much reflection on the ways to strengthen the global financial system. It is becoming increasingly important to acquire a better understanding of what determines financial system soundness and identify those signals, which might help policymakers prevent financial crises. In this context, the International Monetary Fund (IMF) has identified a number of Financial Soundness Indicators (FSIs).

The FSIs include a core set of aggregated prudential indicators of the banking sector and a broader set of indicators that covers the financial health of the non-bank financial, corporate, and household sectors and real estate market. These FSIs, also known as macroprudential indicators, will help countries assess their banking systems' vulnerability to crisis and take preventive measures.

In order to place reliance on the FSIs, there is a need for a supportive framework. Countries should adhere to internationally agreed prudential, accounting and statistical standards. As a member country of IMF, Mauritius has already adhered to some of the Standards.

The following paragraphs give some insights of FSIs and the work undertaken by the Bank of Mauritius to come up with a supportive framework for the implementation of FSIs in Mauritius.

WHAT ARE FSIs?

The origin of FSIs can be traced back to 1999 when the IMF held a consultative meeting on FSIs. Subsequently, in the year 2000, the Executive Board of IMF endorsed a list of macro-prudential indicators. The list was eventually renamed FSIs in June 2001 and recently in March 2003, the IMF has published a draft Compilation Guide (the Guide) on FSIs.

The FSIs are categorised into a Core Set of 15 indicators and an Encouraged Set of 26 indicators which are listed in Table A. The Core Set of indicators consists of ratios, which have been determined on the basis of their relevance in a wide range of countries, the availability of the underlying data and the understanding of how the ratios should be used. On the other hand, the Encouraged Set contains those indicators which are likely to be relevant in many countries but with a need of further analytical work to clarify their usefulness.

In line with the strategic role played by banks within most financial systems, all indicators within the Core Set and the first 14 indicators in the Encouraged Set are calculated using data gathered from banks. The risks leading to financial system instability caused by certain developments in Non Bank Financial Intermediaries (NBFIs), the corporate sector, households and the real estate market are also incorporated. In this context, there are two indicators that reflect the state of health of NBFIs, five for the corporate sector, two for the household sector and three for the real estate market.

The Core Set of indicators is based on the CAMELs framework which analyses the health of an individual institution by looking at its six major aspects, where "C" stands for capital adequacy, "A" for asset quality, "M" for management, "E" for earnings, "L" for liquidity and "s" for sensitivity to market risk. However, for the purpose of computing the FSIs, the "M" component is excluded from the Core Set of indicators. The other components are defined as follows:

(i) the capital adequacy ratios indicate the ability of banks to cope with shocks to their balance sheets;

(ii) the asset quality ratios reflect the quality of banks' assets in terms of overexposure to specific risks, trends in non-performing loans and the health and profitability of bank borrowers;

(iii) earnings and profitability ratios also indicate the quality of assets of banks as well as their sustainability of earnings;

(iv) liquidity ratios capture the ability of banks to meet deposits withdrawals or large maturity mismatches; and

(v) the ratios regarding sensitivity to market risk capture the impact of adverse movements in interest rates and exchange rates on banks' profitability.

Table A

Core Set of FSIs
Deposit-taking institutions

Capital adequacy

1. Regulatory capital to risk-weighted assets
2. Regulatory Tier I capital to risk-weighted assets

Asset quality

3. Nonperforming loans to total gross loans
4. Nonperforming loans net of provisions to capital
5. Sectoral distribution of loans to total loans
6. Large exposures to capital

Earnings and profitability

7. Return on assets (net income to average total assets)
8. Return on equity (net income to average equity)
9. Interest margin to gross income
10. Noninterest expenses to gross income

Liquidity

11. Liquid assets to total assets (liquid asset ratio)
12. Liquid assets to short-term liabilities

Sensitivity to market risk

13. Duration of assets
14. Duration of liabilities
15. Net open position in foreign exchange to capital

Encouraged Set of FSIs
Deposit-taking institutions

1. Capital to assets
2. Geographical distribution of loans to total loans
3. Gross asset position in financial derivatives to capital
4. Gross liability position in financial derivatives to capital
5. Trading and foreign exchange gains (losses) to total income
6. Personnel expenses to noninterest expenses
7. Spread between reference lending and deposit rates
8. Spread between highest and lowest interbank rate
9. Customer deposits to total (non-interbank) loans
10. Foreign currency-denominated loans to total loans
11. Foreign currency-denominated liabilities to total liabilities
12. Net open position in equities to capital

Market liquidity

13. Average bid-ask spread in the securities market
14. Average daily turnover ratio in the securities market

Non-bank financial institutions

15. Assets to total financial system assets
16. Assets to GDP

Corporate sector

17. Total debt to equity
18. Return on equity (earnings before interest and taxes to average equity)
19. Earnings before interest and taxes to interest and principal expenses
20. Corporate net foreign exchange exposure to equity
21. Number of applications for protection from creditors

Households

22. Household debt to GDP
23. Household debt service and principal payments to income

Real estate markets

24. Real estate prices
25. Residential real estate loans to total loans
26. Commercial real estate loans to total loans

The two indicators regarding NBFIs reflect their systemic importance on account of their size and importance in the economy. Moreover, NBFIs and banks are often related via ownership or investment linkages and any adverse impact on the NBFIs will affect banks' performance.

The corporate sector of an economy plays an important role in maintaining financial stability. A significant proportion of banks' assets, which comprises mainly of loans and advances, is invested in corporates. In this respect, five indicators relate to the corporate sector, thus, enabling a proper monitoring of corporate borrowers. The proposed ratios for the corporate sector may act as early warning signals for financial distress. Banks may thus take timely actions, for instance, by strengthening their capital base or reducing their exposures to high-risk corporate customers.

The two indicators regarding the household sector reflect its repayment capacity, which may be used by banks to assess the quality of credit extended to this sector.

The remaining two indicators that relate to the real estate market provide additional signals for financial sector stresses, which normally result from rapid increase in real estate prices followed by a sharp economic downturn. Such cycles can have a negative impact on the profitability of banks notably through a decline in credit quality caused by deterioration in the value of collaterals.

FRAMEWORK FOR AN EFFECTIVE IMPLEMENTATION OF FSIs

FSIs are calculated and disseminated for the purpose of assisting in the assessment and monitoring of the strengths and vulnerabilities of financial systems. However, the FSIs can effectively be implemented if there is a proper framework, in particular, an institutional, legal and conceptual framework.

Institutional Framework

The collection of data for the computation of FSIs is a complex task mainly because of the wide range of data sources. Some countries already have an established system for compiling and disseminating FSIs data. However for many countries, such compilation is a new endeavour.

The Guide on FSIs recommends that one agency should be given the primary responsibility for calculating and disseminating FSIs so as to ensure that there are clear lines of responsibility and accountability. It also emphasizes certain issues such as the periodicity, the range of data to be disseminated, the timeliness of release and the format in which the FSIs should be released. It encourages the dissemination of FSIs data on a quarterly basis but also suggests the release of some key data on a monthly periodicity. Regarding the format, the Guide recommends that the dissemination be centralized on a single website, allowing simultaneous release to all users, general accessibility of the data and transparency.

Legal Framework

A proper legal framework will enhance the data collection mechanism. In this respect, countries need to assess their legal system already in place. The architecture in place may require some adjustments with the following characteristics:

- the types of entities that can be approached for data;
- the boundaries in which compilers will operate and their responsibilities;
- the compliance and power to impose penalties on entities that fail to report;
- the confidentiality aspect and prohibition to use information from individual entities for other than statistical compilation purposes;
- the establishment of independence of the statistical compilation function from other government activity, for instance, the taxation authorities;
- the integrity of statistical releases; and
- the confidence in the compiling agency.

Conceptual Framework

(a) Accounting Framework

The guiding principle in preparing FSIs requires the application of an accounting standard at the national level. One such accounting standard is the International Accounting Standards (IASs). IASs are standards that provide concepts, which underlie the preparation and presentation of financial statements of commercial, industrial and business reporting enterprises, whether in the public or the private sector.

The Guide on FSIs recommends that the accrual concept of accounting be applied, which means revenues and gains should be recognised in the period in which they are earned while expenses and losses should be recognised when they are incurred, rather than when cash is received or disbursed.

(b) Valuation Method

Institutions should value their financial instruments on a basis that gives the most realistic assessment. A market for these instruments or a market for instruments having similar characteristics would help in establishing a proper valuation approach. For instance, an instrument, which is tradable, is expected to be valued at fair value (approximation of market value) whereas for non-tradable instruments, nominal values would be more appropriate.

(c) Residence

There should be a clear distinction between a resident and a non-resident so that the data collected do not distort the FSIs. An institution is said to be resident in the country where it has a centre of economic interest, a place of production, a dwelling or other premises from which it intends to engage in economic activities on a significant scale for at least a year. Corporations, branches and subsidiaries are residents of a country in which they are ordinarily located given that they are engaged in economic activity and transactions from that location rather than the economy in which their parents are located. The residence of offshore units is attributed to the economies in which they are located. Other entities, such as shell companies, are resident in the economy in which they are legally incorporated, or in the absence of legal incorporation, are legally domiciled.

(d) Currency and Exchange Rates

With the increasing trend in international trade, countries transact in various currencies. For the purpose of aggregation and consolidation of data, all transactions in foreign currencies should be converted into the domestic currency. The Guide recommends that the applicable exchange rate be the mid-point rate between the buying and selling exchange rate.

(e) Maturity

The maturity of financial instruments is another important concept that should be viewed from both liquidity and asset/liability mismatch perspectives. Liquidity measurement determines the value of liabilities falling due in the short-term (maturity of one year or less) while the asset/liability mismatch perspective relates to the effect of changes in interest rates on profitability.

The Guide specifies three approaches that can be used to determine the maturity classification of financial instruments as follows:

(i) the first approach is on the basis of the time until repayments of principal (and interest) are due, known as remaining/residual maturity;

(ii) the second approach is on the basis of the maturity at issuance known as original maturity; and

(iii) finally, the duration method is based on the weighted average term to maturity of a financial instrument. The more the cash flows are concentrated towards the early part of an instrument's life, the shorter the duration relative to maturity.

