# BANK OF MAURITIUS

# Annual Report on Banking Supervision 2005

# Contents

| Page | | |
|---|---|---|
| 3 | 1. | Overview of Supervisory Developments |
| 9 | 2. | A Review of the Performance of Banks |
| 33 | 3. | Implementing Basel II in Mauritius |
| 38 | 4. | The Supervisory Role of Bank of Mauritius |
| 42 | 5. | Promoting Financial Stability |
| 47 | 6. | Supervisory Approach to Country Risk |
| | | **Appendix I** |
| 52 | 1. | List of Guidelines/Guidance Notes |
| 53 | 2. | Guideline on Operational Risk Management and Capital Adequacy Determination |
| 72 | 3. | Guideline on Segmental Reporting under a Single Banking Licence Regime |
| | | **Appendix II** |
| 78 | | Financial Soundness Indicators for the Banking Sector, 1998-2004 |
| | | **Appendix III** |
| 80 | 1. | Legislative Changes |
| 84 | 2. | Compliance |
| 85 | 3. | Memorandum of Understanding and Agreement for Information Sharing |
| 86 | 4. | Communiqué – Confidentiality of Regulatory Report |
| 88 | 5. | Notice – Revocation of Authorisation to carry on business as money-changer |
| 89 | 6. | Communiqué – Press Articles on First City Bank |
| 90 | 7. | Public Notice - Surrender of Banking Licence by Mascareignes International Bank Ltd |
| 91 | 8. | List of Authorised Banks, Non-Bank Deposit Taking Institutions, Money-Changers and Foreign Exchange Dealers |
| 92 | 9. | Glossary of Abbreviations |
| 93 | 10. | List of Charts |
| 94 | 11. | List of Tables |

# 1. Overview of Supervisory Developments

## INTRODUCTION

Banks and other similar institutions are at the heart of the financial system. They play a prime role in the proper functioning of the economy by providing basic financial services to the public, finance to enterprise and access to the payment system. The Bank of Mauritius (the Bank) has a strong interest in ensuring the safety and soundness of institutions that make the financial system.

As the world moves towards increasing globalisation and economic integration, and with technological advances, the range and complexity of financial products and institutions have been contributing to significant changes in the risk profile of banks and other similar institutions. These need to be addressed through an effective risk control environment for the good running and safeguard of the financial system.

On the local front, the Bank, with a view to promoting stability and financial soundness of the banking sector, continued to keep pace with international developments. The banking legislations, taking on board the latest developments in the banking industry, were revamped and new guidelines were issued. The Mauritius Credit Information Bureau (MCIB), which acts as a repository for information on credit exposures of borrowers, was launched and is now fully operational.

The following sections highlight the initiatives taken by the Bank as well as those on the international front in order to address the changes taking place in the banking sector.

## LOCAL DEVELOPMENTS

### Implementation of Basel II

The Basel Committee on Banking Supervision (BCBS) finalised the new capital framework, commonly known as Basel II, in June 2004, with a proposed implementation date of end-2006 for member countries. Basel II, like its predecessor, is likely to become the norm for banks in the future. The benefits of its adoption are appealing and the Bank remains committed to its timely implementation in Mauritius.

Aware of the complexity of the new framework, the Bank opted for a consultative and participative approach. In this context, the Banking Committee established the *Committee for the Implementation of Basel II in Mauritius*, consisting of representatives of the Bank, banks and the Mauritius Bankers Association Ltd (MBA). The Committee, which is chaired by the First Deputy Governor, acts as a steering committee for the implementation of Basel II in Mauritius and assists in devising policy frameworks and in proposing solutions to banks as regards the implementation of Basel II. The Committee has set up eight Working Groups consisting of members of the Bank and representatives of the industry to work on technical issues relating to Basel II and to make recommendations to the Committee.

### CAMEL Rating

The Bank started rating individual banks according to the CAMEL rating system. This rating system uses five components, namely Capital Adequacy, Asset Quality, Management, Earnings and Liquidity in assessing the soundness of banks. A rating ('Strong', 'Satisfactory', 'Fair', 'Marginal' or 'Unsatisfactory') is assigned to each of the components of the CAMEL as well as to the overall performance of the banks.

The Bank started communicating its rating to former Category 1 banks as from January 2005, under the strict condition that such rating would not be published or disclosed to any third party without the written consent of the Bank.

### Mauritius Credit Information Bureau (MCIB)

Since the last two years, the Bank has been working towards the setting up of a Credit Information Bureau in Mauritius. The MCIB was officially launched on 1 December 2005 and is now fully operational. The MCIB collects, stores and provides information on the total credit exposure of borrowers. It is a vital tool for banks to ascertain the total

indebtedness of applicants for credit in the making of better-informed decisions.

It is mandatory for all participating banks to make the necessary enquiry from the MCIB before approving, increasing or renewing credit facilities.

Although the MCIB provides credit reports of applicants to banking institutions, the actual lending decision lies with the banks.

The credit information held with the MCIB is strictly confidential. Only participating banks will have access to the credit information. However, if a customer applying for credit is not satisfied with the credit information held with the MCIB, he can request the MCIB to provide him with information pertaining to his credit report. At a later stage, the Bank intends to extend the coverage of the MCIB to include all credit granting institutions.

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

As part of the need to keep up to date the Guidance Notes on AML/CFT to reflect changing circumstances and experience, the Bank issued a revised version of the Guidance Notes in June 2005. The revised Guidance Notes supersede the Guidance Notes issued in December 2003.

The revised Guidance Notes set out the additional broad parameters within which financial institutions should operate in order to ward off money laundering and terrorist financing risks. Financial institutions should, on their part, maintain updated anti-money laundering and terrorist financing deterrence policies, including regular update and training of concerned staff to keep up with emerging typologies.

## Segmental Reporting Under a Single Banking Licence Regime

Following the promulgation of the Banking Act 2004, banks now operate under a single banking licence regime as opposed to the previous regime involving the issue of distinct domestic and offshore banking licences.

The Bank issued a Guideline on Segmental Reporting Under a Single Banking Licence Regime in June 2005 explaining the set up of banking activities in the new context. It became effective on 1 July 2005. The Guideline permits banks to classify their banking activities into two segments, i.e. Segment A and Segment B. Segment B activities relate to banking activities that give rise to 'foreign source income'. All other banking activities are classified under Segment A. There is no restriction on the currency regime, notably rupee and non-rupee, as was applicable in the past. Banks have to report their Segment A and Segment B operations separately by way of segmental disclosure.

## Guideline on Credit Impairment Measurement and Income Recognition

In June 2003, a draft Guideline on Credit Impairment Measurement and Income Recognition was issued to deposit-taking financial institutions for consultation. The Guideline was finally issued in November 2004 to all deposit-taking financial institutions.

The Guideline focuses on the International Accounting Standard 39 (IAS 39), entitled 'Financial Instruments: Recognition and Measurement'. The Standard, which among other things deals with the impairment and uncollectability of financial assets, has been subject to revisions recently. The revised Standard applies to all reporting entities with annual periods beginning on or after 1 January 2005.

The objective of the Guideline is to ensure that financial institutions have adequate processes:

- to determine allowance for credit losses;
- to ensure that the carrying amounts of credit portfolio represent recoverable values; and
- to ensure that there is timely recognition of identified losses.

The derecognition and impairment provisions of the Standard also apply to lease receivables recognised by a lessor.

The Guideline on Credit Impairment Measurement and Income Recognition supersedes the previous Guideline on Credit Classification for Provisioning Purposes and Income Recognition.

## Guideline on Operational Risk Management and Capital Adequacy Determination

The Guideline on Operational Risk Management and Capital Adequacy Determination issued in February 2005 is applicable to all banks. For the purpose of determining capital adequacy, the requirements of the Guideline are supplementary to those of the Guidance Notes on Risk Weighted Capital Adequacy Ratio, which pertain to credit risk.

Recognising that operational risk has similar importance and stature as credit and market risks, BCBS standards require banks to apply similar level of rigour and resources to controlling and managing operational risk. In line with the recommendations made by the BCBS, the Guideline on Operational Risk Management and Capital Adequacy Determination requires each bank to establish an appropriate and comprehensive approach to the identification, measurement, monitoring and control of operational risk and to make an adequate provision of capital to protect against such risk.

In this respect each bank should establish a written policy on operational risk management that should clearly set out, *inter alia*, the principles for identifying, assessing, monitoring and controlling/mitigating operational risk and directives for managing risks associated with outsourcing activities.

The Guideline also requires foreign banks operating branches in Mauritius to implement a management framework for operational risk. The head office of the branch should ensure, at the consolidated level that the branch complies with the capital adequacy requirements for operational risk as well as other applicable regulations, guidelines and instructions.

## Guideline on Fit and Proper Person Criteria

The Guideline on Fit and Proper Person Criteria, issued in March 2005, applies to banks, non-bank deposit-taking institutions, foreign exchange dealers and money-changers and supersedes the Guidance Notes on Fit and Proper Person Criteria issued by the Bank in October 2003. The objective of the Guideline is to set out a framework for assessing a person's capacity to act as a fit and proper person for a financial institution and to provide the basis for a decision in the matter.

The Guideline requires that shareholders with significant influence, directors and senior officers of financial institutions be and be seen as fit and proper. The board of directors has the responsibility to ensure that those persons meet the fit and proper criteria.

The criteria are categorised under three captions:

- Honesty, integrity, diligence, fairness and reputation;
- Compliance and capability; and
- Financial soundness.

The criteria are to be applied individually but it is their cumulative effects that will determine whether a person meets the test. Failure to meet one criterion will not, of its own, necessarily mean failure to meet the test of fit and proper person. The process involves a good measure of judgement, which needs to be exercised in a fair and judicious manner in the best interests of the institution and the sound conduct of its business.

## Outsourcing in Financial Services

Financial service businesses around the world are increasingly using third parties to carry out activities that the businesses themselves would normally have undertaken. These outsourcing arrangements are also becoming increasingly complex.

The rapid rate of information technology innovation, along with increasing reliance on external service providers, has the potential to lead to higher risk of systemic problems unless appropriately controlled. Thus, there is a need to develop a set of principles that gives guidance to financial institutions and to regulators to help them better mitigate these concerns without hindering the efficiency and effectiveness of financial institutions.

The Bank is currently preparing a guideline on outsourcing. The guideline will define policies, systems, processes and controls that should be in place in respect of outsourcing activities.

## Financial Soundness Indicators (FSIs)

The Executive Board of the International Monetary Fund (IMF) has identified a multitude of indicators, referred to as *Financial Soundness Indicators (FSIs),* which are used by IMF/World Bank missions in their

assessment of the financial health and soundness of financial institutions, corporates and households of a country. The IMF has provided standard definitions and techniques for the compilation of the different FSIs in the Financial Soundness Indicators Manual, which is available at www.imf.org.

Appendix II of the present report provides a summary of the main FSIs for the banking sector in Mauritius from 1998 to 2004, using the standard definitions provided in the manual. The disclosure of the FSIs is intended to enhance the transparency of the banking sector.

### Developments in Financial Institutions

*(a) State Bank of India (SBI) and Indian Ocean International Bank Ltd (IOIB)*
SBI acquired 51 per cent of the shareholding of IOIB in February 2005.

*(b) Change Express Ltd (Money Changer)*
On 20 June 2005, the Bank approved the change of name of Direct Plus Ltd to Change Express Ltd.

*(c) Edge Forex Ltd (Foreign Exchange Dealer)*
On 10 December 2004, the Bank approved the change of name of Ciel Finance Ltd to Edge Forex Ltd.

## INTERNATIONAL DEVELOPMENTS

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

In January 2005, the BCBS, the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO) issued an update of their joint note on AML/CFT. The update addresses the vulnerabilities identified in the report issued in June 2003 and gives an account of the ongoing and future work.

The Joint Note provides an overview of the common AML/CFT standards that apply to all three sectors and an assessment as to whether there are serious gaps or inconsistencies in approaches and recommendations. In addition, it covers for each sector:

- the relationships between the institutions and their customers focusing on the products or services that are particularly vulnerable to money laundering;
- the manner in which each Committee has sought to address these vulnerabilities; and
- an account of ongoing and future work.

The BCBS will continue with its efforts to promulgate the principles it has developed for supervisors and the banking industry globally. Moreover, the BCBS has developed fruitful contacts with agencies directly involved in AML/CFT investigation/enforcement actions, such as treasuries, judicial authorities and law enforcement agencies. Members of the BCBS Secretariat and the Financial Stability Institute (FSI) jointly participate in regional training programmes and seminars aimed at promoting awareness of AML/CFT policies and standards.

### Initiatives by Basel-based Committees and the Financial Stability Forum

In July 2005, the BCBS met in session with the Core Principles Liaison Group (CPLG), the Committee's working group that includes banking supervisors from 16 non-Committee member countries, the IMF and the World Bank. As part of the dialogue with the wider supervisory community, views were exchanged on the ongoing efforts to update the *Core Principles for Effective Banking Supervision*, the implementation of Basel II and corporate governance, as well as accounting and auditing issues.

At the time of the meeting, the Committee, together with the IOSCO, released capital recommendations for trading-related exposures and double default effects. In addition, it published guidance on the estimation of loss-given-default (LGD) during economic downturns.

Furthermore, consultative materials were issued on the fifth Quantitative Impact Study and on supervisory guidance for the use by banking organisations of the *fair value option* amendment issued by the International Accounting Standards Board (IASB).

Finally, the Committee issued the revised guidance for public comments to help promote the adoption of sound corporate governance practices by banking organisations.

## Revision of the Core Principles for Effective Banking Supervision

In the *Core Principles for Effective Banking Supervision* (Core Principles) paper, issued in September 1997, BCBS identified 25 principles that make a good and effective banking supervisory structure. Over the years, countries have made considerable progress in beefing up their supervisory structure while trying to achieve compliance with those principles.

In October 2005, given the change in the banking industry over the past decade, the BCBS proposed to revise the Core Principles. The proposed revision of the Core Principles adds on the existing principles but does not propose to change it in a material way. However, it is noted that the proposed revised Core Principles place an accrued responsibility on the supervisors, who will be expected to monitor banks even more closely than is the case presently. The proposed revised principles are currently under restricted discussion and will soon be issued for public comments.

## Financial Action Task Force (FATF)

The FATF and the Asia/Pacific Group (APG) on Money Laundering held their first joint plenary meeting in Singapore with a view to better combating Money Laundering (ML) and Terrorist Financing (TF) in the Asia-Pacific region.

In this joint session, the 55 members of the two groups discussed issues of common interest and the Asian-Pacific jurisdictions reiterated their commitment to implement the FATF standards. They also identified assistance needed to implement the FATF 40+9 Recommendations. FATF and APG members agreed to further co-operation on issues related to:

- the links between corruption and the fight against ML/TF; and
- the implementation of anti-money laundering and counter terrorist financing measures for alternative remittance systems.

In keeping with the objective of strengthening the global network against ML and TF, the FATF has held a joint typology exercise with GAFISUD, its regional partners in South America, in November 2005 in Rio de Janeiro (Brazil), and a joint plenary meeting with ESAAMLG, its regional partner in Southern and Eastern Africa, in February 2006 in Cape Town.

## Compliance and the Compliance Function in Banks

As part of its ongoing efforts to address bank supervisory issues and enhance sound practices in banking organisations, the BCBS issued in April 2005 a paper on *Compliance Risk and the Compliance Function in Banks.* It states that banking supervisors must be satisfied that effective compliance policies and procedures are followed and that management takes appropriate corrective action when compliance failures are identified.

Compliance will be most effective in a corporate culture that emphasises standards of honesty and integrity expected from the board of directors and senior management. It should be viewed as an integral part of the bank's business activities and should be respected at all levels of the bank.

Compliance laws, rules and standards generally cover matters such as observing proper standards of market conduct, managing conflicts of interest, treating customers fairly, and ensuring the suitability of customer advice. They typically include specific areas such as the prevention of ML and TF, and may extend to tax laws that are relevant to the structuring of banking products or customer advice.

A bank should organise its compliance function and set priorities for managing its compliance risk in a way that is consistent with its own risk management strategy and structure.