(f) Sectoral Financial Statements

The computation of FSIs requires a sectoral analysis of the economy. Data reported by individual institutions need to be adjusted at the sector-level primarily to eliminate transactions and positions among institutions within the same sector. The sectoral financial statements present the specific sectors within the context of the overall economy and can be used to analyse financial sector dynamics and the transmission of financial stress across sectors.

(g) Quality of Data

In practice, data collection should pass through various stages notably, processing, compilation and analysis before reaching the dissemination stage. The data should be collected and compiled on an impartial basis. The principle of objectivity has to be firmly adhered to while manipulating data through the various stages. There should also be a frequent data revision policy to assess the reliability of preliminary data and to have regular consistency checks carried out by the lead agency.

USEFULNESS OF FSIs

Assessment of the Soundness of the Financial System

FSIs are considered as a key tool for assessing financial sector soundness by national authorities. Moreover, they enhance the overall effectiveness of surveillance by IMF, increase the transparency and stability of the international financial system and strengthen market discipline.

The levels and trends in FSIs give an indication of the health of the financial system. For instance, the health of the banking sector is assessed by looking at the capital adequacy, asset quality, profitability, liquidity and exposure to market risks and the linkage between these indicators and changes in the macroeconomic environment.

Data from the rest of the financial system, such as the bank borrowers (also referred to as the corporate sector), price trends and exposures to real estate markets, also serve as the basis for quantifying the vulnerability of the financial system. The combination of data analysis and qualitative information will produce an overall assessment of the stability of the financial system.

Tool for Regulators

FSIs will be an effective early warning system for financial distress, through which certain symptoms may appear. Monitoring the behavior of a number of indicators as they exceed certain threshold values or critical levels may be a good prescription. The ratios from the set of FSIs that will issue signals of a forthcoming crisis will be identified and help to determine the source and depth of the macroeconomic problem and subsequently timely remedial actions may be taken.

Comparability

FSIs will promote analysis and potentially foster better data collection and quality in the future which will assist comparison across countries. In fact indicators would be comparable provided that countries adhere to internationally agreed prudential, accounting and statistical standards. The adherence to these standards is important given the magnitude and mobility of international capital and the risk of contagion of financial crises from one country to another.

According to the Guide, advancing international comparability of FSIs and convergence towards a best practice remain a medium-term goal. In the near term, most of these FSIs can be compiled from unharmonized national data that reflect different supervisory and accounting practices. Over the longer term, if FSIs are to be comparable across countries, it will be important to address harmonization of underlying accounting standards, aggregation and consolidation issues and asset valuation, classification and provisioning rules. In the absence of harmonization and resolution of these issues, the usefulness of the core set of FSIs can be enhanced if national authorities disseminate, along with the FSIs, descriptions of the concepts and compilation practices used in their construction.

Complement for Stress Testing

Stress testing is a key element of macroprudential analysis that helps to monitor and anticipate potential vulnerabilities in the financial system. When the set of FSIs is used as a complement to the stress testing, it enhances the macroprudential analysis. It also adds a dynamic element to the analysis of stress testing, that is, the sensitivity of FSIs' outcomes in response to a variety of macroeconomic shocks and scenarios.

APPLICATION TO MAURITIUS

The framework for an effective implementation of the FSIs in Mauritius is already in place. The Mauritian financial system is mainly governed by, inter-alia, the Banking Act 1988, Financial Services Development Act 2001 and Companies Act 2001. The legal framework for banking and non-bank deposit taking business is embodied in the Banking Act, which governs the licensing, regulation and supervision of Category 1 banks, Category 2 banks and non-bank deposit taking businesses.

The Financial Services Development Act 2001 provides the structure for licensing, regulation and supervision of non-bank financial services which mainly consists of global business companies, companies listed on the Stock Exchange of Mauritius, insurance companies and pension funds, asset and pension management companies. The Companies Act 2001 provides for the incorporation, internal management and winding up of companies. It also incorporates international best practices.

Presently, three main institutions gather primary data and process them for dissemination, namely, Bank of Mauritius, Financial Services Commission and Central Statistical Office.

The Bank of Mauritius publishes monthly statistical bulletins and annual reports of the Bank and its Supervision Department. In addition, it has already embarked on the implementation of the IMF Monetary and Financial Statistics Manual for its collection of data from deposit-taking institutions. The adoption of this Manual will further promote harmonization in presenting comparable financial statistics among countries. The Bank has standardized the balance sheet formats of Category 1 banks, Category 2 banks and non-bank deposit-taking institutions. This format has improved comparability, sectorisation and classification of accounts.

Regarding the conceptual framework, the provisions of the Companies Act incorporate the application of international best practices, for instance, companies have to comply with International Accounting Standards. In this respect, the Bank of Mauritius has issued a draft Guideline on Credit Impairment Measurement and Income Recognition with the prime focus on the International Accounting Standard 39 (IAS 39), entitled 'Financial Instruments: Recognition and Measurement'. This Standard deals, among other things, with the valuation of financial instruments, impairment and uncollectability of financial assets.

At the regional level, the East and Southern Africa Banking Supervisors Group (ESAF) has initiated actions to harmonise, among others, the accounting and auditing standards for banks. In this respect, ESAF members have been encouraged to adopt International Accounting Standards, which will promote better integration of the region and also aim at a better comparability of regional financial statements of key financial stakeholders.

CONCLUSION

The compilation of FSIs is a challenging task for Mauritius. Its successful implementation will facilitate the periodic monitoring of financial institutions and help to assess the health of the banking sector vulnerability to a crisis and act in anticipation of any such crisis. However, certain issues such as consolidation of data for conglomerates, poor data on asset quality and lack of reporting of derivatives positions, will need to be addressed in the near term. □

6. Realisation and Securitisation of Assets

By its very nature banking involves taking risks. In most countries and in Mauritius, in particular, banks have deployed their funds into loans which form the bulk of their assets. Consequently, one of the most significant risks faced by banks has been and will continue to be credit risk, that is the risk that the counterparty will default on his obligations as agreed. Banks are now coming up with new techniques to measure, manage and mitigate the risks to which they are exposed.

Traditionally, banks have placed undue reliance on the collaterals when extending credit facilities. When borrowers default and all means are exhausted to recover their dues, banks finally have to foreclose the assets held as security. The foreclosing and disposal of the assets do not always produce the desired results.

Banks in Mauritius have always favoured collaterals in the form of freehold property, the price of which has so far not experienced a sharp down trend in cyclical patterns. In general, the maximum amount of collateralised loans granted by a bank is stated to be equivalent to two thirds of the total estimated market value of the collateral. Therefore, when a borrower defaults, the bank will be expected to recover its dues by disposing of the foreclosed assets. This is unfortunately not always the case.

Although banks do foreclose assets, they are not presently empowered by law to directly sell them. The properties have to be disposed of at the sale by levy. The legal process is overly cumbersome and involves time-consuming procedures. It is common practice for borrowers acting in bad faith to deliberately seek and obtain postponements, thus delaying the liquidation procedures. The sales take place once every Thursday at the Supreme Court's Salle des Ventes. The Salle des Ventes can barely accommodate 20 persons and sales are made on a cash basis, hence the number of potential bidders is limited. Sales are made on a cash basis, with one quarter of the price being payable immediately. To compound matters, if after the sale, a buyer proposes to acquire the property for a price higher than the adjudicated price by one sixteenth, all the procedures have to be restarted. Even when the sale is effected without any request for outbidding, the proceeds are attributed to the various creditors only after a long time which may extend up to 10 years. Due to these constraining factors, the prices that the properties fetch at the sale do not as a rule reflect their market values. The properties are generally adjudicated at less than half their market values. As a result, banks have recourse to this method of recovering their dues only after they have exhausted all the other means available.

In the event, many banks feel that the sale by levy is not an attractive proposition. They even have to make a provision in respect of loans whose attached collateral fetches much less than the expected proceeds. This cuts into their profitability. Banks have been quite desperate in exploring avenues to simplify their recovery process and at the same time realise their securities at values which are more in line with reality.

The solution would lie in the direction of setting up some special purpose or asset management companies which would facilitate the transfer of problem assets from financial institutions in exchange for consideration or financing.

EXPERIENCE OF DIFFERENT COUNTRIES

We could draw from the experience of other countries which have successfully dealt with the problem. During the South East Asian financial crisis in 1997-99, banks were confronted with an unprecedented rise in non-performing loans. This led the authorities to think out a strategy to address the problem. The countries that were hit the hardest by the Asian crisis, viz. Indonesia, Korea, Malaysia and Thailand, created Asset Management Companies (AMCs). India also passed a legislation to come to grips with the problem of non-performing loans. To this end, the Government of India passed The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002. The Act came into effect on 21 June 2002. These measures are reported to be yielding encouraging results and merit our attention towards the satisfactory resolution of problem loans.

Asset reconstruction is concerned mainly with the resolution of non-performing loans. The whole process should be provided with safeguards that preclude abuse on the part of secured lenders. Consequently any policy should be accompanied by a set of clear instructions which should be complied with by all the securitisation or reconstruction companies. Transactions should take place in a prudent and transparent manner and should be executed at arm's length so that the interest of none of the parties is prejudiced. AMCs should be audited regularly to ensure that the prices at which the companies purchase assets reflect market prices. The auditor's reports should be made available to the regulators. AMCs should also be required to publish regular reports describing their performance in pursuing their objectives. In order to promote market discipline, the Guidelines issued by the Reserve Bank of India require banks which sell their assets to a securitisation company/reconstruction company (SC/RC) to disclose in the Notes on Accounts to their balance sheets:

(a) Number of accounts

(b) Aggregate value of accounts sold to SC/RC

(c) Aggregate consideration

(d) Aggregate gain/loss at net book value

NEED FOR EFFECTIVE ASSET MANAGEMENT POLICIES

Non-performing loans represent a major threat to any bank. They carry the potential to bring about the collapse of a bank. In times of economic slowdown, a surge in non-performing loans can be expected which could threaten the whole financial system and, ultimately, the whole economy. The main South Asian countries successfully tackled the problem by using AMCs which they set up during their economic crisis. An effective asset management policy can help to prevent the problem of non-performing assets assuming unmanageable proportions.

An AMC helps to stabilise the financial condition of a distressed bank by the following means:

1. Borrowers get value for money. They are freed from the mercy of unscrupulous buyers.
2. Banks recover their dues.
3. It restores liquidity and solvency to financial institutions, restores confidence in the valuation of assets.
4. It frees banks from the worries of perpetually having to resolve their non-performing loans and helps them to concentrate on banking. The prompt resolution of non-performing assets helps to reallocate resources which is vital to economic recovery.
5. The simultaneous offer of sale of a large number of similar assets exerts a downward pressure on prices. An effective asset management policy will counter that pressure and help to normalise asset prices.

WHAT IS ASSET MANAGEMENT?

Asset management involves in the first instance the identification of non-performing assets. A non-performing asset means an asset or account of borrower, which has been classified by a bank as a sub-standard, doubtful or loss asset in accordance with the guidelines issued by the central bank. This asset is then categorised into one of four broad categories of selling, recovery, restructuring and setting off depending on the characteristics of the asset.

Where any borrower, who is under a liability to a bank under a security agreement, makes any default in repayment of secured debt or any instalment thereof, and his accounts in respect of such debt is classified by the secured creditor as non-performing asset, then, the bank may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within 60 days from the date of notice failing which the secured creditor would be entitled to exercise any or all of the following rights to recover his secured debt:

(a) take possession of the secured assets;

(b) take over the management of the secured assets of the borrower;

(c) appoint any person to manage the secured assets the possession of which has been taken over by the secured creditor.

Where an AMC exists, it will take over from the bank the above responsibilities until the assets are liquidated. The AMC will acquire the assets at a fair market value. Determining a fair value is a complex exercise. The evaluation can be based on net cash flows arising from the loan, viz:

- expected interest and principal repayments;
- security value;
- collection, workout and realisation risks;
- transaction costs.

On acquiring the asset from the bank, the AMC will endeavour to negotiate with the borrower to maximise the prospects of recovery. Various courses of action are open to the AMC:

- Immediate sale of some or all of the loans to a third party;
- Providing borrower additional time to settle his dues;
- Providing additional finance to enable borrower to become viable;
- Reschedulement of interest and/or principal payments.

The success of any of the above approaches is contingent on the borrower's conditions, type of loan and macro-economic conditions prevailing in the country. The ultimate objective of the AMC is to maximise disposal proceeds and produce a win/win situation for both the borrower and the bank.

TYPES OF AMCs

The main types of AMCs currently in place in various countries are:

1. A central disposition agency
2. An entity specific to a particular bank
3. An auction process

The first type would take loans from all financial institutions and manage them alone. The second type would manage the non-performing loans of all the banks forming part of a particular bank and/or group of banks. The auction process would involve accumulating assets rapidly and selling them without considering the other courses of action open to AMCs. It will become evident that the type of an effective AMC will depend primarily on the size of market.

FRAMEWORK FOR AN EFFECTIVE ASSET MANAGEMENT COMPANY

Any effective AMC is highly dependent on two main prerequisites: (a) Legal Framework and (b) Licensing and Regulation of AMC.

An AMC should be backed by an adequate legal framework in which both creditors and debtors have confidence. Besides defining the rights of ownership and the legal obligations of debtors and creditors, the legal framework should provide for the orderly and expeditious resolution of disputed claims, including debt recovery and realisation of collateral for unpaid debt.

While the AMC does provide financial institutions with a powerful weapon to bring defaulting borrowers to toe the line, it should not abuse the rights of borrowers by foreclosing assets indiscriminately. Therefore, the law should provide for rights of appeal. Under the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance 2002 (India) an aggrieved customer may appeal to the Debts Recovery Tribunal within 45 days. If the borrower is still aggrieved by an order made by the Debts Recovery Tribunal he may appeal to an Appellate Tribunal within 30 days from the date of receipt of the order of the Debts Recovery Tribunal.

A sound regulatory and supervisory framework is a basic condition to safeguard the smooth running of an AMC. The mainspring of an asset management policy is non-performing loans. Therefore, the regulator needs to define an appropriate loan classification system and provisioning rules.

Licensing and regulation of AMC is usually vested with central banks. Applicants have statutory conditions to fulfil before being licensed.

The central bank may cancel a certificate of registration granted to a securitisation company if such company fails to comply with any conditions subject to which the certificate was granted.

In order to ensure transparency, the company should maintain accounts in accordance with requirements and submit or offer for inspection its books of accounts or other relevant documents when so required by the central bank.

CONCLUSION

Loans become non-performing when borrowers fall in arrears in the repayment of principal or interest payment or both. Some borrowers have the means to repay but do not have the willingness to repay; i.e. they become wilful defaulters on the loans. On the other hand, there are borrowers who cannot afford to repay on account of hardships of an economic nature. An economic slowdown can severely undermine the capacity of borrowers to continue servicing and to repay their debts. In such circumstances an effective asset management policy in the financial system can help to come to grips with the problem of non-performing assets and so prevent a crisis that may go out of control. Given the size and specificity of Mauritius, a centralised AMC could be considered to serve the needs of our financial system. A centralised AMC entails economies of scale and the building up of a sound data base. However, this factor should not impede the pursuit of the main objective which is to resolve non-performing loans by bringing in an asset reconstruction option.

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. Guideline on Credit Classification for Provisioning Purposes and Income Recognition
4. Guidelines for Calculation and Reporting of Foreign Exchange Exposures of Banks, Foreign Exchange Dealers and Money-Changers
5. Guideline on Credit Concentration Limits
6. Guideline on Liquidity
7. Guideline on Internet Banking
8. Guideline on Corporate Governance
9. Guideline on Related Party Transactions
10. Guideline on Public Disclosure of Information
11. Guideline on Transactions or Conditions Respecting Well-Being of a Financial Institution Reportable by the External Auditor to the Bank of Mauritius
12. Guidance Notes on Fit and Proper Person Criteria
13. Guideline on Credit Risk Management
14. Guidance Notes on Anti-Money Laundering and Combating the Financing of Terrorism
15. Draft Guideline on Credit Impairment Measurement and Income Recognition

2. Guidance Notes on Fit and Proper Person Criteria

1.0 INTRODUCTION

The probity and competence of senior officers, directors and shareholders who exercise significant influence on financial institutions regulated by the Bank of Mauritius are not only of strong interest to the Bank of Mauritius but also to the institutions themselves. Market participants and the public at large need to be confident that persons managing the affairs of the institutions are competent, honest, financially sound and will treat them fairly. Financial institutions must, therefore, ensure that such persons are and are seen to be fit and proper.

1.1 Objective

The objective of the Guidance Notes is to set out a framework for assessing a person's capacity to act as a fit and proper person and to provide for a basis for decision in the matter.

1.2 Applicability

The Guidance Notes apply to banks, non-bank deposit taking institutions, foreign exchange dealers and money changers, collectively referred to as financial institutions or institutions. They are issued under the authority of the Bank of Mauritius Act, particularly section 20, which empowers the Central Bank to require, whenever necessary, the cooperation of authorized banks and other credit institutions "to ensure high standards of conduct and management throughout the banking and credit system" and section 12(v) of the Act which empowers the Bank to do all such things as are incidental to or consequent upon the exercise of its powers or the discharge of its duties under the Act.

The criteria outlined in the Guidance Notes are to be applied individually but it is their cumulative effect, which will determine whether a person meets the test. A failure to meet one criterion will not, of its own, necessarily mean failure to meet the test of fit and proper person. The process will involve a good measure of judgment, which must be exercised in a fair and judicious manner, always in the best interests of the institution and the sound conduct of its business.

2.0 Interpretation

In the Guidance Notes:

"fit and proper person" means a person who when subjected to the criteria of the Guidance Notes together with any other criteria prescribed by the board of directors, presents the likelihood of his being in a position to discharge his responsibilities in a competent, honest and correct manner in the best interests of the institution;

"senior officer" means:

(a) the chief executive officer, deputy chief executive officer, chief operating officer, chief financial officer, secretary to the board of directors, treasurer, chief internal auditor, or manager of a significant unit of the financial institution; or

(b) a person with a similar level of position or responsibilities as a person in paragraph (a);

"significant influence" means the capacity of a shareholder to influence persuasively, because of his shareholdings, the composition of the board of directors of the financial institution and/or its financial and operating policy decisions.

3.0 Responsibilities of Senior Officers, Directors and Shareholders

Shareholders with significant influence, directors and senior officers of financial institutions shall at all times be and be seen as fit and proper. It is incumbent on the board of directors of the institution to ensure that this is actually the case.

3.1 Role of the Board of Directors

To effectively discharge its responsibilities, the board of directors of a financial institution shall:

- establish fit and proper person policy, taking fully into account the criteria stated in the Guidance Notes (the board may need to expand the criteria to provide for the requirements of any special situation);

- apply the policy to directors, senior officers, and shareholders that are in a position to exercise significant influence on the institution;
- ensure creation of appropriate documentation on the process implemented and decisions made; and
- make the documentation available for inspection by the Bank of Mauritius, as required.

The board's further responsibilities are to ensure that:

- nominations, initiated by the Board, of persons for election to the board of directors meet the test of fit and proper person set out in these Guidance Notes before such nominations are placed before the shareholders' meeting;
- candidates for appointment to the senior officer level, meet the test of fit and proper person before the appointments are made;
- acquisition of shares by persons who are likely to be in a position to exercise significant influence on the financial institution meet the test of fit and proper person before their shares are registered in the register of shareholders, and to advise the Bank of Mauritius if events have occurred that put into question their ability to meet the test;
- processes are implemented to keep under constant review the continuing capacity of directors, senior officers, and shareholders with significant influence to meet the fit and proper person test; and
- the chief executive officer applies the fit and proper person test to other management positions below the senior officer level and reports to the board periodically on the result achieved.

3.2 Responsibility of Persons Subject to Fit and Proper Person Test

In the first instance, the onus is on senior officers, directors, and shareholders with significant influence to demonstrate that they are fit and proper persons. They must, accordingly, complete the Fit and Proper Person Questionnaire, outlined in Appendix 1, and provide any additional information that the board of directors may require to complete its investigation. They are further obliged to notify the board forthwith of any events or circumstances that have occurred subsequent to their initial assessment of fit and proper person that might change the assessment or at least have a material bearing on it. The board shall investigate the information, on a priority basis, and decide on the individual's fit and proper person status.