## Sound Credit Risk Assessment and Controls

In November 2005, the Bank for International Settlements (BIS) issued a consultative paper on *Sound Credit Risk Assessment and Valuation for Loans* to serve as a guide to banks and supervisors, consistent with principles of International Financial Reporting Standards (IFRS) applicable to loan impairment. The paper sets out practices for addressing sound credit risk assessments, valuations and control processes for banks and responsibilities of the board of directors and senior management for ensuring adequacy of provisions for loan losses.

Supervisors expect a bank's credit risk assessment and valuation policies and practices to be consistent with prudential guidelines and applicable accounting frameworks. The paper is not intended to bring in additional accounting requirements for provisions for loan losses beyond those established by accounting standard setters or to bring amendments to provisioning for capital adequacy purposes.

The responsibility for compliance with accounting standards remains with the board of directors and senior management, and, in most cases, is subject to verification through formal external audit.

## CONCLUDING REMARKS

Banking is increasingly becoming more complex, and so are its associated risks. Regulation around the world is striving to keep up with the ever-increasing pace of change. International organisations, such as the BCBS and the FATF are very active in that they are constantly proposing solutions to tackle new risks and emerging issues in the industry.

The Bank remains aligned with international best practices. International standards are adjusted, where necessary, in so far as they are relevant to the requirements of the local industry. This approach will help to promote stability and soundness of the banking sector as well as the overall growth and development of the financial sector.

# 2. A Review of the Performance of Banks

## 2.1 INTRODUCTION

Following the enactment of the Banking Act 2004, the distinction between Category 1 and Category 2 banks has been eliminated whereby a single licence is issued for carrying out banking business. Consequently, rules and regulations which were applicable exclusively to former Category 1 banks have been extended to all banks. New banking licences were issued on 17 June 2005 to all banks operating in Mauritius.

Prior to the coming into effect of the Banking Act 2004, eleven Category 1 banks and twelve Category 2 banks were licensed by the Bank of Mauritius (the Bank). During the year under review, three branches of foreign banks, namely Barclays Bank PLC, The Hongkong and Shanghai Banking Corporation Limited and Bank of Baroda, which were operating two different units under the two categories, are now conducting their businesses under a single banking licence.

The State Bank of India became the major shareholder of another bank, namely, Indian Ocean International Bank Limited through the acquisition of 51 per cent of its shareholding in February 2005. It should be noted that it is already the main shareholder of SBI International (Mauritius) Ltd, a former Category 2 bank.

Also, with effect from 28 November 2005, Mascareignes International Bank Ltd, a former Category 2 bank, and Banque des Mascareignes Ltée, a former Category 1 bank, merged to operate under a single banking licence in the name of Banque des Mascareignes Ltée.

Consequently, as on 31 December 2005, the banking sector comprised nineteen banks, of which four local banks, five branches of foreign banks, nine subsidiaries of foreign banks and one joint venture between a local bank and a foreign bank.

A list of the banks in operation as at that date is given in Appendix III.

With effect from 21 December 2004, Standard Bank (Mauritius) Offshore Banking Unit Limited changed its name to Standard Bank (Mauritius) Limited.

As the new Banking Act came into effect in November 2004, for comparative purposes, the review of the performance of banks has been based on former Category 1 and Category 2 banks.

## 2.2 PERFORMANCE OF FORMER CATEGORY 1 BANKS

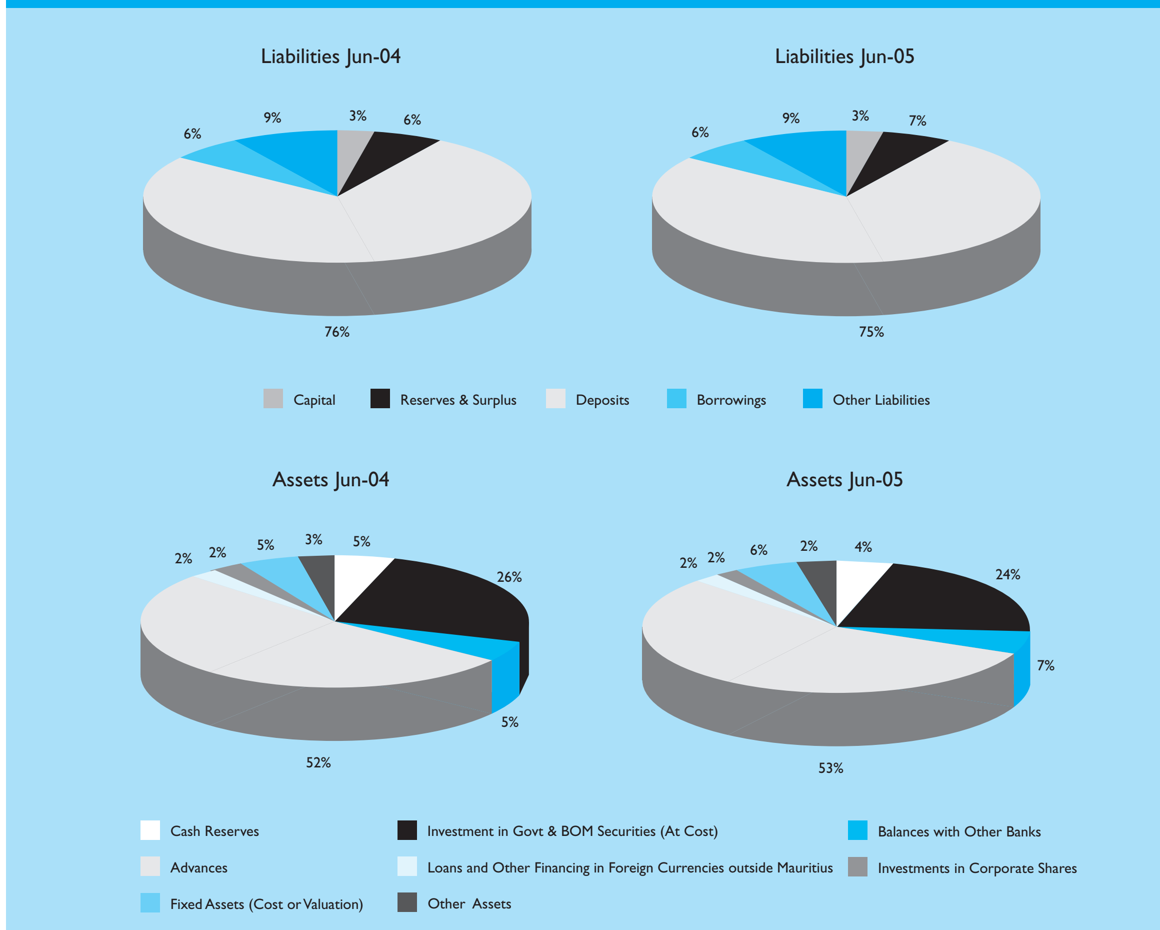
During the year 2004-05, the subdued economic climate continued to weigh down on the activities of banks as evidenced by the gradual slowdown in the growth of their asset base. The on-balance sheet assets of the former Category 1 banks grew by 9.4 per cent, rising from Rs174,641 million at end-June 2004 to Rs191,128 million at end-June 2005 as compared to growth rates of 13 per cent and 14 per cent recorded during the years ended June 2004 and June 2003 respectively. With the exception of one former Category 1 bank which recorded a decline of 12 per cent in its asset growth, the remaining ten banks' asset growth ranged on an individual basis from a low of 1 per cent to a high of 431 per cent.

The share of foreign currency assets of banks represented 15.3 per cent of their total assets equivalent to Rs29,290 million at end-June 2005 as compared to the equivalent of Rs21,845 million a year earlier or 12.5 per cent. Collectively, at end-June 2004 and end-June 2005, banks posted net overall foreign exchange short positions equivalent to Rs2,526 million and Rs1,895 million respectively, reflecting a high demand for foreign currencies on the market.

Off-balance sheet assets, comprising acceptances, guarantees and documentary credits, rose by Rs3,920 million or 22 per cent from Rs17,766 million at end-June 2004 to Rs21,686 million at end-June 2005, indicating that banks are reducing their reliance on interest income.

Chart 1 gives the year-on-year comparison of assets and liabilities of former Category 1 banks. At

Chart 1: Balance Sheet Structure




end-June 2005, the bulk of the assets of Category 1 banks consisted of advances (53 per cent) and investment in Treasury Bills and Government securities (24 per cent). The respective percentages for the previous year were 52 per cent and 26 per cent. Deposits decreased slightly from 76 per cent of former Category 1 banks' total resources at end-June 2004 to 75 per cent at end-June 2005.

A detailed review of the performance of former Category 1 banks over the past two years with respect to capital adequacy, asset quality, management, earnings and liquidity is given below.

## 2.2.1 CAPITAL ADEQUACY

Capital is one of the key factors to be considered when assessing the safety and soundness of a bank. An adequate capital base serves primarily as a safety net for banking risks and acts as a cushion to absorb any unexpected losses caused by events either within its control or due to external factors. It also serves as a foundation for a bank's future growth. All jurisdictions having active banking markets should require their banks to maintain a minimum level of capital to match the risks to which the banks are exposed.

In the late 1980s, the Basel Committee on Banking Supervision (BCBS) took the initiative to develop a risk-based capital adequacy standard that would secure international convergence of supervisory regulations governing the capital adequacy of international banks. This initiative resulted in the Basel Capital Accord of 1988 (Basel I). The Basel Capital Accord was adopted by the Bank in December 1993. Under Basel I, the minimum capital charge for on-balance sheet assets and off-balance sheet exposures are weighted according to their perceived level of risk. The sum of risk-weighted assets for on- and off-balance sheet exposures is related to a bank's capital base and the resulting ratio is used as a measure of capital adequacy.

However, with financial innovations, new challenges and risks have emerged. To improve the

soundness of financial system worldwide, the BCBS came forward with a new capital adequacy framework (Basel II) which is more representative of banks' risk management practices. One of the important characteristics of Basel II is that it provides for more sensitive risk weightings against credit risk and an explicit measure for operational and market risks. The Bank has embarked, in collaboration with the industry, on a programme for the scheduled implementation, with the necessary modifications for the domestic environment, of Basel II. In the meantime, Basel I requirements continue to be in force, except insofar as new measures are being adopted for the phased implementation of Basel II.

As a result of growing sophistication in financial technology and the introduction of complex financial instruments, the risk of operational loss has increased in the banking industry. Operational risks, if not controlled in a timely manner, can lead to other major losses and disrupt the normal operations of a bank. To further enhance the stability and soundness of the banking sector, the BCBS has proposed three different approaches for calculating capital charge for operational risk under Basel II. The three different approaches in terms of increasing complexity are the Basic Indicator Approach, the Standardised Approach and the Advanced Measurement Approach.

To this end, the Bank issued the Guideline on Operational Risk Management and Capital Adequacy Determination in February 2005, which sets out the framework for banks to maintain capital with respect to their operational risks. Banks have the flexibility of choosing one of the three different approaches. As from 1 April 2005, banks are required, as a minimum, to implement the Basic Indicator Approach. In this respect, it is observed that all the former Category 1 banks have adopted the Basic Indicator Approach with the exception of one bank which has embraced the Alternative Standardised Approach, a variant of the Standardised Approach. As at 30 June 2005, the total risk weighted assets for operational risks reported by the former Category 1 banks stood at Rs11,939 million and its inclusion in the calculation of the capital adequacy ratio caused the ratio of the banking sector to decline by 1.5 per cent from 15.2 per cent to 13.7 per cent.

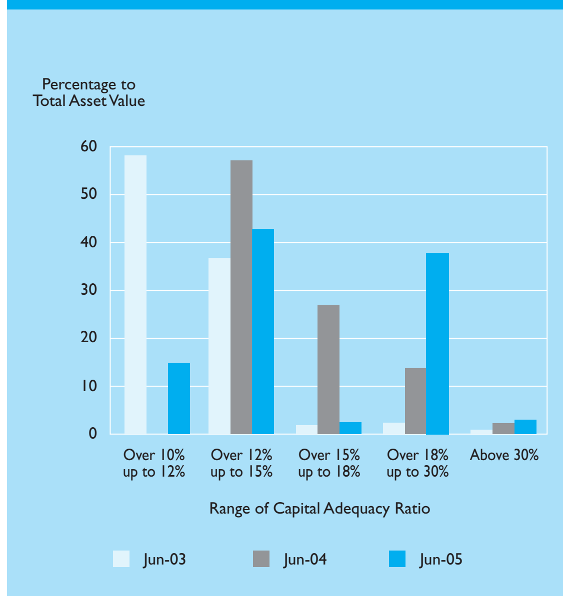
To ensure that the capital base of a bank is not impaired, section 27 of the Banking Act 2004 requires that no bank shall declare, credit or pay, or transfer abroad any dividend or make any other transfer from profits until the central bank is satisfied that the payment of dividend or any other transfer from profits will not cause the bank to be in contravention with the capital adequacy requirements of section 20. Furthermore, the law requires that a bank should ascertain that adequate provisions to the satisfaction of the central bank, has been made in respect of impaired credits.

During the year under review, all former Category 1 banks operated with a risk weighted capital adequacy ratio in excess of the prescribed minimum of 10 per cent. On average, during the year under review the former Category 1 banks maintained a risk weighted capital adequacy ratio ranging from 13.7 per cent to 15.5 per cent.

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

Chart 2 depicts an analysis of the capital adequacy ratio maintained by former Category 1 banks in terms of their total asset value over the past three years. Former Category 1 banks that reported ratios between 12 per cent and 15 per cent held in aggregate the biggest share of the banking sector's total on- and off-balance sheet assets at 57.1 per cent and 43.0 per cent at end-June 2004 and end-June 2005, respectively. On the other hand, banks with capital adequacy ratio ranging between 18 per cent and 30 per cent held

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



around 14 per cent and 38 per cent of total banking sector's on- and off-balance sheet assets at end-June 2004 and end-June 2005, respectively. However, the relationship between capital adequacy ratio and total assets cannot be interpreted in isolation, as it does not provide an accurate assessment of capital requirements. A bank's capital adequacy ratio can be rendered meaningless or highly misleading if other important ratios, such as asset quality is not taken on board. For a proper assessment of capital adequacy, an accurate assessment of asset quality is important. Similarly, an accurate evaluation of loan loss provisions is a critical input in the process of capital adequacy assessment.

As may be seen from Chart 2, at end-June 2003, banks with capital adequacy ratios ranging between 10 per cent and 12 per cent held the biggest share of the banking sector's total asset value and subsequently in June 2004 and June 2005 this percentage fell to zero and 14.3 per cent, respectively. This indicates to some extent that banks are now keeping a higher buffer of capital most probably due to fewer avenues for investing in more risky assets.

### 2.2.1.2 Capital Base

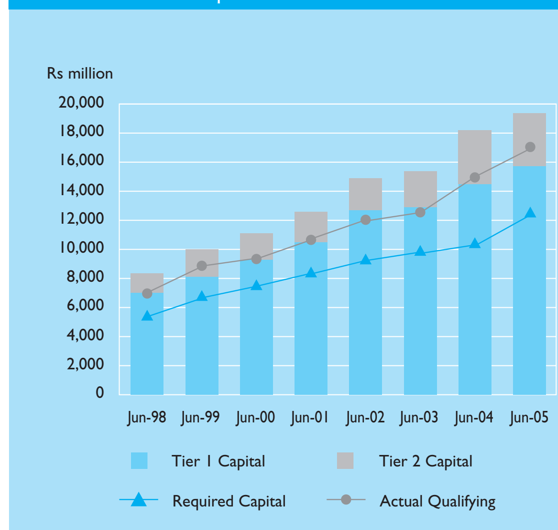
The aggregate capital base of former Category 1 banks increased by Rs1,793 million, from Rs15,226 million at end-June 2004 to Rs17,019 million at end-June 2005. The average capital adequacy ratio of banks at end-June 2005 stood at 13.7 per cent, down from 14.7 per cent at end-June 2004 mainly due to the inclusion of a capital charge for operational risk.

At end-June 2005, Tier 1 capital, constituting the bulk of total capital, accounted for 80.2 per cent of total gross capital of former Category 1 banks. During the year under review, Tier 1 capital grew by 8.9 per cent from Rs14,533 million at end-June 2004 to Rs15,821 million at end-June 2005. On the other hand, Tier 2 capital, which represented 19.8 per cent of total gross capital at end-June 2005, grew by 16.7 per cent from Rs3,352 million to Rs3,913 million during the year. At end-June 2005, Tier 2 capital expressed as a percentage of Tier 1 capital, represented 24.7 per cent thereof compared to 23.1 per cent at end-June 2004.

To reinforce the capital base of banks, the Banking Act 2004 requires banks to raise their minimum paid-up capital to Rs150 million as from 1 July 2005 and further to Rs200 million as from 1 July 2006.

Chart 3 illustrates the split between Tier 1 and Tier 2 capital over the period 1998 to 2005. As may be seen from Chart 3, the increasing trend in the buffer capital (that is, the difference between the required capital and the actual capital) was maintained. This may be explained by banks' prudent attitude towards risk or insufficient investment in 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 former Category 1 banks increased by 9.7 per cent from Rs165,937 million at end-June 2004 to Rs182,028 million at end-June 2005 while the corresponding risk weighted asset value grew by 9.3 per cent from Rs92,399 million to Rs100,970 million.

Table 1 shows the comparative movement in the riskiness of former Category 1 banks' total on-balance sheet assets between end-June 2004 and end-June 2005. The 100 per cent risk weight band continued to carry the bulk of former Category 1 banks' total on-balance sheet assets at 51.9 per cent and 50.8 per cent at end-June 2004 and end-June 2005, respectively. There was a shift from the zero and 100 per cent risk weighted assets to 20 per cent and 50 per cent risk weighted assets as may be observed from the table.

Table 2 sets out a comparison of the total on- and off-balance sheet assets of former Category 1 banks together with their corresponding risk weighted value and their average combined risk weighting over the period June 2000 to June 2005.

| Table 1 : Comparative Change in the Riskiness of Former Category 1 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 2005 | | June 2004 | |
| 0 | 62,249 | 34.2 | 60,155 | 36.3 |
| 10 | 809 | 0.4 | 448 | 0.3 |
| 20 | 16,013 | 8.8 | 11,316 | 6.8 |
| 50 | 10,541 | 5.8 | 7,854 | 4.7 |
| 100 | 92,416 | 50.8 | 86,164 | 51.9 |
| | **182,028** | **100.0** | **165,937** | **100.0** |

| Table 2: Total On- and Off-Balance Sheet Assets of Former Category 1 Banks, Equivalent Risk-Weighted Assets and Average Combined Risk Weighting | | | | | | |
|---|---|---|---|---|---|---|
| | June 00 | June 01 | June 02 | June 03 | June 04 | June 05 |
| A Total On- and Off-Balance Sheet Assets (Rs million ) | 125,884 | 133,244 | 153,023 | 174,731 | 196,934 | 217,608 |
| B Total Risk-Weighted Assets (Rs million ) | 75,264 | 81,986 | 90,927 | 99,607 | 103,767 | 124,071** |
| C Average Combined Risk Weighting (Per cent) B/A | 59.8 | 61.5 | 59.4 | 57.0 | 52.7 | 57.0 |
| D Capital Adequacy Ratio (Per cent) | 12.2 | 13.1 | 13.1 | 12.6 | 14.7 | 13.7 |

*** Includes capital charge for operational risk*

As may be observed from Table 2, from June 2004 to June 2005, the growth of 10.5 per cent in total on- and off-balance sheet assets was less than the growth of 19.6 per cent in total risk weighted assets mainly due to the inclusion of a capital charge for operational risk. The corresponding growth rates for the preceding year were 12.7 per cent and 4.2 per cent, respectively.

The inclusion of a capital charge for operational risk caused the average combined risk weighting to increase from 52.7 per cent in June 2004 to 57.0 per cent in June 2005. As a result, the capital adequacy ratio fell from 14.7 per cent to 13.7 per cent.

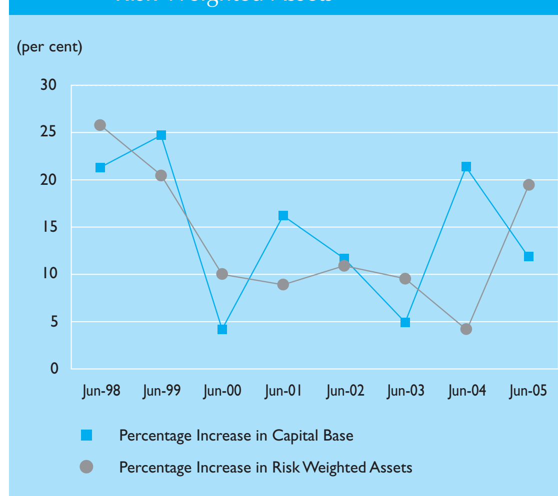
Chart 4 compares the percentage increase in capital base and risk weighted assets over the period June 1998 to June 2005.

## 2.2.2 ASSET QUALITY

The quality of assets of a bank is a major criterion in the determination of its financial soundness as it has a direct bearing on its earning capacity. Deterioration in asset quality may result in an upsurge in the volume of non-performing advances which would cause decline in interest income. A bank's liquidity and capital would be adversely affected if there is chronic deterioration in asset quality.

Given the significance of asset quality in the assessment of the financial soundness of banks,

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



examiners' conclusions regarding the overall condition of a bank including the quality of its management are heavily influenced by asset quality. In this connection, the Bank conducts regular on-site inspections of banks to review, *inter alia*, banks' credit granting and investment processes. It is a legal requirement, under section 42 of the Banking Act 2004, for the central bank to conduct examinations of the operations and affairs of every financial institution at least once every year.

Various provisions of the Banking Act 2004 aim to enhance asset quality of banks thereby preserving their financial soundness.

Section 36 of the Banking Act 2004 empowers the Bank to require any bank to undergo an independent assessment of credit worthiness or financial stability or undergo an independent appraisal to assess the value of its assets, in particular real estate and other related assets, by a person or organization nominated or approved by the Bank.

Under section 40 of the Banking Act 2004, banks incorporated in Mauritius are now legally bound to establish an Audit Committee consisting of not less than three independent directors as its members. The Audit Committee of a bank shall, *inter alia*, require the management of a bank to implement and maintain appropriate accounting and internal control and financial disclosure procedures, and review, evaluate and approve such procedures. The Committee should also review such transactions that could adversely affect the sound financial condition of a bank. Thus the Audit Committee is expected to play a significant role in the preservation of asset quality of banks.

Asset quality of banks very often depends upon the strength of their internal control systems. Banks should have in place effective internal control systems to safeguard their assets. In this connection, the Bank has issued Guidance Notes on General Principles for Maintenance of Accounting and Other Records and Internal Control Systems to banks since November 1994. Section 54 of the Banking Act 2004 requires every bank to maintain adequate internal control systems, commensurate with the nature and volume of its activities.

Further, the Bank has recently established the Mauritius Credit Information Bureau (MCIB) under the powers conferred upon it by section 52 of the Bank of Mauritius Act 2004. In June 2005, the Bank issued the Terms and Conditions which shall be binding on participants of the MCIB. The MCIB shall be a repository of both positive and negative credit information on all account holders. It would be mandatory for all participants to make the necessary enquiry from the MCIB before approving, increasing or renewing any credit facility.

The Bank conducts on-going off-site monitoring of banks with a view to detecting early warning signs of deterioration so that timely remedial action may be triggered. In this connection, the Bank has adopted a CAMEL rating system as an additional tool for off-site supervision. As from January 2005, the Bank communicates to all the former Category 1 banks on a quarterly basis their rating which, *inter alia*, includes a rating on asset quality. The rating on asset quality is based primarily on the magnitude of impaired assets, allowance for credit losses and large exposures of banks, and also on information gathered during on-site inspection.

Various directives in the form of guidelines have been issued by the Bank with the aim of safeguarding the financial soundness of banks. The directives require board of directors of banks to play a more dynamic and rigorous role in the decision making process, particularly in the credit area, through specialised committees consisting of members from the board.

The Guideline on Credit Concentration Limits imposes the duty upon the board members to assess and approve credit concentration risk policy and to review all significant exposures. Under the Guideline on Corporate Governance, the board of a bank is also required to review the adequacy of risk management policies, systems and procedures, to periodically assess their continuing effectiveness and to evaluate management's performance in controlling risks. The Conduct Review and Risk Policy Committee set up under the Guidelines on Related Party Transactions and Public Disclosure of Information is required to monitor and review, *inter alia*, related party transactions, most of which are likely to be credit related.

The Guideline on Credit Risk Management sets out the responsibilities and accountabilities of the board of directors and management (chief executive officer) in credit risk management. It also outlines the processes to be used in managing the credit activity.

The Guideline on Credit Impairment Measurement and Income Recognition, which focuses on the International Accounting Standard (IAS) 39, has the objective of ensuring that banks have adequate processes for determining allowance for credit losses, the carrying amounts of credit portfolio representing recoverable values and timely recognition of identified losses.

Market discipline is expected to foster a culture of transparency by making adequate information available to the public and thus imposing upon banks a self regulatory mechanism to safeguard the quality of their assets. In this connection, banks are required to disclose, as notes to their annual accounts, the level of credit concentration risk, non-performing advances and provision for credit losses by industry sectors as well as the magnitude of credit facilities to related parties. Banks are also required to disclose to the public their credit risk management policies, including the role of the board and management in the development, review, approval and implementation of credit risk management policies, and the procedures in place for the loan review function, related internal controls and monitoring.

During the year 2004-05, total assets of former Category 1 banks recorded a lower growth of 9.4 per cent compared to the growth of 13.0 per cent achieved in 2003-04.

There have been marked changes in the asset mix of former Category 1 banks on an aggregate basis in 2005. The ratio of advances to total assets, which was on a declining trend from 55.6 per cent in June 2003 to 52.2 per cent in June 2004, picked up to 52.6 per cent in June 2005. On the other hand, banks' investments in Government and similar securities, which form the bulk of liquid assets of banks and carry generally a lower rate of return compared to advances, constituted a lesser proportion of total assets in June 2005 as compared to June 2004. The ratio of such investments to total assets which was on a rising trend from 21.5 per cent in June 2003 to 25.6 per cent in June 2004, declined to 23.9 per cent in June 2005.

Cash reserves and bank balances constituted 10.9 per cent of the total assets of the banking sector at end-June 2005 compared to 9.9 per cent at end-June 2004. The ratio of fixed assets to total assets increased from 4.9 per cent to 5.5 per cent during the same period. On the other hand, the proportion of banks' investments in corporate shares to total assets has declined marginally from 2.6 per cent at end-June 2004 to 2.5 per cent at end-June 2005.

### 2.2.2.1 Advances

Most of the resources of former Category 1 banks are employed for extension of advances, which contribute to the bulk of the income of banks. The Bank has issued various guidelines on credit management by banks. On their own, banks pay particular attention to their advance portfolio so as to protect their profit line and avoid having to make unnecessary provisions. As a result, there is now a more measured approach to taking risks in the credit granting process.

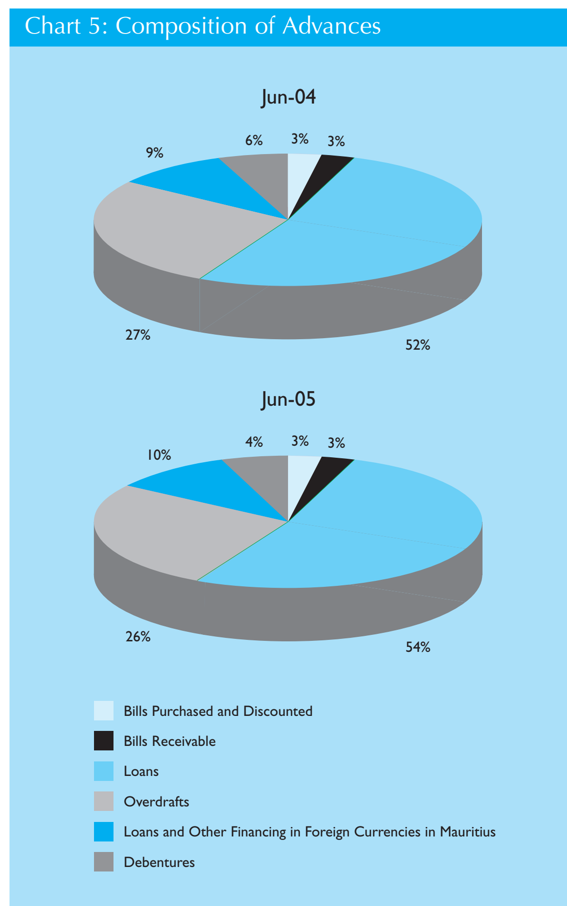
The ratio of advances to total assets fell from 55.6 per cent at end-June 2003 to 52.2 per cent at end-June 2004 but it increased marginally to 52.6 per cent at end-June 2005. Annual growth in advances of former Category 1 banks rose from 5.7 per cent in 2002-03 to 6.3 per cent in 2003-04 and 10.2 per cent in 2004-05. Total advances extended by banks increased by Rs9,270 million from Rs91,267 million at end-June 2004 to Rs100,537 million at end-June 2005, compared to an increase of Rs5,382 million in the preceding year.

Chart 5 compares different components of advances at end-June 2004 and end-June 2005. The shift from debentures and overdrafts to loans in local currency and loans and other financing in foreign currencies in Mauritius continued in 2004-05. In percentage terms, in 2004-05, loans and other financing in foreign currencies in Mauritius registered a growth of 19.0 per cent, followed by bills purchased and discounted (16.8 per cent), loans in local currency (13.9 per cent), overdrafts (7.1 per cent) and bills receivable (6.0 per cent), whereas investment in debentures declined by 25.1 per cent, from Rs5,335 million to Rs3,998 million due to redemption of these instruments.

### *Concentration of Risks*

The Bank's Guideline on Credit Concentration Limits, effective since May 2000, imposes limits on the exposure of banks to credit concentration. A locally

Chart 5: Composition of Advances




incorporated bank (other than a subsidiary of a foreign bank) and a branch or subsidiary of a foreign bank cannot extend credit facilities representing more than 25 per cent and 50 per cent, respectively, of the bank's capital base to any one customer/group of closely-related customers without the approval of the Bank. Also, all credit facilities extended to any one customer/group of closely-related customers for amounts aggregating 15 per cent or more of a bank's capital base (large exposures) should not in aggregate exceed 600 per cent of the capital base without the approval of the Bank.

Banks are required to report regularly all their large exposures to the Bank. At end-June 2005, large exposures of former Category 1 banks aggregated Rs39,331 million compared to Rs38,637 million at end-June 2004. The large exposures represented 32 per cent of overall on- and off-balance sheet commitments of banks compared to 35 per cent at end-June 2004. Overall, banks' large exposures as a percentage of capital base was 215 per cent at end-June 2005 down from 226 per cent at end-June 2004. On an individual basis, the ratios ranged from zero per cent to 621 per cent at end-June 2005 compared to 37 per cent and 556 per cent at end-June 2004.

Apart from exposure to credit concentration on single customers or groups of closely-related customers, banks may also be significantly exposed to specific sectors of the economy. At present, there is no regulatory limit on sectoral exposure. However, banks are expected to implement sound loan diversification policies to mitigate such risk. The Bank monitors the sectorwise credit exposure of banks on an on-going basis as well as the level of non-performing advances arising in each sector and provisions made thereon. This information is disclosed in the year-end financial statements of banks.

Chart 6 shows that the 'Construction' sector continued to account for the highest share of total credit to the private sector at 17.0 per cent compared to 15.4 per cent at end-June 2004 followed by credit to the 'Traders' sector which rose from 14.6 per cent of total private sector credit at end-June 2004 to 15.2 per cent at end-June 2005. The share of credit to the 'Tourism' sector declined marginally from 14.8 per cent at end-June 2004 to 14.3 per cent at end-June 2005. Credit to the 'Manufacturing' sector recorded a decline from 14.2 per cent of the total credit at end-June 2004 to 14.0 per cent at end-June 2005.