The board shall, in case an individual fails to observe the above notification responsibility, nevertheless, remain vigilant about all information available that might throw light on an individual's fit and proper person status and take action as appropriate. It remains the board's responsibility to keep under constant review the fitness and propriety of all persons covered under the Guidance Notes.

3.3 Role of the External Auditors

If during the course of their statutory audit of a financial institution, the external auditors become aware of information that points to non-compliance or potential non-compliance by a person with the fit and proper person requirements of the Guidance Notes, they shall forthwith advise the board of directors of the matter and provide all information necessary. The board shall, on a priority basis, take a decision in the case and initiate whatever action is necessary. The board's proceedings shall be properly documented. The board shall advise the Bank of Mauritius of the matter and its decision.

3.4 Establishment of a New Institution

Any person, group of persons or entity applying for a licence or authorisation to establish the business of a bank, non-bank deposit taking institution, foreign exchange dealer, or money changer, shall be subjected to the fit and proper person criteria specified in these Guidance Notes. Based on the information provided by the applicant(s), the Bank of Mauritius will assess their fitness and propriety for the purpose of granting a licence or an authorisation under the Banking Act or other appropriate statutes. The criteria will be applicable on an on-going basis if the applicant(s) is successful in obtaining the licence or authorisation.

4.0 Assessing fitness and propriety

Criteria for assessing fitness and propriety of a person are outlined under three captions.

1. Honesty, integrity, fairness and reputation;
2. Competence, and capability; and
3. Financial soundness.

As stated earlier, it is the cumulative effect of the application of the criteria that will determine the fitness and propriety of a person. In applying the criteria, the board may need to discuss the matter with an informed party, in which a summary of the discussion should be minuted for future reference.

4.1 Honesty, Integrity, Fairness and Reputation

Honesty, integrity and fairness are qualities that are demonstrated over time. These attributes demand a disciplined, on-going commitment to high standards of behaviour and honesty.

In determining a person's honesty, integrity, fairness and reputation, the board of directors shall consider all appropriate factors, including but not limited to:

1. whether the person is or has been the subject of any proceedings of a disciplinary or criminal nature, or has been notified of any impending proceedings or of any investigation, which might lead to such proceedings;
2. whether the person, or any business in which he has controlling interest or exercises significant influence, has been investigated, disciplined, suspended or criticised by a regulatory or professional body, a court or tribunal, whether publicly or privately;
3. whether the person has been associated, in ownership or management capacity, with a company, partnership or other organisation that has been refused registration, authorisation, membership or a licence to conduct trade, business or profession, or has had that registration, authorisation, membership or licence revoked, withdrawn or terminated;
4. whether, as a result of the removal of the licence, registration or other authority mentioned in criterion 3, the person has been refused the right to carry on a trade, business or profession requiring a licence, registration or other authorisation;
5. whether the person has been the subject of any justified complaint relating to regulated activities;
6. whether the person has been charged or convicted of any criminal offence, particularly an offence relating to dishonesty, fraud, financial crime or other criminal acts;
7. whether the person has contravened any of the requirements and standards of a regulatory body, professional body, government or its agencies, which are of the nature and/or significance that may have affected his fitness and propriety;
8. whether the person has been a director, partner, or otherwise involved in the management, of a business that has gone into receivership, insolvency, or liquidation while the person was connected with that organisation or within one year after the connection;
9. whether the person has been dismissed, asked to resign or resigned from employment or from a position of trust, fiduciary appointment or similar position because of questions about his honesty and integrity;
10. whether the person has ever been disqualified, under the Companies Legislation or any other legislation or regulation, from acting as a director or serving in a managerial capacity;
11. whether the person has at any time shown strong opposition or lack of willingness to maintaining effective internal control systems;
12. whether, in the past, the person has been fair, truthful and forthcoming in his dealings with his customers, superiors, auditors and regulatory authorities; and
13. whether the person demonstrates a readiness and willingness to comply with the requirements and standards of the regulatory system and other legal, regulatory or professional requirements and standards.

The above matters may have arisen either in Mauritius or elsewhere. The board of directors should be informed of any of these matters, but will consider the extent and circumstances of the person's involvement in the relevant events, the time it occurred and its seriousness. The board of directors will gather information from all appropriate sources, on the overall reputation of a person regardless of whether such information results from the above criteria and factor it in its assessment of the person's fitness and propriety.

4.2 Competence and Capability

A person must demonstrate his competence and ability to understand the technical requirements of the business, risks inherent and management processes required to conduct its operations effectively, with due regard to the interests of all stakeholders.

In determining competence, and capability of a person, the board of directors shall take into account all relevant considerations including, but not limited to:

1. whether the person has demonstrated, through his qualifications and experience, the capacity to successfully undertake the cognate responsibilities of the position, including the establishment of effective control regime;

2. whether the person has ever been diagnosed as being mentally ill or unstable;

3. whether the person has ever been disciplined by a professional, trade or regulatory body, or dismissed or requested to resign from any position or office for negligence, incompetence or mismanagement; and

4. whether the person has a sound knowledge of the business and responsibilities he will be called upon to shoulder.

4.3 Financial Soundness

In order to demonstrate his capacity to ensure safety and soundness of a financial institution, including the balancing of risks and rewards, and protect the interests of depositors and other stakeholders, a person must demonstrate, to the satisfaction of the board of directors, that he has managed his own financial affairs properly and prudently.

In determining a person's financial soundness, the board of directors must consider all relevant factors, including but not limited to:

1. whether the person has been the subject of any judgment or award in Mauritius or elsewhere, that remains outstanding or was not satisfied within a reasonable period;

2. whether, in Mauritius or elsewhere, the person has made any arrangements or composition with his creditors, filed for bankruptcy, been adjudged bankrupt, had assets sequestrated, or been involved in proceedings relating to any of these;

3. whether a person who has been a senior officer of a company or a shareholder in a position to exercise significant influence in the company that:

    a. has been the subject of any judgment or award, in Mauritius or elsewhere, that remains outstanding or was not satisfied within a reasonable period; and

    b. has, in Mauritius or elsewhere, made any arrangements or composition with its creditors, filed for bankruptcy, been adjudged bankrupt, had assets sequestrated, or been involved in proceedings relating to any of the foregoing.

The fact that a person may be of limited financial means will not, in itself, affect his ability to satisfy the financial soundness criteria.

5.0 Commencement

This Guidance Notes shall come into effect immediately.

Bank of Mauritius
October 2003

Bank of Mauritius
Fit and Proper Person Questionnaire

FOR ASSESSING THE FITNESS AND PROBITY OF PERSONS WITH MATERIAL INFLUENCE ON THE OPERATION AND AFFAIRS OF BANKS, NON-BANK DEPOSIT TAKING INSTITUTIONS, MONEY CHANGERS AND CASH DEALERS REGULATED BY THE BANK OF MAURITIUS

PURPOSE OF ASSESSMENT

PROPOSED POSITION	INSTITUTION

PERSONAL DETAILS

FAMILY NAME	FIRST NAME
DATE OF BIRTH (DD/MM/YYYY)	PLACE OF BIRTH (TOWN AND COUNTRY)
NATIONALITY	HOW NATIONALITY WAS ACQUIRED? Birth Naturalisation Marriage
GENDER Male Female	MARITAL STATUS Single Married Divorced
ID NUMBER	PASSPORT NUMBER
CURRENT POSTAL ADDRESS	CURRENT RESIDENTIAL ADDRESS (if different from current postal address)
PERMANENT ADDRESS (if different from current residential address)	TELEPHONE NUMBER Residential Business
FAX NUMBER	EMAIL ADDRESS

ADDITIONAL DETAILS

HAVE YOU EVER BEEN SUBJECT TO A CHANGE OF NAME (if 'Yes' provide full details below)		YES NO
PREVIOUS FAMILY NAME	PREVIOUS NAME	DATE OF CHANGE
REASONS FOR CHANGE		
HAVE YOU CHANGED YOUR PERMANENT ADDRESS DURING THE LAST TEN YEARS (if 'Yes' provide full details below)		YES NO
FULL PREVIOUS PERMANENT ADDRESS		DATE OF CHANGE

ACADEMIC QUALIFICATIONS

QUALIFICATION AND YEAR	EXAMINING BODY	GRADE

PROFESSIONAL QUALIFICATIONS

PROFESSIONAL BODY	STATUS	DATE OF ADMISSION

PROPOSED RESPONSIBILITIES

PROFESSIONAL BODY	STATUS	DATE OF ADMISSION
Please provide full details of your proposed duties and responsibilities		

EMPLOYMENT HISTORY COVERING AT LEAST THE TEN PREVIOUS YEARS (start with current and most recent position)

1 EMPLOYER'S NAME

NATURE OF EMPLOYER'S BUSINESS

EMPLOYER'S ADDRESS

EMPLOYER'S PHONE NUMBER | EMPLOYER'S FAX NUMBER | EMPLOYER'S EMAIL

YOUR JOB TITLE

BRIEF DESCRIPTION DUTIES AND RESPONSIBILITIES

DATE OF APPOINTMENT | DATE OF RESIGNATION

REASONS FOR RESIGNATION

2 EMPLOYER'S NAME

NATURE OF EMPLOYER'S BUSINESS

EMPLOYER'S ADDRESS

EMPLOYER'S PHONE NUMBER | EMPLOYER'S FAX NUMBER | EMPLOYER'S EMAIL

YOUR JOB TITLE

BRIEF DESCRIPTION DUTIES AND RESPONSIBILITIES

DATE OF APPOINTMENT | DATE OF RESIGNATION

REASONS FOR RESIGNATION

3 EMPLOYER'S NAME

NATURE OF EMPLOYER'S BUSINESS

EMPLOYER'S ADDRESS

EMPLOYER'S PHONE NUMBER | EMPLOYER'S FAX NUMBER | EMPLOYER'S EMAIL

YOUR JOB TITLE

BRIEF DESCRIPTION DUTIES AND RESPONSIBILITIES

DATE OF APPOINTMENT | DATE OF RESIGNATION

REASONS FOR RESIGNATION

SIGNIFICANT SHAREHOLDINGS (INCLUDING INDIRECT HOLDINGS) HISTORY OVER AT LEAST THE LAST TEN YEARS (include only those holdings which provided you a significant influence over the operations and affairs of the entity)