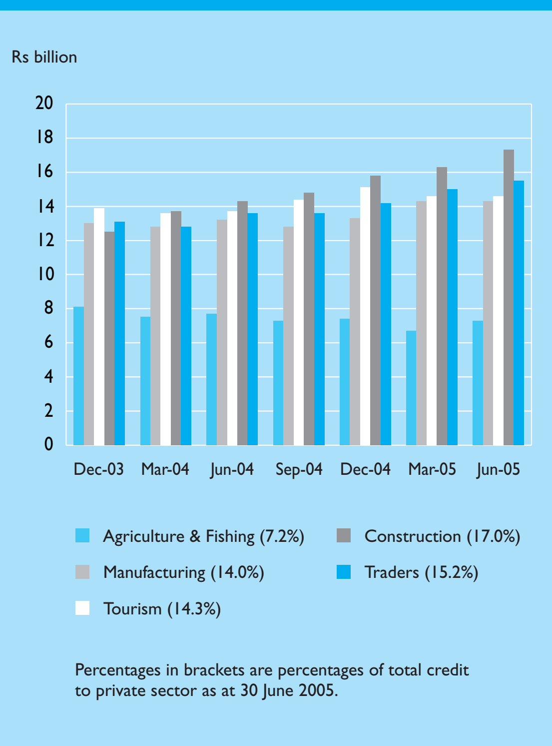
## *Loan Loss Provisioning*

With respect to the calculation of allowance for credit losses, the Bank issued the Guideline on Credit Impairment Measurement and Income Recognition in November 2004 based on fair value accounting principles in accordance with IAS 39. The Guideline requires banks to assess at balance sheet date whether there is any objective evidence that a financial asset or group of assets is impaired and to determine and reflect in the accounts the amount of impairment loss if there is evidence of impairment.

In accordance with the new Guideline, banks are required to maintain specific provisions on individually assessed credits as well as on portfolio assessed loans.

In order to determine the amount of impairment loss, the recoverable values of the financial assets should be estimated individually. A similar exercise should be

Chart 6: Sectorwise Distribution of Credit to Private Sector




Percentages in brackets are percentages of total credit to private sector as at 30 June 2005.

carried out on a portfolio basis for all other assets which have not been individually assessed. The recoverable amount of an individually assessed credit is based on the present value of future cash flows on the credit. The recoverable value of the collateral is based on an amount not exceeding 50 per cent of the appraised value of the collateral, discounted to its present value using the loan's effective interest rate. In determining the provisions for credit losses on individually assessed credits, the carrying amount of the loan should be netted against the present value of the expected future cash flows and the discounted net realisable value of the collateral. The result is the amount of provision to be made under individually assessed credits.

Loans that have not been individually assessed for impairment are assessed on a portfolio basis by classifying them into groups with similar characteristics and loss attributes and evaluated for impairment. In determining provisions for credit losses for the groups, factors such as past loan loss experience and current economic and other relevant conditions, including known adverse economic conditions likely to affect sectoral financial performance should be taken into account. However, the percentage of loan loss provision to aggregate amounts of loans in the entire portfolio should not be less than 1 per cent.

Apart from specific provisions on identified impaired loans and portfolio provisions, banks may also maintain a general provision to ensure the adequacy of the overall allowance for credit losses. This provision is appropriated from the institution's retained earnings for the year. Factors in support of a general provision are normally future-oriented and banks should exercise their best judgement to determine the amount of the general provision.

Total non-performing advances reported by former Category 1 banks dropped by 5.5 per cent from Rs7,638 million at end-June 2004 to Rs7,220 million at end-June 2005. Non-performing advances constituted 7.2 per cent of total advances at end-June 2005 compared to 8.4 per cent at end-June 2004. Non-performing advances by sectors of the economy and the respective loan loss provisions made over the period end-June 2003 to end-June 2005 are shown in Table 3. The 'Manufacturing', 'Construction', 'Traders' and 'Personal' sectors accounted for 85.2 per cent of the non-performing advances at end-June 2005.

Specific provisions for loan losses made by the banks went up to Rs4,461 million or 61.8 per cent of the non-performing advances at end-June 2005 compared to Rs3,174 million or 41.6 per cent of the non-performing advances at end-June 2004 mainly due to the application of the new Guideline on Credit Impairment Measurement and Income Recognition.

### 2.2.2.2 Investments in Securities

Investments in securities represent an important vehicle through which banks can channel their excess resources. This class of assets comprises Treasury Bills, Bank of Mauritius Bills and Government securities, and carries a zero risk weight for capital adequacy purposes.

Investments in securities increased from Rs44,792 million to Rs45,683 million between end-June 2004 and end-June 2005. Such investments still occupy a prominent position in the balance sheet of banks. At end-June 2005, such investments represented 31.9 per cent of total deposits and 23.9 per cent of total assets. The corresponding figures at end-June 2004 were 33.7 per cent and 25.6 per cent respectively.

| Table 3: Provision for Credit Losses by Industry Sectors | | | | | | |
|---|---|---|---|---|---|---|
| | **End-June 2003** | | **End-June 2004** | | **End-June 2005** | |
| | **Non-performing Advances** | **Specific Provision** | **Non-performing Advances** | **Specific Provision** | **Non-performing Advances** | **Specific Provision** |
| | **(Rs million)** | | | | | |
| Agriculture and Fishing | 96 | 16 | 93 | 28 | 94 | 94 |
| Manufacturing *(including EPZ)* | 2,481 | 970 | 2,626 | 1,258 | 1,763 | 1,185 |
| Tourism | 278 | 30 | 201 | 48 | 282 | 95 |
| Transport | 63 | 12 | 51 | 19 | 54 | 30 |
| Construction | 1,680 | 356 | 1,485 | 554 | 1,382 | 815 |
| Traders | 1,197 | 431 | 1,670 | 689 | 1,733 | 1,082 |
| Financial and Business Services | 146 | 21 | 51 | 35 | 53 | 44 |
| Personal *(including credit card advances)* | 939 | 216 | 1,131 | 368 | 1,271 | 669 |
| Professional *(including credit card advances)* | 58 | 17 | 77 | 21 | 109 | 64 |
| Others | 331 | 153 | 253 | 154 | 479 | 383 |
| **Total** | **7,269** | **2,222** | **7,638** | **3,174** | **7,220** | **4,461** |

### 2.2.2.3 Balances with Banks

Banks maintain working balances with their correspondent banks abroad to cater for their daily operational requirements such as satisfaction of payment obligations.

Balances held with banks by the former Category 1 banks recorded a significant increase between 2004 and 2005. As at end-June 2005, balances with banks went up by 55.7 per cent to Rs12,582 million.

### 2.2.2.4 Investments in Corporate Shares

Banks' investments in corporate shares include investments in subsidiaries and associates as well as shares of non-group companies.

Investments in corporate shares registered a growth of 7.4 per cent from Rs4,518 million at end-June 2004 to Rs4,852 million at end-June 2005. These investments are generally not held for trading in the banks' books.

### 2.2.2.5 Fixed Assets

The ratio of gross fixed assets to total assets stood at 5.5 per cent at end-June 2005, up from 4.9 per cent at end-June 2004.

Fixed assets of former Category 1 banks increased from Rs8,532 million at end-June 2004 to Rs10,582 million at end-June 2005. During the year ended 30 June 2005, banks made additional provision for depreciation amounting to Rs322 million causing the accumulated depreciation to stand at Rs4,013 million. On a net basis, fixed assets stood at Rs6,569 million at end-June 2005 as opposed to Rs4,841 million at end-June 2004. Banks' revaluation reserves stood at Rs392 million at end-June 2005 as compared to Rs286 million at end-June 2004.

### 2.2.2.6 Cash Reserves

As at 30 June 2005, banks were required to maintain a minimum of 5.5 per cent of their deposit liabilities as cash reserves which comprise cash in hand and balances with Bank of Mauritius. These assets are highly liquid and do not carry any risk. Consequently, banks are not required to maintain capital with respect to these assets.

Cash reserves of former Category 1 banks fell from Rs8,709 million at end-June 2004 to Rs8,259 million at end-June 2005. These reserves constituted 4.3 per cent of total assets at end-June 2005 compared to 5.0 per cent at end-June 2004. For individual banks, the percentage ranged from 2.3 per cent to 5.6 per

cent at end-June 2005 compared to 2.7 per cent and 9.1 per cent at end-June 2004.

### 2.2.3 MANAGEMENT

Experience has shown that focus on good quality management is critical to the success of banks. Banks around the world are operating in a dynamic and ever competitive environment. They are also engaging in ever diverse and wide ranging activities. Thus, it is essential for banks to ensure that sustainable objectives are defined and met through proper strategic planning, coordination and risk management. Coupled with these measures, banks are called upon to remedy their weaknesses, analyse their strengths, take advantage of opportunities and make adequate provision to face potential threats.

To that effect, the Bank issued the Guideline on Corporate Governance in April 2001 highlighting the responsibility of the board and senior executives in setting out the vision and putting in place the infrastructure for the achievement of balanced short and long-term goals. According to the Guideline, the board is responsible for the stewardship of a bank, setting its overall direction and supervising the management of its business.

Studies have shown that the board directors of a large number of failed banks lacked basic knowledge about the banks' affairs. For example, the boards did not have any notion of the level of risks faced by their institutions and their members were unable to properly analyse their banks' financial statements or take the right decisions regarding management of the banks.

Thus, to ensure that risks faced by banks are minimised, it is desirable for board members to possess demonstrated expertise and experience relevant to issues such as financial controls, capital management, banking risks and corporate planning. A board must be strong, independent and actively involved in the bank's affairs. Both the bank directors and the executive management must adhere to high ethical standards and be fit and proper. The Banking Act 2004 has brought significant changes in the way directors and top management should assume responsibility and manage banks.

Section 7 (2)(a)(i) of the Banking Act 2004 stipulates that no banking licence shall be granted by the central bank unless it is satisfied that the applicant has demonstrated that the proposed directors or senior officers have technical knowledge, experience in banking or finance and are fit and proper persons to carry on the proposed banking business.

Section 46(1) of the Act requires that no person shall be appointed or reappointed as director of a financial institution unless the appointment or reappointment takes into account the guidelines issued by the central bank relating to fit and proper persons. The senior officers and directors must on a prior basis demonstrate their competence, honesty, diligence, probity and integrity to manage a bank.

In accordance with sections 46(2)(c) and 46(4) of the Act, the appointment or reappointment of senior officers can be approved only if the Bank is satisfied that they meet the fit and proper criteria.

To ensure sound management of banks, a further restriction is imposed on their shareholding structure. In this context, the Banking Act 2004 stipulates that, except with the approval of the Bank, no single person can hold directly or indirectly 10 per cent or more of the capital or of the voting rights of a bank. The object of this provision is to ensure that no single person can exercise a significant influence over the management of a bank.

To ensure that the management of a bank does not take undue risks, section 18(5) of the Act stipulates that "no financial institution shall employ any person whose remuneration is linked to the income of the financial institution or to the level of activities on customers' accounts". This measure acts as a safeguard against employees of banks indulging in practices that carry excessive risks but offer attractive returns to the detriment of the bank. In that case, such practices may be detrimental to the interest of depositors.

With regard to self-dealing, the Bank has issued the Guideline on Related Party Transactions whereby all transactions entered into by any director or officer of senior management with the bank have to be carried out at arm's length. The Guideline imposes limits on individual and aggregate exposures to related parties. Dealings with related parties will have to be disclosed in the bank's year-end financial statements. Moreover, the Guideline on Public Disclosure of Information also highlights the need for financial institutions to provide aggregated data on its

on- and off-balance sheet credit exposure to related parties relative to the institution's exposure to all customers. Section 28(2) of the Banking Act 2004 stipulates that the central bank may determine the maximum limits of credits and off-balance sheet commitments, which a bank or non-bank deposit taking institution may grant to a related party or to all related parties.

With a view to eliminate any conflict of interest in the manner in which the banks' affairs are conducted, section 48(1) of the Banking Act 2004 requires that any director or senior officer disclose in writing the nature and extent of his interest in an advance, loan or credit from the bank to the board of directors. Furthermore, there may also be situations where conflict of interest may be created during acquisition of property or holding office whether directly or indirectly by a director or senior officer. In this connection, section 48(4) of the Banking Act 2004 requires that these persons abstain from taking part in any deliberation relating thereto.

To ensure good governance of banks, the Guideline on Corporate Governance requires the establishment of various committees, namely, Audit Committee, Risk Management and Conduct Review Committee, and Executive Committee, comprising mostly independent directors to oversee the way in which the affairs of the bank are conducted by top management.

The Guideline on Operational Risk Management and Capital Adequacy Determination issued in February 2005 requires the establishment of a written policy on operational risk by management where the bank has to define its appetite and tolerance for operational risk and the principles for identifying, assessing, monitoring and controlling/mitigating operational risk.

During on-site inspections, a thorough assessment of management is carried out. The CAMEL rating ascribed to banks and communicated to them on a quarterly basis, incorporates a rating on management based on the Bank's findings during the on-site inspection and thereafter.

### 2.2.4 PROFITABILITY

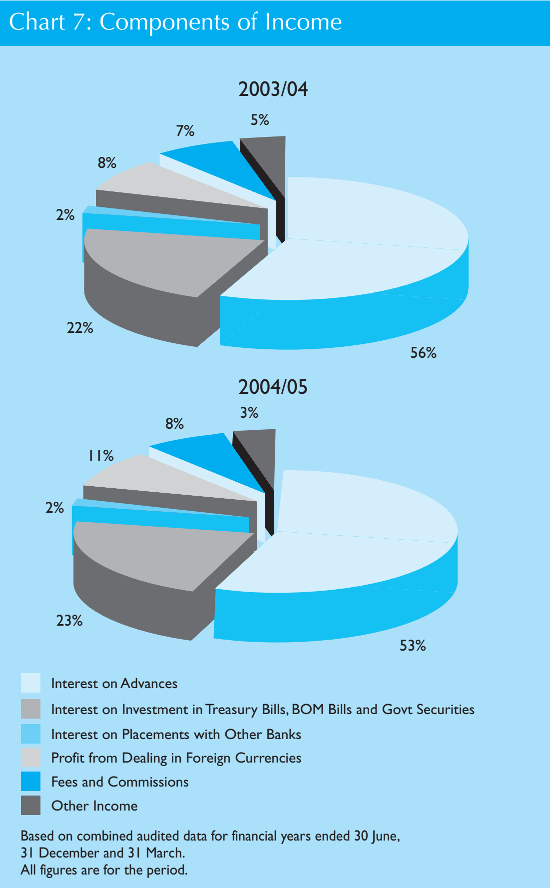
This section reviews the profitability of banks formerly known as Category 1 banks.

The profit performance of former Category 1 banks over the past three years is summarised in Table 4. The consolidated profitability figures are based on the audited results of the eleven banks operating during

Table 4: Consolidated Profit Performance

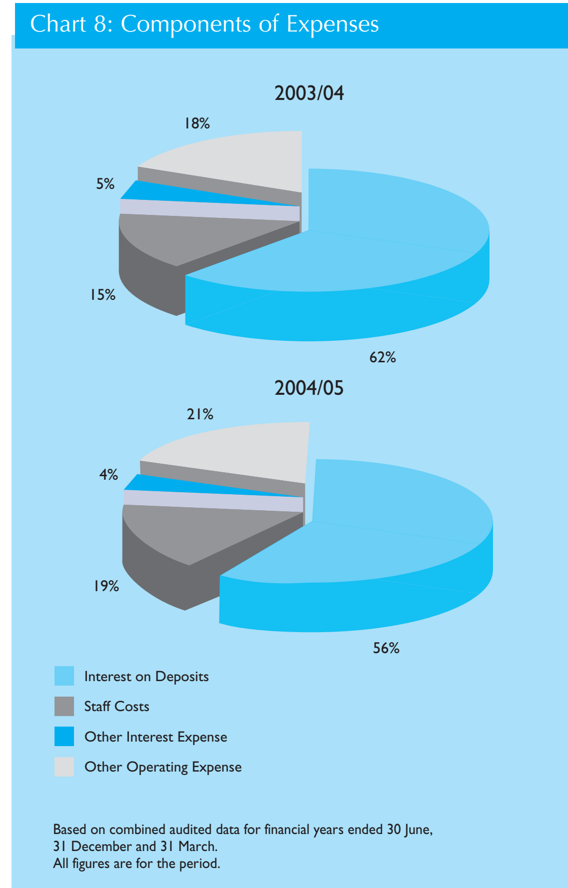
| | 2002/03 | 2003/04 (Rs million) | 2004/05 |
|---|---|---|---|
| **Total Interest Income** | **10,572** | **12,154** | **11,883** |
| Interest Income from Advances | 8,075 | 8,493 | 8,079 |
| Interest Income from Investment in Treasury Bills, | | | |
| Bank of Mauritius Bills and Government securities | 2,187 | 3,331 | 3,473 |
| Other Interest Income | 310 | 330 | 331 |
| **Total Interest Expenses** | **6,371** | **7,232** | **6,529** |
| Interest Expense on Deposits | 6,059 | 6,750 | 6,039 |
| Other Interest Expense | 312 | 482 | 490 |
| **Net Interest Income** | **4,201** | **4,922** | **5,354** |
| Add: Non-interest Income | 2,093 | 3,005 | 3,323 |
| **Operating Income** | **6,294** | **7,927** | **8,677** |
| Less: Staff Costs | 1,341 | 1,659 | 2,013 |
| Other Operating Expenses | 1,600 | 1,994 | 2,254 |
| **Operating Profit before Bad and Doubtful Debts and Taxation** | **3,353** | **4,274** | **4,410** |
| Less: Charge for Bad and Doubtful Debts | 906 | 805 | 907 |
| Exceptional Items | 37 | 520 | 129 |
| **Operating Profit** | **2,410** | **2,949** | **3,374** |
| Share of Profits in subsidiaries and associates | 201 | 163 | 216 |
| **Profit before Tax** | **2,611** | **3,112** | **3,590** |

Chart 7: Components of Income




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

Chart 8: Components of Expenses




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

2004/05 involving financial years ended 30 June, 31 December and 31 March, and are referred to as 2004/05. Former Category 1 banks realised an overall pre-tax profit of Rs3,590 million in 2004/05 as compared to Rs3,112 million in 2003/04.

Charts 7 and 8 compare the main components of income and expenses respectively, for the periods 2003/04 and 2004/05.

### 2.2.4.1 Income

Total income of former Category 1 banks increased from Rs15,159 million in 2003/04 to Rs15,206 million in 2004/05, representing a marginal increase of 0.3 per cent. Advances and investments in Treasury Bills, Bank of Mauritius Bills and Government securities remain the main sources of income for former Category 1 banks, accounting for an average of 79.2 per cent of their total income through the years 2000/01 to 2004/05.

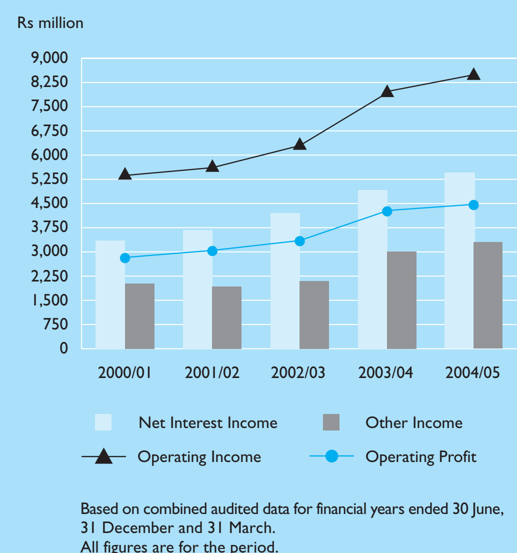
The share of non-interest income in the overall earnings of banks increased further as income generated by banks from their non-core activities continued to increase at a higher rate than their interest earnings, as may be seen from Table 5. During 2004/05, former Category 1 banks registered a drop of 2.2 per cent in interest income while other income went up by 10.6 per cent. Accordingly, the ratio of non-interest income in total revenue increased from 19.8 per cent in 2003/04 to 21.9 per cent in 2004/05.

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

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

| | 2002/03 | 2003/04 | 2004/05 |
|---|---|---|---|
| Growth in Interest Income (%) | 4.7 | 15.0 | -2.2 |
| Growth in Non-Interest Income (%) | 8.6 | 43.6 | 10.6 |

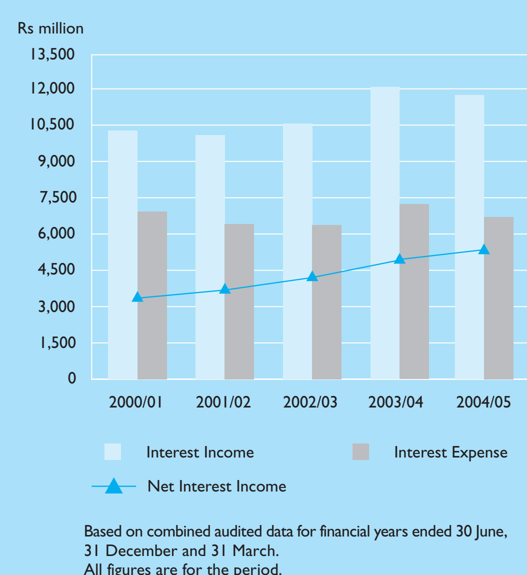
Chart 9: Evolution of Net Interest Income, Other Income, Operating Income and Operating Profit




### 2.2.4.2 Net Interest Income

Chart 10 shows the increasing trend, albeit at a lower rate in 2004/05, in net interest income for former Category 1 banks from 2000/01 through 2004/05. The falling interest rates during 2004 coupled with the persistently low demand for loan dampened down the growth rates of the key components of interest income as may be observed from Table 6, resulting in a decline in total interest income from Rs12,154 million in 2003/04 to Rs11,883 million in 2004/05. Interest earned from lending activities contracted by Rs414 million to reach Rs8,079 million in 2004/05, representing 68.0 per cent of total interest income as compared to 69.9 per cent in 2003/04. On the other hand, interest earned by banks on their holdings of Treasury Bills, Bank of Mauritius Bills and Government securities increased from 27.4 per cent of total interest income in 2003/04 to 29.2 per cent for the year under review. Interest received on placements with other banks remained stable at 2.8 per cent of total interest income.

Chart 10: Components of Net Interest Income




Total interest expense comprising interest paid on deposits and borrowings from other banks and financial institutions, stood at Rs6,529 million for 2004/05, down by Rs703 million or 9.7 per cent over the previous period. Interest paid on deposits fell sharply by Rs711 million or 10.5 per cent in 2004/05 in spite of the 14.3 per cent increase recorded in average deposits of the former Category 1 banking sector during that period reflecting the fall in cost of funds. Cost of borrowings from other banks and financial institutions, constituting 7.5 per cent of total interest expense of former Category 1 banks posted a slight increase of Rs8 million during 2004/05. Net interest income increased by Rs432 million or 8.8 per cent from Rs4,922 million in 2003/04 to Rs5,354 million in 2004/05.

As can be seen from Table 7, interest earned on Rs100 of advances dropped by Rs1.18 in 2004/05 as compared with a higher decrease of Rs1.30 on the interest paid on Rs100 of deposits in the same period. Consequently, the interest spread widened from Rs3.72 to Rs3.84.

### 2.2.4.3 Non-Interest Income

Non-interest income grew by a moderate 10.6 per cent to Rs3,323 million in 2004/05 following the 43.6 per cent rise registered in 2003/04 on account of a significant non-recurrent income recorded by one bank which boosted up the overall non-interest income. Income in the form of fees and commissions, and profit from dealing in foreign currencies contributed to 36.8 per cent and 48.4 per cent respectively of total non-interest related revenue. During 2004/05, fee-related income and profit arising from dealing in foreign currencies posted

| Table 6: Growth in Interest on Advances v/s Growth in Interest on Treasury Bills, Bank of Mauritius Bills and Government Securities | 2002/03 | 2003/04 | 2004/05 |
|---|---|---|---|
| Growth in Interest earned on Advances (%) | 1.4 | 5.2 | -4.9 |
| Growth in Interest Income from Treasury Bills, Bank of Mauritius Bills and Government securities (%) | 26.4 | 52.3 | 4.3 |

| Table 7: Interest Spread | 2002/03 | 2003/04 | 2004/05 |
|---|---|---|---|
| Interest earned on Rs100 of advances | 9.97 | 9.72 | 8.54 |
| Cost per Rs100 of deposits | 6.18 | 6.00 | 4.70 |
| Interest spread | 3.79 | 3.72 | 3.84 |

growths of 21.1 per cent and 18.3 per cent respectively or increases of Rs213 million and Rs249 million.

### 2.2.4.4 Non-Interest Expenses

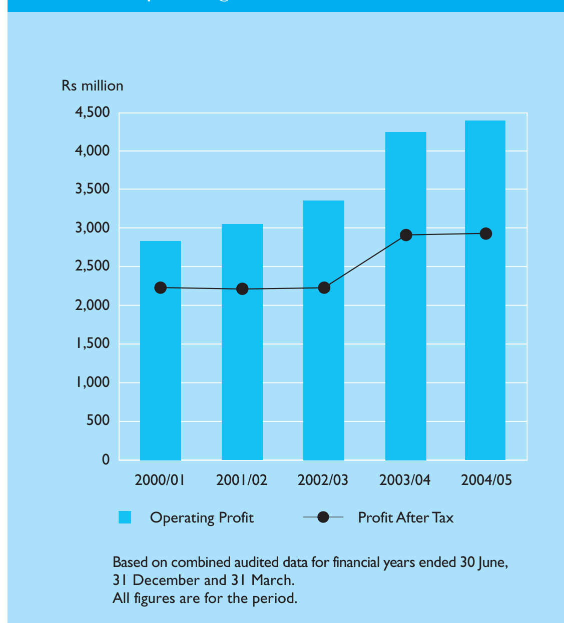
Non-interest expenses consisting of staff costs and other operating expenses were contained in 2004/05, rising by 16.8 per cent to Rs4,267 million as compared to the 24.2 per cent increase recorded in 2003/04. Staff costs rose by 21.3 per cent in 2004/05 stemming from the growth in human resource of banks in response to the increasing volume of transactions combined with the strengthening of controls as part of their risk management programmes. The number of staff of former Category 1 banks increased from 3,504 to 4,080. Other operating expenses increased by 13.0 per cent to stand at Rs2,254 million in 2004/05.

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) increased from 51.3 per cent in 2003/04 to 54.9 per cent in 2004/05.

### 2.2.4.5 Operating Profit

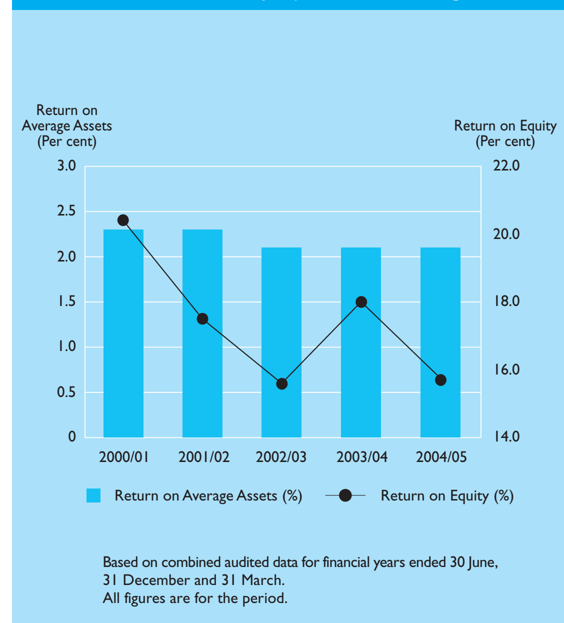
Former Category 1 banks realised operating profit before bad and doubtful debts of Rs4,410 million for 2004/05 representing an increase of Rs136 million

Chart 11: Operating Profit and Profit After Tax




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

Chart 12: Return on Equity and on Average Assets




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

or 3.2 per cent over the figures of 2003/04. Profit before tax achieved by the banks for 2004/05 reached Rs3,590 million, 15.4 per cent higher than the pre-tax profit of Rs3,112 million realised in 2003/04. Chart 11 depicts the evolution in former Category 1 banks' profit through the years 2000/01 to 2004/05.

### 2.2.4.6 Return on Average Assets and Equity

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

The return on average assets which relates earnings to the asset size of banks improved from 2.08 per cent in 2003/04 to 2.13 per cent in 2004/05, indicating a higher efficiency in management's decisions in relation to asset structure and pricing. With the exception of two banks, all individual banks recorded a positive return on average assets in 2004/05 ranging from a low of 0.8 per cent to a high of 3.4 per cent. Five former Category 1 banks achieved ratios above 2 per cent. The negative returns recorded by the two banks were mainly due to the impact of significant provisions set aside for bad and doubtful debts and higher expenses associated with the initial years of business.

Return on equity fell from 18.0 per cent in 2003/04 to 15.7 per cent in 2004/05, attributable, among others, to the higher tax provisioning in the period under review. For individual banks, return on equity ranged from a low of negative 47.1 per cent to a high of 24.2 per cent in 2004/05 with five banks achieving ratios of over 15 per cent, compared to a low of 0.4 per cent to a high of 25.8 per cent in 2003/04.

Chart 12 shows the variations in returns on average assets and equity over the period 2000/01 to 2004/05.

### 2.2.5 LIQUIDITY

Sound liquidity management is critical to a healthy financial sector. The vulnerability of banks to sudden and unexpected demands for funds renders efficient liquidity management pivotal to their operations. Therefore, banks must develop qualitative and quantitative standards to be able to measure, assess and control their liquidity position at all times, including stressful events in the market. The overriding objective of a bank's liquidity policy is to be able to maintain adequate liquidity at all times, so as to be in a position to meet its liabilities and obligations as they fall due.

Liquidity shortfalls in a single institution can have system-wide repercussions. The Guideline on Liquidity issued by the Bank in January 2000 requires banks to establish and implement prudent liquidity management policies including, *inter alia*, cash flow projections, maintenance of readily available high quality liquid assets, measurement and control of funding requirements. The Guideline also lays emphasis on good management information systems, analysis of net funding requirements under alternative scenarios, diversification of funding sources and contingency planning for proper liquidity management within banks. In addition, banks are required to establish prudential maturity mismatch limits for their cumulative funding positions as reflected by the maturity profiles at various selected time bands.

### 2.2.5.1 Cash Ratio

As can be observed from Chart 13, former Category 1 banks averaged a monthly cash ratio ranging from 5.8 per cent to 6.4 per cent in 2004-05, whereas in 2003-04, the ratio varied from 5.8 per cent

Chart 13: Fluctuations in Monthly Average Cash Holdings and in Monthly Average Cash Ratio

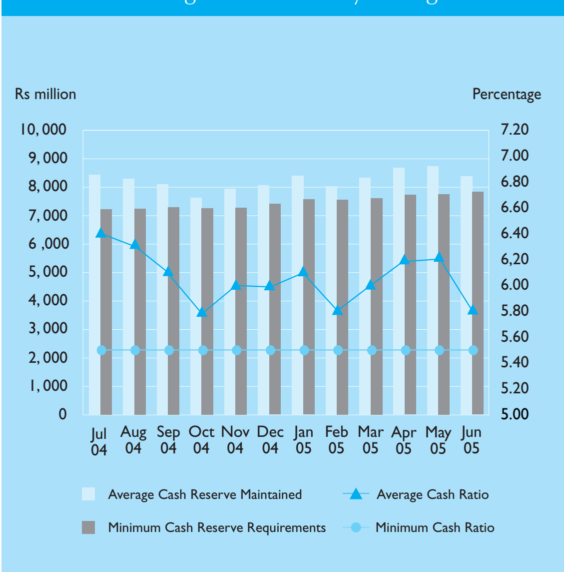


**Table 8: Deposit Structure**

| | 2003 (Rs million) | End of June 2004 (Rs million) | 2005 (Rs million) |
|---|---|---|---|
| Demand | 16,320 | 19,504 | 20,663 |
| | *(14.0)* | *(14.7)* | *(14.4)* |
| Savings | 51,573 | 61,720 | 68,856 |
| | *(44.4)* | *(46.5)* | *(48.1)* |
| Time | 48,403 | 51,554 | 53,711 |
| | *(41.6)* | *(38.8)* | *(37.5)* |
| **Total** | **116,296** | **132,778** | **143,230** |
| | *(100.0)* | *(100.0)* | *(100.0)* |

*Figures in brackets are percentages to total*

to 7.1 per cent. During the year under review, former Category 1 banks were required to maintain a minimum average weekly cash reserve, consisting of cash in hand and balances with Bank of Mauritius, of 5.5 per cent of their total deposit liabilities inclusive of foreign currency deposits.