NAME OF ENTITY	DATE INFLUENCE WAS ACQUIRED	DATE CONTROL WAS RELINQUISHED

DIRECTORSHIP HISTORY OVER AT LEAST THE LAST TEN YEARS

NAME OF ENTITY	DATE OF APPOINTMENT	DATE OF RESIGNATION

SPECIFIC TEST TO ASSESS FITNESS AND PROPRIETY

	YES	NO	REF.
1. Have you ever been subject to any proceedings of a disciplinary or criminal nature, or have been notified of any impending proceedings or of any investigation, which might lead to such proceedings?	–	–	....
2. Have you, or any business in which you have had controlling interest or have exercised significant influence, been investigated, disciplined, suspended or criticised by a regulatory or professional body, a court or tribunal, whether publicly or privately?	–	–	....
3. Have you ever been associated, in ownership or management capacity, with a company, partnership or other organisation that has been refused registration, authorisation, membership or a licence to conduct trade, business or profession, or has had that registration, authorisation, membership or licence revoked, withdrawn or terminated?	–	–	……………
4. As a result of the removal of the relevant licence, registration or other authority mentioned in question 3 above, have you ever been refused the right to carry on a trade, business or profession requiring a licence, registration or other authorisation?	–	–	……………
5. Have you ever been subject of any justified complaint relating to regulated activities?	–	–	....
6. Have you ever been charged or convicted of any criminal offence, particularly an offence relating to dishonesty, fraud, financial crime or other criminal acts?	–	–	....
7. Have you ever contravened any of the requirements and standards of a regulatory body, professional body, government or its agencies?	–	–	....
8. Have you ever been a director, partner, or otherwise involved in the management, of a business that has gone into receivership, insolvency or liquidation while you have been connected with that organisation or within one year after that connection?	–	–	....
9. Have you ever been dismissed, asked to resign or resigned, from employment or from a position of trust, fiduciary appointment or similar because of questions about your honesty and integrity?	–	–	....
10. Have you ever been disqualified, under the Companies legislation or any other legislation or regulation from acting as a director or serving in a managerial capacity?	–	–	....
11. Have you ever been diagnosed as being mentally ill or unstable?	–	–	....
12. Have you ever been disciplined by a professional, trade or regulatory body; or dismissed or requested to resign from any position or office for negligence, incompetence or mismanagement?	–	–	……………
13. Have you ever been the subject of any judgment or award, in Mauritius or elsewhere that remains outstanding or was not satisfied within a reasonable period?	–	–	....
14. Have you ever made any arrangements or composition with your creditors, filed for bankruptcy, been adjudged bankrupt, had your assets sequestrated, or been involved in proceedings relating to any of these?	–	–	....
15. Have you ever been a senior officer of a company or a shareholder in a position to exercise significant influence in the company that: a. has been the subject of any judgment or award, in Mauritius or elsewhere, that remains outstanding or was not satisfied within a reasonable period; b. has, in Mauritius or elsewhere, made any arrangements or composition with its creditors, filed for bankruptcy, been adjudged bankrupt, had assets sequestrated, or been involved in proceedings relating to any of the foregoing?	–	–	....
16. Do you have reasons to believe that any of your close relatives or business associates, if subject to the above tests, would have responded by a 'Yes' to any of the above questions?	–	–	……………

IF THE ANSWER TO ANY OF THESE QUESTIONS IS 'YES' PLEASE PROVIDE DETAILS ON SEPARATE PAGES WITH PROPER REFERENCING

SIGNATURE AND ACKNOWLEDGEMENT

I hereby certify that:

a. to the best of my knowledge and belief the statement made and the information supplied in this questionnaire and the attachments are correct and that there are no other facts that are relevant to the board of directors for assessing my fitness and propriety;

b. I understand that the board of directors may seek additional information from any third parties it deems necessary in view of assessing my fitness and propriety; and

c. I will bring to the attention of the board of directors any matter which may potentially affect my status as being someone fit and proper as and when it crops up.

SIGNED: ______________________ DATE: ________________

3. Guideline on Credit Risk Management

1.0 INTRODUCTION

The importance of credit policy has been highlighted in several guidelines issued by the Bank of Mauritius.

The Guideline on Related Party Transactions requires the board of directors of a financial institution to establish a conduct review committee (name subsequently changed to Conduct Review and Risk Policy Committee) from its membership to monitor and review related party transactions (most of which are likely to be credit related).

The Guideline on Corporate Governance ascribes specific responsibility to the board of directors to review the adequacy of risk management policies, systems and procedures, approve them and periodically review their continuing effectiveness and management's performance in controlling risks.

Under the Guideline on Credit Concentration Limits, the board is mandated to:

- assess and approve the credit concentration risk policy;
- review at least once a year the policy and related techniques, procedures and information systems;
- ensure through audit and inspection adherence to the credit concentration risk policy; and
- review all significant exposures to credit concentration risk.

The Guideline on Public Disclosure of Information requires a financial institution to disclose publicly the role of its board of directors in approving and periodically reviewing risk management policies, ensuring employment of competent and qualified persons to control and manage risks, and reviewing reports from management to ensure the adequacy of the institution's risk profile and controls. It further enlarges the role of the conduct review committee to review and approve risk policies and ensure their effective implementation. This new committee, called Conduct Review and Risk Policy Committee, shall consist of only independent directors.

The proposed Guideline on Credit Impairment Measurement and Income Recognition requires the board of directors to establish credit risk management policy and credit impairment recognition and measurement policy.

The guideline at hand does not replace, but rather supplements the existing regulations and guidelines. Where it imposes more stringent requirements than those in the existing regulations and guidelines, such requirements shall apply. The guideline will become a focal point of reference for all requirements of the Bank of Mauritius for credit risk policy formulation and management. For the specific subject of credit impairment recognition and measurement, reliance will be placed on the proposed Guideline on Credit Impairment Measurement and Income Recognition.

The guideline underlines, in no uncertain terms, that the role of the board of directors and, through it, the chief executive officer, is to manage the credit activity of the financial institution with integrity, using strictly and exclusively prudential credit criteria. They shall remain accountable and liable for actions taken, or not taken when such actions were called for using normal prudence, not only during the time they were in office but also afterwards.

The guideline draws its authority from the Bank of Mauritius Act and the Banking Act, with particular reference to Section 20 of the former and Section 33 of the latter. The applicable provisions of the Companies Act are Section 143, specifying duties of directors to act in good faith and in the best interest of the company, Section 160, setting out standards of care and civil liability of officers and directors, and Section 139, providing for continuing liability of directors even after they cease to hold office. Section 174 of the same Act permits personal actions by shareholders against directors.

The guideline applies to all deposit taking financial institutions regulated by the Bank of Mauritius. It is not intended to be so comprehensive that it covers each and every aspect of credit risk management activity. A financial institution may want to establish a more comprehensive and sophisticated framework than that outlined in the guideline. This is entirely acceptable as long as all essential elements of the guideline are fully taken into account.

2.0 Purposes

The Guideline has two purposes. First, it sets out the responsibilities and accountabilities of the board of directors and management (chief executive officer) in credit risk management and second, it outlines the processes to be used in managing the credit activity in a financial institution. The guideline recognizes that the design of processes will take into account the specific nature of an institution's business, its constraints, risks, opportunities and strategies.

The guideline further recognizes that credit constitutes by far the largest part of a financial institution's business in Mauritius and its mismanagement can pose a serious threat to the institution's continued existence, with resulting impacts on the interests of depositors and other stakeholders. Prudential credit risk management is, therefore, of utmost importance.

When a banking operation is conducted by way of a branch of a foreign bank, the role of the board of directors shall be assumed by the head office. The head office shall ensure that its branch is complying with applicable laws, regulations, guidelines and other prudential directives.

3.0 Interpretation

"credit" means a provision of, or commitment to provide, funds or substitutes for funds, to a borrower, including off-balance sheet transactions, customers' lines of credit, overdrafts, bills purchased and discounted, and finance leases.

"credit risk" means the risk of credit loss that results from the failure of a borrower to honour the borrower's credit obligation to the financial institution.

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

"prudent", in respect of a financial institution, means the exercise of careful and practical judgment that would be exercised by a knowledgeable person in the financial institutions industry, having regard to

- the objectives of the financial institution,
- all risks to which the financial institution is exposed, including credit risk, and
- the amount and nature of the financial institution's capital.

4.0 Establishment of Credit Risk Policy

A financial institution must establish a written credit risk policy that

- includes a statement of principles and objectives governing the extent to which the institution is willing to accept credit risk;
- establishes the areas of credit (types of credit, target industry sectors, geographical areas, countries) in which the financial institution is willing to engage and those in which it is not willing to engage;
- clearly defines the levels of authority to approve credits;
- establishes prudent limits on the financial institution's exposure to credit risk and on the concentration of credit risk in different areas of the institution's credit portfolio; and
- **clearly defines the accountabilities of the chief executive officer to the board of directors in the light of this guideline.**

5.0 Responsibilities and Accountabilities of the Board of Directors

The board of directors shall, as a minimum,

- approve, if acceptable, the credit risk policy;
- review, at least once a year, the policy and related techniques, controls, procedures, and information systems to implement the policy to ensure their continued adequacy and effectiveness;
- ensure through independent inspection/audit function adherence to the policy, techniques, controls, procedures, and information systems;
- **ensure the selection and appointment of qualified and competent management to administer the credit risk management function;**
- ensure the establishment and proper functioning of the **Conduct Review and Risk Policy Committee of the board,** as called for in the Guideline on Public Disclosure of Information, it being understood that credit risk management will be a prime function of this committee;

- direct the Conduct Review and Risk Policy Committee to report to the board on its activities and decisions taken, at such frequency as the board may decide;
- **direct the chief executive officer to submit a comprehensive written report to the board on the management of exposures to credit risk at least once every six months** (format and components of the report to be decided between the two beforehand), and submit such other reports at such intervals as the board may specify;
- review credits granted to, or guaranteed by, directors or management personnel or to entities in which directors or management personnel are partners, directors or officers, and review the institution's policy related to such credits;
- review credits granted to, or guaranteed by, entities controlled by the financial institution, or officers or directors of such entities, and review the institution's policy related to such credits;
- establish country risk limits and ensure that in case of international credit transactions, in addition to standard risks, any risks associated with economic, political and social environment in the country as well as transfer risk are taken into account;
- review all significant credit exposures of the financial institution, the term significant to be defined by the board in relation to the institution's capital base;
- review all significant delinquent credits and management's actions taken or contemplated for their recovery;
- review any credits granted in conflict of the written credit risk policy, and take action to ensure future compliance with the policy;
- review trends in the quality of, and concentration in, the financial institution's credit portfolio, to identify emerging problems and take action to deal with the problems; and
- ensure that the financial institution's remuneration policy is in line with the credit risk strategy and does not reward imprudent activities of credit staff.