### 2.2.5.2 Non-Cash Liquid Assets Ratio

Though there is no mandatory requirement for former Category 1 banks to observe a minimum non-cash liquid assets ratio, banks have been advised to exercise prudential management by maintaining an adequate stock of unencumbered, high quality liquid assets to cater for any unexpected liquidity pressures or fluctuations under both normal and adverse operating conditions. Readily liquefiable assets allow a bank to meet its obligations without the burden of a substantial discount while liquidity problems are being addressed. The liquid portfolio should be diversified to avoid any undue reliance on any one class of liquid assets.

During the year under review, former Category 1 banks' holdings of Treasury Bills, Bank of Mauritius Bills and Government securities, which are the most liquefiable non-cash assets of banks rose by an amount of Rs891 million from Rs44,792 million at end-June 2004 to Rs45,683 million at end-June 2005, and represented 23.9 per cent of total assets at end-June 2005, lower than 25.6 per cent in the previous year.

Such investments expressed as a percentage of total deposits stood at 31.9 per cent as at end-June 2005 as compared to 33.7 per cent a year earlier.

### 2.2.5.3 Deposits

Deposits remained former Category 1 banks' primary source of funding representing an average of 75 per cent of their total funds over the last three years. During the year under review, deposit growth slowed down to 7.9 per cent, as compared to a growth of 14.2 per cent recorded during 2003-04. As at end-June 2005, deposits mobilised went up by Rs10,452 million to Rs143,230 million. Of the increase in total deposits, increase in savings accounted for Rs7,136 million or 68.3 per cent.

As may be seen from Table 8, deposits maintained the same configuration over the past three years with savings and time deposits representing in aggregate 85.6 per cent of the total deposits. The gradual shift in the composition of deposits from time to savings deposits in the banking sector's deposit base during the same period persisted, stemming to some extent from the fierce competition emanating from non-bank deposit taking sector which sustained an annual growth of 16 per cent in its deposit base over that period.

### *Concentration of Deposits*

The liquidity management of banks encompasses their ability to anticipate depositors' demands through evaluations of the volatility of their deposit base. Table 9 gives the value range of deposits of the banking sector as at end-June 2005. It may be observed that banks hold a large deposit base of relatively low value accounts, thus providing the banking sector with a cushion against sudden withdrawals from large deposit accounts. Furthermore, the "Personal sector" which

| Table 9: Value Range of Deposits | | | |
|---|---|---|---|
| | | End of June 2005 | |
| | No of accounts | Amount (Rs million) | Percentage to Total Deposits |
| Up to Rs 1 million | 1,689,345 | 76,984 | 53.7 |
| Over Rs 1 million to Rs 5 million | 15,146 | 28,652 | 20.0 |
| Over Rs 5 million | 1,986 | 37,594 | 26.3 |

| Table 10: Maturity Structure of Time Deposits | | | | |
|---|---|---|---|---|
| | June-2004 | | June-2005 | |
| | Amount (Rs million) | % of Time Deposits | Amount (Rs million) | % of Time Deposits |
| Up to 12 months | 28,740 | 55.7 | 31,648 | 58.9 |
| Over 12 months to 48 months | 16,112 | 31.3 | 14,496 | 27.0 |
| Over 48 months | 6,702 | 13.0 | 7,567 | 14.1 |
| | **51,554** | **100.0** | **53,711** | **100.0** |

carries a lower withdrawal risk than large corporate accounts remained banks' main source of deposits accounting for over 70 per cent of total deposits.

### *Maturity of Deposits*

The maturity pattern of time deposits enables banks to gauge the expected calls on their deposits over a period of time and thus match their inflow to mitigate the liquidity risk. At end-June 2005, time deposits spread within a maturity period of up to 12 months represented 58.9 per cent of total deposits with fixed maturity as against 55.6 per cent a year earlier indicating a higher liquidity preference for short-term deposits. On the other hand, the share of fixed deposits with maturity exceeding 48 months was slightly higher at end-June 2005 when compared to a year earlier as may be observed from Table 10.

### *Advances to Deposits Ratio*

Advances to deposits ratio is a simple measure of liquidity which describes the extent to which banks have utilised funds from their deposits to finance their lending activities. The ratio which has been declining steadily in recent years, from 78.3 per cent at end-June 2002 to 73.9 per cent and 68.7 per cent at end-June 2003 and 2004 respectively, edged up slightly to 70.2 per cent at end-June 2005. This is explained by the higher growth registered during 2004-05 in the loan portfolio of banks triggered by the aggressive marketing strategy embarked upon by some of them in view of reducing the prevailing excess liquidity situation which was driving them to maintain excessive low income generating liquid assets.

### 2.2.5.4 Interbank Transactions

The interbank money market is another important source of liquidity for banks in both normal and crisis conditions. Banks with excess liquidity can channel their surplus funds to other banks with short liquidity positions. Transactions are mainly short-term, ranging from overnight to call deposits for periods of up to one month. Daily average transactions on the interbank market decreased from Rs239 million in 2003-04 to Rs174 million in 2004-05, fluctuating between a minimum of Rs10 million and a maximum of Rs465 million during the year under review. In formulating liquidity management procedures, banks should estimate their normal borrowing capacity in the interbank money market and establish a policy accordingly. When markets are thin or segmented, banks may resort to repurchase transactions or borrow under the Lombard facility from the Bank.

## 2.3 ELECTRONIC BANKING TRANSACTIONS

As at end-June 2005, eight of the former Category 1 banks were providing electronic banking services. The volume of transactions using electronic delivery channels witnessed substantial growth during the past three years. The monthly average number of transactions involving the use of credit and debit cards at Automated Teller Machines (ATMs) and Merchant

| Table 11: Electronic Banking Transactions | | | | | |
|---|---|---|---|---|---|
| | **Jun-04** | **Sep-04** | **Dec-04** | **Mar-05** | **Jun-05** |
| **At end of Month**<br>**No. of ATMs in Operation** | **273** | **278** | **283** | **283** | **293** |
| **During the Month**<br>**No. of Transactions** | 2,286,308 | 2,420,260 | 3,285,091 | 2,583,371 | 2,525,605 |
| **Value of transactions (Rs mn)**<br>(Involving the use of Credit Cards and Debit Cards at ATMs and Merchant Points of Sale) | 3,598 | 3,965 | 6,430 | 4,424 | 4,096 |
| **At end of Month**<br>**No. of Cards in Circulation** | | | | | |
| Credit Cards | 171,764 | 173,979 | 176,562 | 178,947 | 182,860 |
| Debit Cards and others | 659,622 | 674,409 | 691,864 | 706,516 | 725,816 |
| **Total** | **831,286** | **848,388** | **868,426** | **885,463** | **908,676** |
| **At end of Month**<br>**Outstanding Advances on Credit Cards (Rs mn)** | 822.0 | 864.4 | 902.9 | 890.0 | 907.3 |

Points of Sale increased from 2.0 million in 2002-03 to 2.4 million in 2003-04 and further to 2.6 million in 2004-05 for monthly average amounts of Rs3,290 million, Rs3,940 million and Rs4,460 million respectively.

Between end-June 2004 and end-June 2005, the number of ATMs in operation in Mauritius, inclusive of Rodrigues, increased by 20 from 273 to 293 while the number of cards in circulation grew significantly by 77,290 from 831,386 to 908,676. The number of debit cards rose by 9.9 per cent while that of credit cards increased by 6.5 per cent.

At end-June 2005, outstanding advances on 182,860 credit cards in circulation amounted to Rs907 million, indicating an average outstanding amount of Rs4,960 per card.

Table 11 shows the quarterly positions of former Category 1 banks' electronic banking transactions from end-June 2004 to end-June 2005.

## 2.4 PERFORMANCE OF FORMER CATEGORY 2 BANKS

The main objective of the Government of Mauritius has always been to promote Mauritius as a reputable financial centre. In this connection, the Bank has applied a rigorous regime to ensure that only reputable banking institutions having a proven track record are licensed to operate in this sector. Section 7 of the Banking Act 2004 pertaining to the "Grant or refusal to grant banking licence" lays down the conditions which the Bank considers before granting a banking licence.

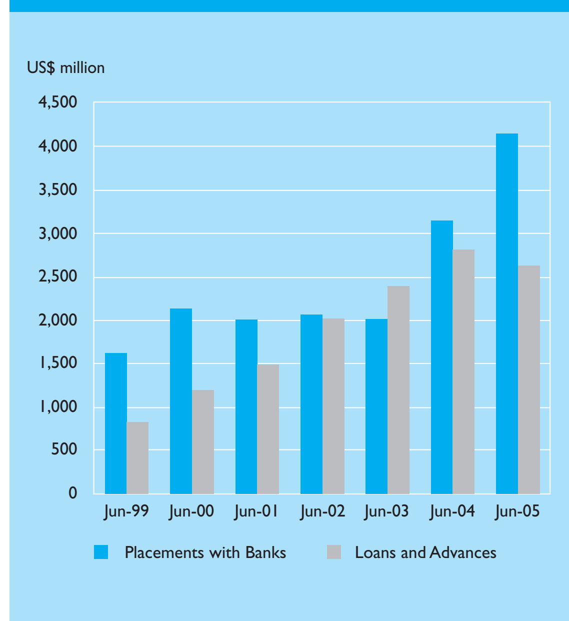
As mentioned earlier, the enactment of the Banking Act 2004 has removed the distinction between the different categories of banks existing prior to this date. The dual licensing system has been replaced by a single banking licence. Hence, all banks can carry out both domestic and international banking transactions. All banks are accordingly free to transact in all currencies, including the Mauritian rupee with both residents and non-residents. Furthermore, former Category 2 banks will have to comply with all the guidelines and instructions that have been issued but which were not applicable to them previously.

A detailed review of the performance of the former Category 2 banks over the past two years is outlined in the following paragraphs.

### 2.4.1 ASSETS

The activities of the former Category 2 banks continued to grow during the year ended 30 June 2005. The overall asset base of these banks went up by US$1,269 million or 19.2 per cent from US$6,617 million at end-June 2004 to US$7,886 million at end-June 2005 compared to a growth rate of 41.1 per cent recorded last year.

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




The main income generating assets of the former Category 2 banks remained placements with banks and advances to non-bank customers, which together accounted for 87 per cent of total assets. However, the relative share of these two classes of assets shifted slightly as the proportion of advances extended to non-bank customers as a percentage to total assets of the sector fell from 43.3 per cent in 2004 to 33.8 per cent in 2005. This decline impacted directly on placements which caused its ratio to total assets to rise from 47.6 per cent to 53.1 per cent.

Chart 14 shows the trend in the growth of advances to non-bank customers and placements during the past seven years. It may be observed therefrom, that with the exception of the year ended 30 June 2003, placements with banks have always been the main activity of these banks.

### 2.4.1.1 Placements with Banks

Placements comprising the bulk of the former Category 2 banks' total assets increased by US$1,037 million or 32.9 per cent from US$3,151 million at end-June 2004 to US$4,188 million at end-June 2005, of which, 89.5 per cent were effected with head office, branches and sister companies.

At end-June 2005, more than 80 per cent of the total placements were made in three countries, namely, Hong Kong (39.5 per cent), United Kingdom (38.8 per cent) and South Africa (6.5 per cent).

### 2.4.1.2 Loans and Advances to Non-Bank Customers

Advances to non-bank customers declined by US$177 million or by 6.3 per cent from US$2,817 million to US$2,640 million at end-June 2005 as compared to a growth of 17.4 per cent in the preceding year.

As at 30 June 2005, former Category 2 banks' advance portfolio comprised mainly credit to non-residents which accounted for 85.3 per cent thereof as compared to 81.4 per cent a year earlier. Loan facilities to companies holding global business licences domiciled in Mauritius stood at US$252 million or 9.6 per cent of total advances against US$389 million or 13.8 per cent in the preceding year. Advances to residents remained stable at US$135 million and at end-June 2005, it accounted for 5.1 per cent of total advances extended by these banks.

### 2.4.1.3 Investments

Investments in shares and securities soared by 125 per cent from US$379 million at end-June 2004 to US$855 million at end-June 2005. Consequently, the share of investments to total assets nearly doubled, going up from 5.7 per cent to 10.8 per cent during this period.

During the year under review, former Category 2 banks secured additional foreign securities, other than those issued by foreign governments, amounting to US$434 million bringing their total holdings of such securities to US$803 million.

## 2.4.2 FUNDING

Chart 15 shows the trend in non-bank deposits and borrowings during the past seven years. The former Category 2 banks continued to raise the bulk of their funds by way of deposits from non-bank customers and borrowings from banks which, altogether accounted for 89.6 per cent of their total resources at end-June 2005.

Borrowings from banks accounted for 38.4 per cent of total resources as compared to 45.0 per cent a year earlier. On the other hand, the share of deposits mobilised from non-bank customers to total resources stood at 51.2 per cent up from 40.0 per cent at end-June 2004.

During the year under review, former Category 2 banks relied more on non-bank deposits rather than on borrowings to finance their activities contrary to the previous years. This is clearly reflected in the higher monthly average figure of non-bank deposits of US$3,013 million as compared to the monthly average borrowings of US$2,954 million. The corresponding figures for the preceding year stood at US$2,346 million and US$2,474 million, respectively.

### 2.4.2.1 Non-Bank Deposits

Total deposits from non-bank customers went up by 52.4 per cent or by US$1,388 million from US$2,650 million to US$4,038 million at end-June 2005 on the back of an increase of US$713 million or 36.8 per cent in the preceding year.

The composition of non-bank deposits showed that the level of fixed deposits in total deposits continued to fall. This ratio stood at 47.1 per cent at end-June 2005 as compared to 52.9 per cent at end-June 2004 and 65.1 per cent at end-June 2003.

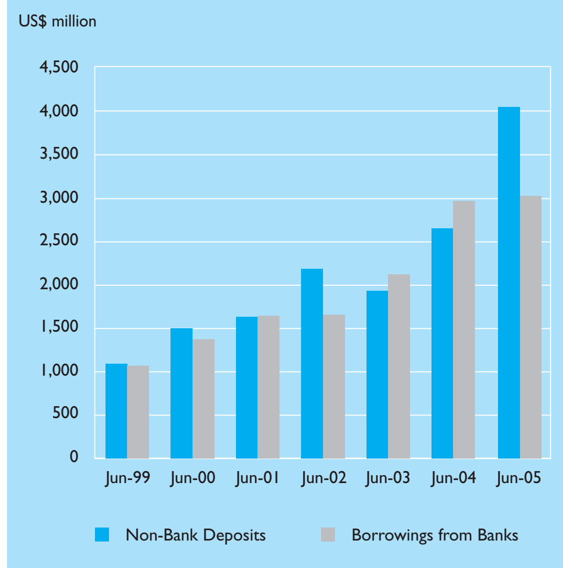
### 2.4.2.2 Borrowings from International Money Market

Borrowings from the international money market rose marginally by 1.7 per cent from US$2,975 million at end-June 2004 to US$3,027 million at end-June 2005 as opposed to 39.9 per cent increase recorded a year earlier.

Funds borrowed outside Mauritius accounted for 97.2 per cent of total borrowings. During the year, these banks continued to rely heavily on borrowed funds from their head office, parent bank, subsidiaries and fellow subsidiaries and as at 30 June 2005, these borrowings amounted to US$2,368 million increasing by 14.1 per cent from the preceding year.

Borrowings from banks outside Mauritius, other than intra-group banks, declined from US$841 million at end-June 2004 to US$576 million at end-June 2005 while borrowings from banks in Mauritius rose from US$58 million to US$83 million during the same period.

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




## 2.4.3 PROFITABILITY

Of the twelve banks operating under former Category 2 banking licence, eight close their accounts on 31 December, three on 31 March and one on 30 June. The consolidated position of the profit and loss accounts of the twelve banks based on the combined data of the three different financial year-ends up to March 2005 is referred to as 2004/05.