6.0 Responsibilities and Accountabilities of Chief Executive Officer

The chief executive officer shall, as a minimum,

- **develop a soundly based credit risk management policy** for approval by the board of directors, which deals with, among other things,
  - the extent to which the financial institution should assume credit risk, taking into account the capital base of the institution, a prudential assessment of the institution's ability to absorb losses, the financial health of its existing credit portfolio, the diversification of the portfolio, and the institution's business plan;
  - the targeted portfolio concentration limits in terms of counterparties, industry sectors, geographic regions, foreign country or class of countries, and classes of security;
  - the areas of credit in which the institution should engage or restrict itself from engaging;
  - an in-depth analysis of risks associated with the introduction of new products or new initiatives and development of adequate systems to control the risks, and seek approval of the board of directors before launching them;
  - **clearly documented delegation of credit approval authority of management personnel and committees,** taking into account the type and size of credit, the types of risks to be assessed, and the experience and competence of individuals; and
  - consistency and tie in with the institution's business plan and other asset/liability management considerations;
- **ensure that the board approved credit risk management policy is implemented in its true spirit, using strictly and exclusively prudential credit appraisal criteria and considerations and not influenced by any extraneous factors;**
- establish and ensure proper functioning of Risk Management Committee of management, as called for in the Guideline on Public Disclosure of Information, it being understood that credit risk management will be a prime function of this committee, which shall report on its work to the chief executive officer for ratification of decisions taken;

- ensure that the credit approval process is not unduly influenced by market share or growth targets;
- establish and utilize effectively a system to monitor and control the nature, composition, and quality of the credit portfolio and to ensure that the portfolio is conservatively valued and the guideline of the Bank of Mauritius on credit impairment measurement and income recognition is fully complied with;
- ensure implementation of a credit management information system that
  - tracks the evolving circumstances of a credit, repayments regularity, borrower's financial condition, continuing value of the security, and other attributes of the credit;
  - tracks credits by portfolio characteristics, including single and associated groups of borrowers, types of credit facilities, industry sectors and geographical regions;
- ensure implementation of an appropriate management reporting system covering the content, format and frequency of information to management concerning the institution's credit risk position, to permit sound and prudent analysis and control of existing and potential credit risk exposures;
- **install adequate internal controls, covering the entire credit spectrum,** including segregation of activities between the persons responsible for analysis, authorization, and execution of credit transactions and those responsible for their monitoring and in the case of impaired credits, their follow-up, and the establishment of an appropriate internal rating system for individual credits;
- **ensure implementation of an effective internal inspection/audit function** to review and assess the credit risk management activities, which will provide assurance to management and the board that
  - credit activities are in compliance with the credit risk management policy and with the laws and guidelines;
  - credits are duly authorized, accurately recorded, and appropriately valued;
  - credits are appropriately rated according to the internal rating system in place;
  - credit files are properly maintained and complete;
  - potential problem accounts are being identified on a timely basis and a determination can be made whether provision for credit losses is adequate in accordance with the guideline on the subject; and
  - credit risk management information reports are adequate and accurate;
- establish a communication system for effective dissemination of credit risk management policies and procedures to employees engaged in the credit risk management process;
- submit comprehensive written reports to the board of directors at a frequency to be decided by the board but no less than once every six months, dealing with
  - significant credit activities of the financial institution and composition and quality of the credit portfolio;
  - significant credit exposures outstanding;
  - significant impaired credits, their current status and collection prospects;
  - credit transactions undertaken that are not in accordance with the credit risk management policy, including delegated approval authorities, giving reasons for departure and outlining initiatives planned by management to curtail repetition of such transactions;
  - credits granted to, or guaranteed by, directors or management personnel or to entities in which directors or management personnel are partners, directors or officers, including the institution's policy related to such credits;
  - credits granted to, or guaranteed by, entities controlled by the financial institution, or officers or directors of such entities, including the institution's policy related to such credits; and
  - trends in portfolio quality and the level of diversification, and an analysis of emerging problems and remedial actions contemplated.
- submit such other reports to the board of directors and at such interval as the board may decide.

7.0 Conduct Review and Risk Policy Committee

The Guideline on Public Disclosure of Information envisages a much larger role of the Conduct Review and Risk Policy Committee than merely credit risk management. For functionality reasons, the board may decide to establish a separate credit risk management committee reporting to it rather than relying on the Conduct Review and Risk Policy Committee. Regardless of the format chosen, the function of the committee would be to assist the board in discharging its responsibilities in the area.

The board will assign responsibility with respect to related party transactions to the committee and such other responsibilities listed in paragraph 5.0 as it may decide. All decisions taken by the committee shall be submitted to the board for ratification. The board will decide on the frequency of reporting by the committee but in view of the sensitivities normally surrounding credit risk management issues, reporting at short intervals is advisable.

8.0 Credit Risk Management Process

Credit risk management process should cover the entire credit cycle starting from the origination of the credit in a financial institution's books to the point the credit is extinguished from the books. It should provide for sound practices in:

- credit processing/appraisal;
- credit approval/sanction;
- credit documentation;
- credit administration;
- disbursement;
- monitoring and control of individual credits;
- monitoring the overall credit portfolio (stress testing);
- credit classification; and
- managing problem credits/recovery.

There is some duplication between the previous sections of the guideline and this section. This is acceptable in the interest of completeness of processes outlined.

8.1 Credit Processing/Appraisal

Credit processing is the stage where all required information on credit is gathered and applications are screened. Credit application forms should be sufficiently detailed to permit gathering of all information needed for credit assessment at the outset. In this connection, financial institutions should have a checklist to ensure that all required information is, in fact, collected.

Financial institutions should set out pre-qualification screening criteria, which would act as a guide for their officers to determine the types of credit that are acceptable. For instance, the criteria may include rejecting applications from blacklisted customers. These criteria would help institutions avoid processing and screening applications that would be later rejected.

Moreover, all credits should be for legitimate purposes and adequate processes should be established to ensure that financial institutions are not used for fraudulent activities or activities that are prohibited by law or are of such nature that if permitted would contravene the provisions of law. Institutions must not expose themselves to reputational risk associated with granting credit to customers of questionable repute and integrity.

The next stage to credit screening is credit appraisal where the financial institution assesses the customer's ability to meet his obligations. Institutions should establish well designed credit appraisal criteria to ensure that facilities are granted only to creditworthy customers who can make repayments from reasonably determinable sources of cash flow on a timely basis.

Financial institutions usually require collateral or guarantees in support of a credit in order to mitigate risk. It must be recognized that collateral and guarantees are merely instruments of risk mitigation. They are, by no means, substitutes for a customer's ability to generate sufficient cash flows to honour his contractual repayment obligations. Collateral and guarantees cannot obviate or minimize the need for a comprehensive assessment of the customers ability to observe repayment schedule nor should they be allowed to compensate for insufficient information from the customer.

Care should be taken that working capital financing is not based entirely on the existence of collateral or guarantees. Such financing must be supported by a proper analysis of projected levels of sales and cost of sales, prudential working capital ratio, past experience of working capital financing, and contributions to such capital by the borrower itself.

Financial institutions must have a policy for valuing collateral, taking into account the requirements of the Bank of Mauritius guidelines dealing with the matter. Such a policy shall, among other things, provide for acceptability of various forms of collateral, their periodic valuation, process for ensuring their continuing legal enforceability and realization value. Needless to say that in the event of credit deterioration, credit enforcement or foreclosure actions may yield proceeds much less than initially foreseen and the value of collaterals should accordingly be very conservatively determined as a set-off against default risk.

In the case of loan syndication, a participating financial institution should have a policy to ensure that it does not place undue reliance on the credit risk analysis carried out by the lead underwriter. The institution must carry out its own due diligence, including credit risk analysis, and an assessment of the terms and conditions of the syndication.

The appraisal criteria will of necessity vary between corporate credit applicants and personal credit customers. Corporate credit applicants must provide audited financial statements in support of their applications. As a general rule, the appraisal criteria will focus on:

- amount and purpose of facilities and sources of repayment;
- integrity and reputation of the applicant as well as his legal capacity to assume the credit obligation;
- risk profile of the borrower and the sensitivity of the applicable industry sector to economic fluctuations;
- performance of the borrower in any credit previously granted by the financial institution, and other institutions, in which case a credit report should be sought from them;
- the borrower's capacity to repay based on his business plan, if relevant, and projected cash flows using different scenarios;
- cumulative exposure of the borrower to different institutions;
- physical inspection of the borrower's business premises as well as the facility that is the subject of the proposed financing;
- borrower's business expertise;
- adequacy and enforceability of collateral or guarantees, taking into account the existence of any previous charges of other institutions on the collateral;
- current and forecast operating environment of the borrower;
- background information on shareholders, directors and beneficial owners for corporate customers; and
- management capacity of corporate customers.

8.2 Credit-approval/Sanction

A financial institution must have in place written guidelines on the credit approval process and the approval authorities of individuals or committees as well as the basis of those decisions. Approval authorities should be sanctioned by the board of directors. Approval authorities will cover new credit approvals, renewals of existing credits, and changes in terms and conditions of previously approved credits, particularly credit restructuring, all of which should be fully documented and recorded. Prudent credit practice requires that persons empowered with the credit approval authority should not also have the customer relationship responsibility.

Approval authorities of individuals should be commensurate to their positions within management ranks as well as their expertise. Depending on the nature and size of credit, it would be prudent to require approval of two officers on a credit application, in accordance with the Board's policy. The approval process should be based on a system of checks and balances. Some approval authorities will be reserved for the credit committee in view of the size and complexity of the credit transaction. Local banks operating through branches in Mauritius should consider centralizing their credit approval process at the head office.

Depending on the size of the financial institution, it should develop a corps of credit risk specialists who have high level expertise and experience and demonstrated judgment in assessing, approving and managing credit risk. An accountability regime should be established for the decision-making process, accompanied by a clear audit trail of decisions taken, with proper identification of individuals/committees involved. All this must be properly documented.

All credit approvals should be at an arm's length, based on established criteria. Credits to related parties should be closely analyzed and monitored so that no senior individual in the institution is able to override the established credit granting process. Related party transactions should be reviewed by the board of directors under due processes of good governance.

8.3 Credit Documentation

Documentation is an essential part of the credit process and is required for each phase of the credit cycle, including credit application, credit analysis, credit approval, credit monitoring, collateral valuation, impairment recognition, foreclosure of impaired loan and realization of security. The format of credit files must be standardized and files neatly maintained with an appropriate system of cross-indexing to facilitate review and follow-up. The Bank of Mauritius will pay particular attention to the quality of files and the systems in place for their maintenance.

Documentation establishes the relationship between the financial institution and the borrower and forms the basis for any legal action in a court of law. Institutions must ensure that contractual agreements with their borrowers are vetted by their legal advisers. Credit applications must be documented regardless of their approval or rejection. All documentation should be available for examination by the Bank of Mauritius.

Financial institutions must establish policies on information to be documented at each stage of the credit cycle. The depth and detail of information from a customer will depend on the nature of the facility and his prior performance with the institution. A separate credit file should be maintained for each customer. If a subsidiary file is created, it should be properly cross-indexed to the main credit file.

For security reasons, financial institutions should consider keeping only the copies of critical documents (i.e., those of legal value, facility letters, signed loan agreements) in credit files while retaining the originals in more secure custody. Credit files should also be stored in fire-proof cabinets and should not be removed from the institution's premises.

Financial institutions should maintain a checklist that can show that all their policies and procedures ranging from receiving the credit application to the disbursement of funds have been complied with. The checklist should also include the identity of individual(s) and/or committee(s) involved in the decision-making process.

8.4 Credit Administration

Financial institutions must ensure that their credit portfolio is properly administered, that is, loan agreements are duly prepared, renewal notices are sent systematically and credit files are regularly updated.

An institution may allocate its credit administration function to a separate department or to designated individuals in credit operations, depending on the size and complexity of its credit portfolio.

A financial institution's credit administration function should, as a minimum, ensure that:

- credit files are neatly organized, cross-indexed, and their removal from the premises is not permitted;
- the borrower has registered the required insurance policy in favour of the bank and is regularly paying the premiums;
- the borrower is making timely repayments of lease rents in respect of charged leasehold properties;
- credit facilities are disbursed only after all the contractual terms and conditions have been met and all the required documents have been received;
- collateral value is regularly monitored;
- the borrower is making timely repayments on interest, principal and any agreed to fees and commissions;
- information provided to management is both accurate and timely;

- responsibilities within the financial institution are adequately segregated;
- funds disbursed under the credit agreement are, in fact, used for the purpose for which they were granted;
- "back office" operations are properly controlled;
- the established policies and procedures as well as relevant laws and regulations are complied with; and
- on-site inspection visits of the borrower's business are regularly conducted and assessments documented.

8.5 Disbursement

Once the credit is approved, the customer should be advised of the terms and conditions of the credit by way of a letter of offer. The duplicate of this letter should be duly signed and returned to the institution by the customer. The facility disbursement process should start only upon receipt of this letter and should involve, inter alia, the completion of formalities regarding documentation, the registration of collateral, insurance cover in the institution's favour and the vetting of documents by a legal expert. Under no circumstances shall funds be released prior to compliance with pre-disbursement conditions and approval by the relevant authorities in the financial institution.

8.6 Monitoring and Control of Individual Credits

To safeguard financial institutions against potential losses, problem facilities need to be identified early. A proper credit monitoring system will provide the basis for taking prompt corrective actions when warning signs point to a deterioration in the financial health of the borrower. Examples of such warning signs include unauthorised drawings, arrears in capital and interest and a deterioration in the borrower's operating environment. Financial institutions must have a system in place to formally review the status of the credit and the financial health of the borrower at least once a year. More frequent reviews (e.g at least quarterly) should be carried out of large credits, problem credits or when the operating environment of the customer is undergoing significant changes.

In broad terms, the monitoring activity of the institution will ensure that:

- funds advanced are used only for the purpose stated in the customer's credit application;
- financial condition of a borrower is regularly tracked and management advised in a timely fashion;
- borrowers are complying with contractual covenants;
- collateral coverage is regularly assessed and related to the borrower's financial health;
- the institution's internal risk ratings reflect the current condition of the customer;
- contractual payment delinquencies are identified and emerging problem credits are classified on a timely basis; and
- problem credits are promptly directed to management for remedial actions.

More specifically, the above monitoring will include a review of up-to-date information on the borrower, encompassing:

- opinions from other financial institutions with whom the customer deals;
- findings of site visits;
- audited financial statements and latest management accounts;
- details of customers' business plans;
- financial budgets and cash flow projections; and
- any relevant board resolutions for corporate customers.

The borrower should be asked to explain any major variances in projections provided in support of his credit application and the actual performance, in particular variances respecting projected cash flows and sales turnover.

8.7 Monitoring the Overall Credit Portfolio (Stress Testing)

An important element of sound credit risk management is analysing what could potentially go wrong with individual credits and the overall credit portfolio if conditions/environment in which borrowers operate change significantly. The results of this analysis should then be factored into the assessment of the adequacy of provisioning and capital of the institution. Such stress analysis can reveal previously undetected areas of potential credit risk exposure that could arise in times of crisis.

Possible scenarios that financial institutions should consider in carrying out stress testing include:

- significant economic or industry sector downturns;
- adverse market-risk events; and
- unfavourable liquidity conditions.

Financial institutions should have industry profiles in respect of all industries where they have significant exposures. Such profiles must be reviewed /updated every year.

Each stress test should be followed by a contingency plan as regards recommended corrective actions. Senior management must regularly review the results of stress tests and contingency plans. The results must serve as an important input into a review of credit risk management framework and setting limits and provisioning levels.

8.8 Classification of credit

The proposed Guideline on Credit Impairment Measurement and Income Recognition that will replace the existing Guideline on Credit Classification for Provisioning Purposes and Income Recognition, requires the board of directors of a financial institution to

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

Credit classification process grades individual credits in terms of the expected degree of recoverability. Financial institutions must have in place the processes and controls to implement the board approved policies, which will, in turn, be in accord with the proposed guideline. They should have appropriate criteria for credit provisioning and write off. Up until the time the proposed guideline comes into effect, the existing guideline on credit classification will continue to apply.

International Accounting Standard 39 requires that financial institutions shall, in addition to individual credit provisioning, assess credit impairment and ensuing provisioning on a credit portfolio basis. Financial institutions must, therefore, establish appropriate systems and processes to identify credits with similar characteristics in order to assess the degree of their recoverability on a portfolio basis.

The proposed Guideline on Credit Impairment Measurement and Income Recognition specifies rules for consideration of collateral in assessment of the recoverable value of credit. Financial institutions should establish appropriate systems and controls to ensure that collateral continues to be legally valid and enforceable and its net realizable value is properly determined. This is particularly important for any delinquent credits, before netting off the collateral's value against the outstanding amount of the credit for determining provision.

As to any guarantees given in support of credits, financial institutions must establish procedures for verifying periodically the net worth of the guarantor.

8.9 Managing Problem Credits/Recovery

A financial institution's credit risk policy should clearly set out how problem credits are to be managed. The positioning of this responsibility in the credit department of an institution may depend on the size and complexity of credit operations. It may form part of the credit monitoring section of the credit department or located as an independent unit, called the credit workout unit, within the department. Often it is more prudent and indeed preferable to segregate the workout activity from the area that originated the credit in order to achieve a more detached review of problem credits. The workout unit will follow all aspects of the problem credit, including rehabilitation of the borrower, restructuring of credit, monitoring the value of applicable collateral, scrutiny of legal documents, and dealing with receiver/manager until the recovery matters are finalized.

Financial institutions will put in place systems to ensure that management is kept advised on a regular basis on all developments in the recovery process, may that emanate from the credit workout unit or other parts of the credit department.

There should be clear evidence on file of the steps that have been taken by the financial institution in pursuing its claims against a delinquent customer, including any legal steps initiated to realize on the collateral. Where there is a delay in the liquidation of collateral or other credit recovery processes, the rationale should be properly documented and anticipated actions recorded, taking into account any revised plans submitted by the borrower.

The accountability of individuals/committees who sanctioned the credit as well as those who subsequently monitored the credit should be revisited and responsibilities ascribed. Lessons learned from the post mortem should be duly recorded on file.

9.0 Management Information Systems

The feasibility and effectiveness of the various requirements of the credit risk management framework, outlined in this guideline, depend, in large measure, on the adequacy of management information systems in a financial institution.

The information generated by management information systems enables the board and management to fulfill their respective oversight roles, including the adequate level of capital that the institution should be carrying. The quality, detail and timeliness of information respecting the composition and soundness of credit portfolio, are critical to credit risk management.

A well functioning information system would permit credit exposures approaching risk limits to be identified and brought to the timely attention of management and the board. Also, the system's design can throw out information on concentration of risks within the credit portfolio, including concentration in maturity streams, enabling management to take remedial action in a timely manner.

10.0 Commencement

The Guideline shall come into effect on 5 January 2004.

Bank of Mauritius

December 2003

APPENDIX II

1. Legislative Changes and Regulatory Measures

Relevant legislative changes effected during the year under review and regulatory measures taken to enhance the operational efficiency of financial institutions are set out below:-

Legislative Changes

The following enactments were amended by the Finance Act 2002.

(i) The Banking Act 1988

The definitions of "class A banking" formerly domestic banking and "class B banking" formerly offshore banking were amended to "category 1 banking" and "category 2 banking" respectively and accordingly a corresponding change in the definitions of "Class A Banking Licence" to "Category 1 Banking Licence", "Class B Banking Licence" to "Category 2 Banking Licence" and "class B banking transactions" to "category 2 banking transactions" was effected.

The definition of "related corporation" in the Banking Act was deleted and, in line with the Companies Act 2001, replaced by that of "related company".