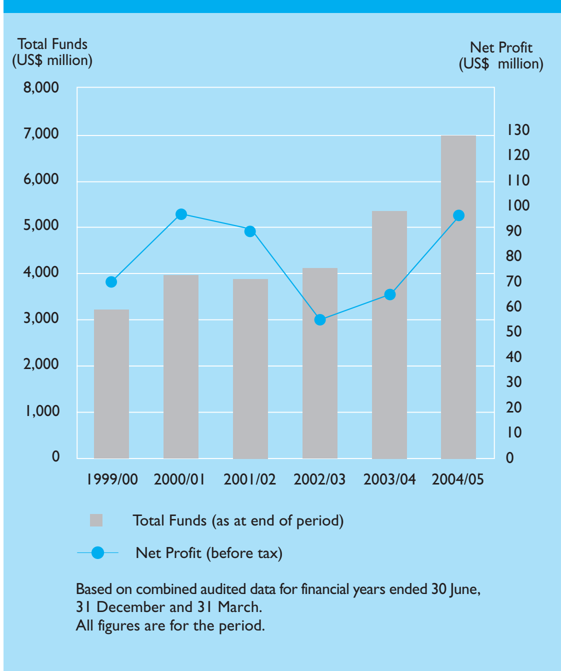
All the former Category 2 banks realized net profits during 2004/05. On an overall basis, these banks posted a net pre-tax profit of US$96.4 million in 2004/05, which is 49.9 per cent higher than the figure of US$64.3 million achieved in 2003/04.

Pre-tax profits achieved by banks individually were in the range of US$0.9 million and US$28.5 million in 2004/05 compared to the range of US$0.8 million and US$25.3 million a year earlier.

Table 12 gives the consolidated profit performance of the former Category 2 banks from 2002/03 to 2004/05.

Chart 16 shows net profits of former Category 2 banks in relation to their total funds for the period 1999/00 through 2004/05.

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




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

### 2.4.3.1 Net Interest Income

Net interest income grew by US$9.9 million or 11.8 per cent, from US$83.9 million to US$93.8 million, compared to an increase of US$21.5 million or 34.4 per cent for the previous year.

During the year 2004/05, interest income increased by US$19.4 million or 10.3 per cent ahead of the 10.5 per cent rise recorded in the preceding year. The share of interest income in total income, however, fell to 92.4 per cent in 2004/05 from 98.5 per cent a year earlier due to the significant increase in non-interest income.

The bulk of the interest income was derived from placements with banks and advances to non-bank customers, which together contributed 90.4 per cent to the total interest income or 83.6 per cent to total income. The corresponding figures for the previous year were 92.7 per cent and 91.3 per cent, indicating that these assets continued to be the main income generating assets.

Interest earned on loans and advances from non-bank customers remained the highest component of interest income notwithstanding the drop from US$121.4 million in 2003/04 to US$116.8 million in 2004/05, which resulted in the proportion of such earnings in the interest income to fall from 64.7 per cent

Table 12: Profit Performance of Former Category 2 Banks

| | 2002/03 | 2003/04<br>(US$ million) | 2004/05 |
|---|---|---|---|
| **Interest Income** | **169.9** | **187.7** | **207.1** |
| Less Interest Expense on Deposits and Borrowings | 107.5 | 103.8 | 113.3 |
| **Net Interest Income** | **62.4** | **83.9** | **93.8** |
| Add Non-Interest Income | 15.3 | 2.8 | 16.9 |
| **Operating Income** | **77.7** | **86.7** | **110.7** |
| **Less Total Operating Costs** | **10.5** | **15.3** | **16.3** |
| *Of which Staff Expenses* | *4.0* | *5.3* | *6.7* |
| **Operating Profit** | **67.2** | **71.4** | **94.4** |
| Less Charge for Bad and Doubtful Debts | 12.3 | 7.1 | (2.0) |
| **Net Profit before Tax** | **54.9** | **64.3** | **96.4** |
| *Interest income as a percentage of total income (per cent)* | *91.7* | *98.5* | *92.4* |
| *Cost to income ratio (per cent)* | *16.0* | *19.2* | *14.5* |
| *Return on average assets (per cent)* | *1.5* | *1.3* | *1.5* |
| *Return on equity (per cent)* | *18.2* | *17.0* | *20.3* |

in 2003/04 to 56.4 per cent in 2004/05. In contrast, interest earned from placements with banks went up by US$17.9 million, from US$52.6 million in 2003/04 to US$70.5 million in 2004/05. Consequently, the ratio of interest income from placements with banks to total interest income edged up to 34.0 per cent in 2004/05, from 28.0 per cent in 2003/04.

Total interest expenses went up by US$9.5 million or 9.1 per cent in 2004/05 after a drop of US$3.7 million or 3.4 per cent in 2003/04. Interest paid on borrowings from banks and non-bank deposits were the main items of interest expenses of the former Category 2 banks and together constituted 95.0 per cent of the interest expenses in 2004/05 compared to 97.8 per cent a year earlier.

Interest paid on borrowings from banks representing 58.4 per cent of total interest expenses amounted to US$66.2 million for the current year as compared to US$72.6 million a year earlier. Contrary to previous years, interest paid on deposits went up by US$12.5 million from US$28.9 million in 2003/04 to US$41.4 million in 2004/05.

### 2.4.3.2 Non-Interest Income

Non-interest income comprising mainly fees and commissions went up by US$14.1 million from US$2.8 million to reach US$16.9 million in 2004/05. This substantial increase is explained by an exceptional loss in 2003/04 which eroded the non-interest revenue. Accordingly, the share of non-interest income in total income rose to 7.5 per cent in 2004/05 from 1.5 per cent in 2003/04.

### 2.4.3.3 Non-Interest Expenses

Non-interest expenses made up of staff and other operating costs rose by US$1.0 million or 6.5 per cent from US$15.3 million in 2003/04 to US$16.3 million in 2004/05. Expressed as a percentage to total expenses, non-interest expenses declined from 12.8 per cent in 2003/04 to 12.6 per cent in 2004/05. Staff costs increased by US$1.4 million to US$6.7 million in 2004/05 and constituted 41.1 per cent of non-interest expenses.

The cost to income ratio fell from 19.2 per cent in 2003/04 to 14.5 per cent in 2004/05 reflecting enhancement of the operational efficiency of these banks during the period under review.

### 2.4.3.4 Return on Average Assets and Equity

Table 12 also outlines the financial performance of former Category 2 banks in terms of their returns on average assets and equity in 2002/03, 2003/04 and 2004/05. It can be observed therefrom that the profitability indicators pointed to improved performance arising mainly from the significant increase in pre-tax profits from US$64.3 million to US$96.4 million.

The overall return on average assets rose from 1.3 per cent to 1.5 per cent in 2004/05, as growth in

Table 13: Former Category 2 Banks – Total Advances, Non-performing Advances and Provision for Bad and Doubtful Debts*

| | 2002/03 | 2003/04<br>(US$ million) | 2004/05 |
|---|---|---|---|
| General Provision | 20.2 | 27.4 | 27.3 |
| Specific Provision | 15.5 | 11.7 | 5.9 |
| **Total Provision for Bad and Doubtful Debts** | **35.7** | **39.1** | **33.2** |
| Total Advances | 1,550.6 | 2,682.6 | 3,061.2 |
| Non-performing Advances | **52.2** | **32.3** | **31.6** |
| Ratio of Non-performing Advances to total Advances (Per cent) | **3.4** | **1.2** | **1.0** |
| Ratio of Specific Provision for Bad and Doubtful Debts to Non-performing Advances (Per cent) | **29.7** | **36.2** | **18.7** |

** based on audited accounts*

profits generated outpaced the 32 per cent growth recorded in average assets during the period. Individual banks' returns on average assets ranged from 0.8 per cent to 2.9 per cent in 2004/05 compared to 0.7 per cent and 2.0 per cent a year earlier. In 2004/05, five banks achieved return on average assets higher than 1.8 per cent as compared to only one bank in 2003/04.

The overall return on equity which stood at 17.0 per cent in 2003/04 as against 18.2 per cent in 2002/03 increased to 20.3 per cent in 2004/05. In 2004/05, individual banks' returns on equity ranged from 3.5 per cent to 46.0 per cent against a range of 3.2 per cent and 46.4 per cent in the previous year. Three banks achieved return on equity of 37 per cent or higher in 2004/05 as against two banks in 2003/04.

#### 2.4.3.5 Loan Loss Provisioning

Table 13 shows the trend of the provisions for bad and doubtful debts with respect to non-performing advances and total advances of the former Category 2 banks during the period 2002/03 to 2004/05. Following a substantial fall of US$19.9 million in the previous year, the non-performing advances declined marginally by US$0.7 million or 2.2 per cent to US$31.6 million. However, the ratio of non-performing advances to total advances improved slightly from 1.2 per cent in 2003/04 to 1.0 per cent in 2004/05. On the other hand, specific provision for bad and doubtful debts amounted to US$5.9 million in 2004/05 down from US$11.7 million in the previous year. The ratio of the specific provisions to the non-performing advances fell from 36.2 per cent in 2003/04 to 18.7 per cent in 2004/05.

### 2.4.4 LIQUIDITY

Former Category 2 banks are required to have in place liquidity management policies for the sound management of liquidity risk. As this risk can trigger other risks in the financial system, any mismanagement of liquidity may give rise to other problems. For instance, a bank's inability to meet its financial obligations as and when they fall due may damage its reputation and handicap it to raise resources for funding its activities. Banks operating at the global business level maintained a healthy match between their liquid resources and fund commitments during the year. It is expected that the same prudential policies will continue to be maintained by former Category 2 banks in future.

# 3. Implementing Basel II in Mauritius

## INTRODUCTION

Basel II, like its predecessor, has been primarily designed for internationally active banks of the member countries of the Basel Committee on Banking Supervision (BCBS), with expected implementation by year-end 2006. Like Basel I, it is likely to interest non-member countries as well. The BCBS thus included an array of alternative approaches with varying degrees of sophistication in the new framework to ensure that its implementation is also accessible to non-member countries. However, while encouraging non–member supervisory authorities to adopt the new framework, the BCBS has requested national supervisors to consider carefully the benefits of the new framework to their domestic banking system when developing a timetable and an approach for its implementation. The World Bank has adopted a similar stance. It recommends that the implementation of Basel II should not take precedence over the quality of the implementation, especially with regard to the level of baseline supervision and readiness. It stresses that resource-constrained and less advanced banking systems in developing countries should not make compliance with Basel II, a priority, but must rather address more immediate concerns such as building strong systems for risk-based supervision and ensuring compliance with the *Core Principles for Effective Banking Supervision* (Core Principles). The World Bank makes it clear that it will not assess countries on whether they are complying with Basel II but rather on the quality of the implementation of their chosen capital standards.

## Bank of Mauritius and Basel II

The Bank of Mauritius (the Bank) concurs with the views of the World Bank and does not propose to act hastily in the implementation of Basel II in Mauritius. However, the benefits of its adoption for the industry are too appealing to defer its application for too long. Over the past years, the Mauritian jurisdiction has made considerable progress in its compliance with the Core Principles. The Bank has proceeded to prioritise the implementation of the more relevant Core Principles, while taking on board the remaining few in a next round. The time is ripe to start preparing the industry for a material shift in the framework for capital regulation. Banks in Mauritius, especially those not forming part of large international banking groups, have relatively simple risk management systems and it is felt that unless they are encouraged to beef up their systems, processes, databases, capacities and logistics, there would be little incentive for them to do so. Eventually these banks may lag behind in implementing the new framework and thus let pass the associated opportunities.

It is proposed to use supervisory discretion, as recommended under the new framework, to adapt the Basel II model to the needs of the Mauritian jurisdiction, while keeping open the option for banks to proceed towards implementing the more sophisticated approaches, if they so desire.

The Bank has adopted a consultative and participative approach. The deadline for Basel II implementation in Mauritius has been tentatively set at year-end 2007. In this connection, a *Committee for the Implementation of Basel II* (the Committee), consisting of representatives of the Bank, banks and the Mauritius Bankers Association Ltd (MBA) and chaired by the First Deputy Governor, was set up in July 2005 by the Banking Committee. The Committee acts as a steering committee for the implementation of Basel II in Mauritius and assists in devising policy frameworks and proposes solutions to banks in response to the changing regulatory environment under Basel II. It serves as a forum to discuss, address and clarify issues and concerns, and guides banks in building their systems, processes, databases, capacities and logistics. The Committee has established various Working Groups, comprising representatives from the Bank and banks, to work on the different key issues relating to Basel II. There are eight Working Groups working on six different areas: Scope of Application, Credit Risk, Market

Risk, Operational Risk, Eligible Capital and Market Discipline.

## Scope of Application

The Working Group on Scope of Application is responsible for considering the entities and operations that will be subject to the requirements of Basel II in Mauritius and their consolidation method in this respect. It has recently finalised its recommendations.

It has identified three types of banking entities operating in Mauritius: home banking groups (i.e., a banking group whose centre of economic interest is in Mauritius, with the Bank as the home regulator), subsidiaries of foreign banking groups and branches of foreign banking groups. All banking entities operating in Mauritius shall be subject to capital adequacy requirements on a stand-alone basis. In addition, the consolidation rule shall apply to all home banking groups in respect of their operations in, and/or controlled from, Mauritius. However, branches of foreign banks shall be subject to capital adequacy requirements in respect of their Segment A[1] operations only.

## Credit Risk

There are three Working Groups for credit risk management and measurement to address issues relating to the Standardised Approach, the Internal Ratings-Based Approach and the accreditation of External Credit Assessment Institutions (ECAIs). The Working Groups shall, among others, address the areas of national supervisory discretion and propose the approaches that are most appropriate to the local context, in consultation with the banking industry.

The Bank does not propose to impose any particular approach on banks but will allow them to choose among the Standardised Approach, the Foundation Internal Ratings-Based Approach and the Advanced Internal Ratings-Based Approach, for evaluating their minimum capital requirements for credit risk. However, banks opting for a particular approach will have to meet certain minimum qualitative and quantitative criteria. Besides, a transition period will be defined for the implementation of the new framework during which banks will be required to compute the capital charge for credit risk under the new framework in parallel with the current framework.

The Standardised Approach is the simplest approach available for computing the capital requirements for credit risk and at a minimum, banks should be able to comply with it. Taking into consideration the data and other resources required for the implementation of the Internal Ratings-Based Approach, the Standardised Approach would more likely be the preferred approach for local banks in the coming years. In this respect, in 2004, the Bank conducted a Quantitative Impact Study (QIS) for implementing the Standardised Approach on the minimum regulatory capital requirements of banks.

The survey showed that currently all corporate exposures which on average represent around 40 per cent of the total exposure of the banking industry are risk weighted at 100 per cent. The QIS revealed that a very minor component of banks' corporate exposure is currently being rated by ECAIs. However, there are no ECAIs in the domestic market. While the new framework is likely to result in the establishment of such agencies in Mauritius in the future, these agencies will have to provide the Bank with the ten-year average of the three-year cumulative default rate for each type of risk rating for meaningful works to be undertaken in the Basel II context.

While the setting up of ECAIs would be a positive factor for the economy, this mechanism should not and cannot be a substitute for proper credit assessment by banks. Banks should not be led to place undue reliance on external credit ratings, resulting in a quasi-outsourcing of their credit assessment activities and thus losing the related skills. Consequently, banks adopting the Standardised Approach would be encouraged to develop internal credit risk rating models. At the outset, the models may be qualitative in nature. However, with time, as banks develop their databases, systems and competencies,

[1] Segment A is defined in the Guideline on Segmental Reporting under a Single Banking Licence Regime (June 2005).

quantitative elements can be included and reliable internal models developed. This would ease the transition to the more advanced, risk sensitive approach.

## Market Risk

The BCBS issued a paper entitled *Amendments to the Capital Accord to Incorporate Market Risk* in January 1996, which was last updated in November 2005. The paper established the general framework for measuring and managing market risk. The Bank is discussing the matter with the industry and is contemplating, in the light of available market information, to issue a guideline on market risk.

The Working Group on Market Risk is working on a guideline on the management of market risk and the computation of the associated capital charge by banks in Mauritius. It has proposed the adoption of a three-tier approach:

1. Conducting a Trading Book Survey;
2. Preparing a guideline for measuring and managing market risk; and
3. Designing a set of returns for market risk.

The Trading Book Survey was conducted in September 2005. The objectives were:

1. to identify whether banks were keeping separate trading and banking books;
2. to identify the components of market risk in banks' trading books;
3. to determine the significance of trading book activities; and
4. to take cognisance of the approach used/to be used by banks for measuring and managing market risk.