By virtue of the addition of a new subsection (5) after section 22 subsection (4), banks were, for the purpose of participating in the equity capital of enterprises, permitted to set up or participate in equity funds approved by the Financial Services Commission with the proviso, however, that the capital adequacy requirements imposed by the Bank of Mauritius from time to time are not impaired by such investments.

(ii) The Companies Act 2001

The definition of "International Accounting Standards" in section 2(1) of the Companies Act 2001 was limited to standards issued by the International Accounting Standards Committee and any other entity to which responsibility thereof had been assigned by the Committee and such interpretations issued in respect of those Standards by the International Accounting Standards Committee. It has, by the Finance Act 2002, been deleted and replaced by a new larger definition.

The new definition brings within its four corners, the International Accounting Standards issued by the International Accounting Standards Committee, the International Financial Reporting Standards issued by the International Accounting Standards Board, and and any Standards issued by these bodies or their successor bodies and includes the Interpretations of the Standing Interpretations Committee of the International Accounting Standards Committee, the International Financial Reporting Interpretations Committee of the International Accounting Standards Board, and any Interpretations issued by the Interpretations Committees of the above bodies or their successor bodies.

(iii) The Financial Services Development Act 2001

Section 33 of the Financial Services Development Act 2001 with respect to confidentiality has been amended to permit the disclosure of information in relation to financial institutions carrying out activities specified in Part II of the First Schedule of the Act, to the Bank of Mauritius and to foreign institutions performing functions similar to those of the Financial Services Commission. The information so disclosed, however, should remain within the precincts of those bodies and should not be revealed to any other party.

Further, the words "Class A Banking Licence" in section 21(2)(a), "Class B Banking Licence" and "class B banking transactions" in section 42(3) of the Financial Services Development Act 2001 were deleted and replaced by the words "Category 1 Banking Licence", "Category 2 Banking Licence" and "category 2 banking transactions", respectively, in line with the changes brought in that respect, in the Banking Act.

(iv) The Foreign Exchange Dealers Act 1995

The definitions of "domestic bank" and "offshore bank" were deleted in the Foreign Exchange Dealers Act and definitions for "Category 1 banking", "Category 2 banking", "Category 1 Banking Licence" and "Category 2 Banking Licence" inserted and ascribed as having the same meaning as in the Banking Act. Similarly, the definition of "offshore company" was deleted and a definition for "Category 1 Global Business Licence" was inserted and ascribed as having the same meaning as in the Financial Services Development Act 2001.

(v) The Non-Citizens (Property Restriction) Act

The definition of "share" in the Non-Citizens (Property Restriction) Act which was limited to an interest in a company, partnership or société or any other body corporate which holds or purchases or otherwise acquires an immovable property in Mauritius has been enlarged to include:

(i) A share in a partnership or société or any other body corporate which reckons amongst its assets -

- (A) any freehold or leasehold immovable property in Mauritius; or
- (B) any share in a company or in a company holding shares in a subsidiary or any share in a partnership or société or any other body corporate, which itself reckons amongst its assets, freehold or leasehold immovable property in Mauritius.

(ii) A share in a company which reckons amongst its assets –

- (A) any freehold or leasehold immovable property in Mauritius; or
- (B) any share in a company holding shares in a subsidiary or any share in a partnership or société or any other body corporate, which itself reckons amongst its assets, freehold or leasehold immovable property in Mauritius.

No certificate under the Act was required to enable a non-citizen to hold property in virtue of a lease for a term not exceeding in the aggregate, 6 months in a year. The no-certificate requirement has been enlarged to a lease agreement or tenancy agreement for a term not exceeding 20 years.

Further, a new subparagraph (iii) has been added in section 3(3) of the Act requiring no certificate for a non-citizen or a person not resident in Mauritius to purchase or otherwise acquire an immovable property, a flat or apartment under the Permanent Resident Scheme, or under the Scheme to Attract Professionals for Emerging Sectors or from a company holding an investment certificate in respect of a project under the Integrated Resort Scheme, prescribed under the Investment Promotion Act.

The words "Class B Banking Licence" wherever they appeared in the Non-Citizens (Property Restriction) Act were deleted and replaced by the words "Category 2 Banking Licence" in line with the changes brought in that respect in the Banking Act.

(vi) The Unified Revenue Act

The definition of "large taxpayer" in section 8B(5) of the Act was amended to exclude a corporation holding a Category 1 Global Business Licence or a bank holding a Category 2 Banking Licence or a bank holding both a Category 1 Banking Licence and a Category 2 Banking Licence in so far as it relates to the business in respect of the Category 2 Banking Licence.

(vii) The Value Added Tax Act

The Value Added Tax Act was amended to make the following services subject to VAT:

- (A) services provided to merchants accepting a credit card or debit card as payment for the supply of goods or services (merchant's discount);
- (B) services in respect of safe deposit lockers, issue and renewal of credit cards and debit cards; and
- (C) services for keeping and maintaining customers' accounts (other than transactions involving the primary dealer system).

Services provided by the Bank of Mauritius were exempted from the payment of VAT.

All Category 1 banks, irrespective of their turnover of taxable supplies, are henceforth required to apply to the Commissioner for Value Added Tax for compulsory registration as a registered person under the Act. Category 1 banks have, however, been dispensed from issuing receipts or invoices in respect of the services rendered by them or to keep legible copies thereof.

Furthermore, no input tax is allowed as a credit under the Act in respect of goods and services used by banks, or services provided by banks, holding a Category 1 Banking Licence under the Banking Act.

2. COMMUNIQUÉ

On 14 February 2003, the Mauritius Commercial Bank Ltd (MCB) made a public announcement to the effect that a fraud in the hundreds of millions of rupees would have been committed to the detriment of the bank. The Bank of Mauritius has sent a team of inspectors to the MCB to conduct an examination, investigate and report thereon. The team of the Bank of Mauritius inspectors has submitted its preliminary findings and is still carrying on its work at the MCB.

The Bank of Mauritius considers that it is of utmost importance to fully identify and address relevant issues comprehensively. In view of the complexity of the nature of the examination, the Bank will employ as from today, 17 March 2003, the expert assistance of Mr Nicky Tan Ng Kuang of Singapore, a forensic accountant who investigated, amongst others, the collapse of the Barings Bank in 1995. The Bank of Mauritius will issue a further communiqué in the light of its findings.

Bank of Mauritius

17 March 2003

3. PRESS RELEASE

It has come to the notice of the Bank of Mauritius that an organization calling itself by the name of **Atlantic Trust Bank** has advertised itself on the website www.atlantictrustbank.com as a provider of a range of financial services, including private banking, investment management and offshore fund management, claiming that it is located in Mauritius.

The Bank advises the public that the said **Atlantic Trust Bank** has never applied for, nor been issued with, a licence to carry on banking or deposit taking business under the Banking Act. The Bank is informed that no company bearing a similar name has been licensed by the Financial Services Commission. Only duly licensed institutions by the Bank of Mauritius and the Financial Services Commission are permitted to undertake financial business in Mauritius. Consequently, it is a deliberate misrepresentation on the part of the said **Atlantic Trust Bank** to claim that it would be located in Mauritius for the purposes of providing financial services. No transactions should therefore be conducted with it under the misapprehension that an organization under the name of **Atlantic Trust Bank** would have been licensed as a financial institution in Mauritius.

The Bank of Mauritius provides a regular update of all banks and non-bank financial institutions authorized by it and a list of those institutions which have been authorized can be found on the Bank's website http://bom.intnet.mu.

Bank of Mauritius

28 May 2003

4. PRESS RELEASE

It has come to the notice of the Bank of Mauritius that an organisation calling itself by the name of **Trans Intercontinental Finance** has advertised itself on the website www.tif-online.com as a provider of a range of financial services for the personal, professional and corporate client, including private banking, fiduciary and corporate services, stockbroking, investment management and offshore management, claiming that it is located in Mauritius.

The Bank advises the public that the said **Trans Intercontinental Finance** has never applied for, nor been issued with, a licence to carry on banking or deposit taking or any other business under the Banking Act 1988. Only institutions duly licensed by the Bank of Mauritius are permitted to undertake deposit taking and banking business in Mauritius. Consequently, it is a deliberate misrepresentation on the part of the said **Trans Intercontinental Finance** to claim that it would be located in Mauritius for the purposes of providing banking and deposit taking services. No transactions should therefore be conducted with it under the misapprehension that an organisation under the name of **Trans Intercontinental Finance** would have been licensed as a deposit taking financial institution in Mauritius.

The Bank provides a regular update of all banks and non-bank financial institutions authorised by it and a list of those institutions, which have been authorised, can be found on the Bank's website http://bom.intnet.mu

Bank of Mauritius

19 December 2003

5. PUBLIC NOTICE

It has come to the notice of the Bank of Mauritius that a group calling itself by the name of The Armstrong Group has advertised itself on the website www.the-armstrong-group.com as having set up offices in Mauritius and providing a range of private banking services.

The Bank advises the public that the said The Armstrong Group has never applied for, nor has been issued with, a licence to carry on banking or deposit taking business in Mauritius. Only institutions duly licensed by the Bank of Mauritius are permitted to undertake banking or deposit taking business in Mauritius. The advertisement made by The Armstrong Group to the effect that it has set up offices in Mauritius for the purposes of providing private banking services is misleading. The public is therefore advised that no transactions should be conducted with the Group on the premise that it would have been licensed to carry on private banking services in Mauritius.

The Bank of Mauritius provides a regular update of all banks and non-bank deposit taking institutions authorized by it and a list of those institutions can be found on the Bank's website http://bom.intnet.mu

Bank of Mauritius

24 December 2003

6. 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 2003.

Banks holding a Category 1 Banking Licence

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

Banks holding a Category 2 Banking Licence

1. Bank of Baroda
2. Banque Internationale des Mascareignes Ltée
3. Barclays Bank PLC
4. Deutsche Bank (Mauritius) Limited
5. Investec Bank (Mauritius) Limited
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. Island Leasing Co. Ltd
7. La Prudence Leasing Finance Co. Ltd
8. Mauritius Housing Company Ltd
9. Mauritian Eagle Leasing Company Limited
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. Shibani Finance Co. Ltd
3. Grand Bay Helipad Co. Ltd
4. Max & Deep Co. Ltd
5. 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