For the purpose of the survey, trading books were defined as banks' proprietary positions in financial instruments held intentionally:

1. for short-term resale; and/or
2. with the intent of benefiting from actual or expected short-term price movements; and/or
3. to lock in arbitrage profits.

The results showed that trading book instruments are not currently a significant component of banks' total assets. Consequently, market risks arising from trading book activities are considered to be immaterial for the time being.

However, the survey revealed that banking books contain a considerable element of market risk in the form of interest rate risk and foreign exchange risk. The survey further showed that banks in Mauritius do not hold positions in commodities.

The *Amendments to the Capital Accord to Incorporate Market Risk* paper (Market Risk Amendment) requires a regulatory capital charge for the following risks:

Risks assessed under the Market Risk Amendment

| | Interest Rate Risk | Equity Risk | FX Risk | Commodities Risk |
|---|---|---|---|---|
| **Trading Book** | | | | |
| General Market Risk | ✓ | ✓ | ✓ | ✓ |
| Specific Risk | ✓ | ✓ | x | x |
| **Banking Book** | | | | |
| General Market Risk | x | x | ✓ | ✓ |
| Specific Risk | x | x | x | x |

The BCBS does not require holding mandatory capital buffer for interest rate risk in the banking book. However, a bank is required to maintain an adequate system to manage and measure the level of interest rate risk in its banking book in a manner that is commensurate with its capital. Besides, a bank should have sufficient capital to support its interest rate risk in the banking book. In case it does not, it will be required to either reduce the risk or increase the capital held to support it, or a combination of both.

The current framework in Mauritius already provides for a capital charge in respect of foreign exchange exposure, irrespective of whether it arises from trading book or banking book activities. The Working Group will study whether additional capital charges will have to be imposed for interest rate risk and equity risk, bearing in mind the specificities of the market, and make recommendations for appropriate actions.

## Operational Risk

In February 2005, following consultation with the banking industry, the Bank issued a Guideline on Operational Risk Management and Capital Adequacy Determination. The guideline sets out the minimum requirements for an effective operational risk management and measurement framework. Indeed, it is imperative for operational risk capital charge to be viewed more as an incentive for banks to better manage and control such inherent risk rather than being viewed as a burden or a restriction on exploiting capital.

The guideline provides three main approaches for computing capital charge for operational risk in a continuum of increasing sophistication and risk sensitivity, namely the Basic Indicator Approach, the Standardised Approach and the Advanced Measurement Approach. Capital charges under the first two approaches are based on the gross income of banks. In addition, there is an Alternative Standardised Approach which, among others, allows banks to use average outstanding balance for computing capital charges for their retail and commercial loans. While no approach has been imposed on banks, the latter are expected to use the Basic Indicator Approach as a minimum and are encouraged to move to more sophisticated approaches for a more accurate assessment of operational risk.

Moreover, the guideline spells out ten sound practices for the management and supervision of operational risk for an effective operational risk management framework. Banks should establish a written policy on operational risk management. They are also encouraged to ensure adequate protection against key and significant operational risks. The guideline explicitly spells out the responsibilities and accountabilities of both the board of directors and senior management. Operational risk management is so important that although branches of foreign banks are not required to keep a capital buffer in respect of their Segment B activities, they still have to implement a management framework for operational risk and their respective head office must ensure compliance with the guideline on a consolidated level.

The guideline requires banks to submit their historical loss data by event types along eight business lines. The Bank intends to pool these internal loss data into a database for the industry. Such database will be used for the refinement of the parameters set by the BCBS to better reflect the operational risk in the local industry. The database will also be used to assess whether the capital charges are commensurate with the risk profile of individual banks.

The Working Group on Operational Risk will oversee the practical aspects of implementing the guideline and carry out further work related to operational risk management and measurement. The Working Group will act as a discussion forum for implementation issues.

## Eligible Capital

Basel II has not brought any amendments to the numerator of the capital adequacy formula[2], though the BCBS is working on a revision. Concurrently, with changes in accounting standards and the inclusion of minority interest in eligible capital, the Committee has set up a Working Group on Eligible Capital to advise on the components that should form part of eligible capital.

## Market Discipline

Market discipline, the third pillar of Basel II, relies on the disclosure of sufficient information by financial institutions to the market and the public at large so as to enable them to make informed decisions regarding their investments and deposits in banking entities. Through their actions, market participants would encourage banks to maintain an adequate capital buffer to cover the risks inherent in their operations.

The Bank issued the Guideline on Public Disclosure of Information in November 2002, which follows the spirit of market discipline. It requires extensive disclosure by banks of their risk profiles and risk management strategies and policies. These requirements will have to be beefed

[2] Capital Adequacy Ratio is the ratio of Capital Base to Total Risk Weighted Assets.

up in line with the changes brought about by Basel II. The Working Group on Market Discipline has the responsibility to look at this particular aspect.

## CONCLUDING REMARKS

The Bank is aware of the challenges of implementing Basel II by year-end 2007. The establishment of the Committee for Implementation of Basel II and the setting up of the Working Groups, composed of representatives of the Bank, banks and the MBA, are largely contributing towards modernising and reinforcing banks' risk management structure and systems. Through this approach, the Bank expects that the transition to Basel II would be a smooth one.

# 4. The Supervisory Role of Bank of Mauritius

## INTRODUCTION

Banks fulfil an important function as financial intermediaries in the economy of a country by taking deposits from those holding extra financial resources and lending to those in need of funds. However, the business of banking involves risk-taking. Risks, which are improperly managed, can result in losses and jeopardise the security of deposits held by banks. Since depositors' money is at risk and the stability of a financial system is dependent on the soundness of its banking system, effective supervision of banks is of paramount importance. In Mauritius, the regulation and supervision of banks are carried out by the Bank of Mauritius (the Bank) under the provisions of the Banking Act 2004 and the Bank of Mauritius Act 2004. The non-bank deposit-taking institutions and cash dealers which comprise money-changers and foreign exchange dealers also fall under the regulatory purview of the Bank.

Section 5(1)(b) of the Bank of Mauritius Act 2004 sets out the role of the Bank as the regulator as follows:

*"The Bank shall have such functions as are necessary to achieve the attainment of its objects and, in particular, it shall ... regulate and supervise financial institutions carrying on activities in, or from within, Mauritius".*

The responsibility of managing the business of any financial institution lies entirely in the hands of its board of directors and its senior management under the direction and control of the board. The Bank, on its part, is responsible for supervising, regulating and safeguarding the banking system in Mauritius under the provisions of the banking laws. To fulfil these duties, the Bank uses a combination of on-site examination and off-site surveillance, supported by guidelines issued to the regulated institutions for the safe conduct of business in the public interest.

## OFF-SITE SURVEILLANCE

Off-site surveillance by the Bank involves the analysis of returns submitted by financial institutions and the formulation of policies to ensure adherence to best practices by the institutions. The Bank requires financial institutions to submit returns at stated frequencies, depending on the sensitivity of the information. The returns are analysed to gain an insight into the risks faced by individual institutions and to determine the risk areas to be examined during the course of the on-site examinations of the institutions. As part of its responsibility to carry out off-site monitoring of banks, the Bank has been using the CAMEL ratings, on a pilot basis, since the beginning of 2004 to make periodic assessment of the overall condition of individual former Category 1 banks. As from the quarter ended December 2004, the Bank started communicating the results of its CAMEL Ratings to the banks.

The assessment of four of the elements of CAMEL namely Capital, Asset Quality, Earnings and Liquidity, are based mainly on data provided by banks through their returns and the appraisal of the 'Management' component is based on the results of the on-site examination of banks. A rating ('Strong', 'Satisfactory', 'Fair', 'Marginal' or 'Unsatisfactory') is assigned to each of the components of the CAMEL as well as to the overall performance of the banks. The CAMEL rating is an important tool used by the Bank to determine the frequency of on-site examination of banks and the resources to be allocated during on-site examinations.

The rating provided to 'Management' is an important factor in the overall rating assigned to a bank. A bank for which 'Management' has been assigned a poor rating would be subject to a more rigorous examination. 'Management' incorporates the whole corporate governance process at the bank. This ranges from the fitness and propriety of shareholders and directors, the role of the board and its different committees, the extent and conditions under which related party transactions are carried out, the risk management processes put in place

with regard to the major risks faced by the institutions and the role of internal and external auditors in the corporate governance process.

## Guidelines

As part of its role in the promotion of sound corporate governance, the Bank regularly issues guidelines covering emerging issues and risks in the banking sector. Guidelines are issued under the authority of section 50 of the Bank of Mauritius Act 2004 and section 100 of the Banking Act 2004. The Bank has so far issued sixteen guidelines. Some guidelines deal with risk areas faced by financial institutions such as credit, operational and market risks. Others deal specifically with corporate governance issues. These include the Guideline on Corporate Governance, the Guideline on Related Party Transactions, the Guidance Notes on Fit and Proper Person Criteria and the Guideline on Transactions Respecting the Well-being of a Financial Institution Reportable by the External Auditor to the Bank of Mauritius.

## ON-SITE EXAMINATION

Section 42 of the Banking Act 2004 bestows on the central bank the authority to conduct regular examinations of the operations and affairs of financial institutions at least once a year. It is also specified at section 51(5) of the Bank of Mauritius Act 2004 that the central bank be authorised to examine the accounts, books, records and other documents in whatever form, of any financial institution. On-site examination allows supervisors to assess whether a financial institution is complying effectively with the provisions of the banking laws, guidelines and instructions issued by the central bank and whether it is in a sound financial condition. In circumstances which warrant intervention, the Bank is empowered under section 43(1) of the Banking Act 2004 to conduct special examinations in respect of the affairs of any financial institution.

On-site examination involves a preparatory stage. Supervisors use information and other records submitted by financial institutions as the starting point for conducting on-site examination. The compilation and analysis of data submitted by financial institutions through statistical returns and prudential reports constitute the groundwork for carrying out on-site examination. Supervisors should determine the extent of reliance that can be placed on the reports produced by both the internal and external auditors before embarking on the on-site examination of a financial institution. Reliance on the work carried out by auditors will depend on the extent to which they have been able to assess the risks inherent in each area of operation of a financial institution, to identify the key controls in place to mitigate those risks and to assess the weaknesses in the controls. Supervisors also need to ascertain the internal auditor's independence by determining whether the latter has direct access to the audit committee and the board, and whether the audit program is comprehensive. It is the responsibility of supervisors to assess the extent to which recommendations made by the internal and external auditors have been implemented. As a requirement of the Bank's Guidance Notes on General Principles for Maintenance of Accounting and Other Records and Internal Control Systems, external auditors have to provide a report to the central bank to express their opinion on the adequacy of the internal control systems at a financial institution. Following a directive issued by the Bank, a financial institution is also required to report details of any exceptional event such as frauds or irregularities to the Bank. All the abovementioned information constitute a framework for supervisors to identify the areas to be examined. During an on-site examination, supervisors prioritise high-risk areas, which have a critical importance for the safety and soundness of a financial institution.

One focal point of the on-site examination of a financial institution is its internal control systems. The examination of the policies, procedures and processes of the internal control systems of a financial institution enables supervisors to assess the extent to which the institution is able to control its operational risk. The internal control systems should be designed to ensure that all its expenses are properly authorised and disbursed, all its assets are adequately safeguarded and all its liabilities accurately recorded. Supervisors should satisfy themselves that internal controls are comprehensive, clearly documented and regularly reviewed. Policies and procedures should include a clear definition and allocation of responsibilities.

Lines of reporting should be well identified and segregation of duties clearly established. The role of the supervisors is not to carry out a full inspection of all business activities of the financial institution or to examine every single transaction. Their main concern is to ascertain that all procedures and policies to ward off risks inherent in the institution's business are effectively implemented.

Loans and advances are the main assets on the balance sheets of banks in Mauritius. In this respect, during on-site examinations supervisors focus to a large extent on this area of activity. Supervisors therefore have to ensure that the credit risk management of a financial institution is adequate. The Bank's Guideline on Credit Risk Management highlights the responsibilities of the board of directors and senior management in overseeing the credit risk management function. Supervisors oversee whether strict prudential credit criteria are being applied within the institution by examining the credit risk policy that it has adopted. The policy should clearly define the levels of authority to approve credits. The various stages involved in the credit risk management process, from the origination of the credit to the point it is cleared in the books of a financial institution, should also be looked at.

Supervisors also examine whether a financial institution is taking appropriate measures to ensure that its services are not being used to commit or to facilitate the commission of a money laundering offence as laid down in the Financial Intelligence and Anti-money Laundering Act 2002 (FIAML Act 2002). The Bank's Guideline on Corporate Governance stipulates that a financial institution must ascertain that adequate systems and procedures have been established, and sufficient resources committed to ensure compliance with the requirements of the FIAML Act 2002, the regulations made thereunder, and the Guidance Notes on Anti-Money Laundering and Combating the Financing of Terrorism issued by the Bank. In this respect, much emphasis is laid on a thorough analysis of the due diligence exercised by an institution before accepting customers and authorising transactions. The Bank's Guidance Notes lays down the essential elements of KYC standards to be observed by financial institutions, which include customer acceptance policy, customer identification and on-going monitoring of high risk accounts. The roles of the compliance officer and of the money laundering reporting officer are of paramount importance in this context. Reports prepared by them and procedures put in place are examined for a proper assessment of the capacity of the financial institution to comply with laws pertaining to money laundering activities.

The board of directors of a financial institution is ultimately responsible for its financial soundness, establishing and reviewing its strategies, controlling risk inherent in the business and monitoring its performance. In this respect, supervisors are called upon to assess the capability, judgement and integrity of the board of directors in managing a financial institution. The Guideline on Corporate Governance highlights the importance for the board to function independently of management and recommends that a board should have sufficient directors to represent a variety of skills and perspectives reflective of the functions of the institution. Minutes of the board and its specialised committees are examined to assess the independence of directors in decision-making, their active involvement in the institution's affairs and their competence in dealing with issues pertaining to banking risks and financial controls. Supervisors determine whether there is a sufficient number of independent directors in the board and whether a governance committee has been set up. Supervisors also evaluate whether a specialised risk management committee of the board, as recommended in the Bank's Guideline on Corporate Governance, regularly assesses the adequacy of the risk management policies, systems and procedures and periodically reviews management's performance in controlling the risks in the light of the established policies.

Supervisors ensure that the audit committee maintains direct communication channels with the auditors. They also assess the extent to which the committee is overseeing the performance of the external and internal audit functions and reviewing management's financial stewardship of the institution as recommended in the Bank's Guideline on Corporate Governance.

Supervisors verify whether the institution is adhering to the requirements of the Guideline on Related Party Transactions according to which the

Conduct Review and Risk Policy Committee of the board should ascertain that transactions with related parties are at arm's length. The activities of the Conduct Review and Risk Policy Committee are monitored to ensure that adequate controls and information systems are in place to implement the institution's policies.

The supervisory work also involves interaction between the supervisors and the financial institution's officials as part of an overall assessment of the sound management of the institution. Before an examination starts meetings are held to discuss, *inter alia*, matters pertaining to the general strategy, financial performance and risk areas of the institution. Further discussions are held during the examination period to have a deeper insight into the policies, procedures and processes examined. At the end of the examination, issues that have come to the attention of the supervisors are subsequently taken up with the senior management of the institution.

Section 39(18) of the Banking Act 2004 requires the central bank to arrange, at least once a year, a trilateral meeting with the management of every financial institution and its auditors. The Bank also exchanges views on the policy adopted by a financial institution in the course of meetings held with its board of directors.

With a view to conducting consolidated supervision effectively, the Bank has signed a Memorandum of Understanding (MoU) with the Financial Services Commission of Mauritius, which regulates the non-banking activities of banking groups. The Bank has also signed MoUs with foreign regulators in respect of foreign banks operating in Mauritius.

## CHALLENGES

The banking industry worldwide has undergone significant transformation in the last decade. Supervisors need to keep abreast of changes and developments taking place within the environment in which financial institutions operate to ensure that they are adopting the appropriate risk management framework. The document issued by the Basel Committee on Banking Supervision (BCBS) *International Convergence of Capital Measurement and Capital Standards – A Revised Framework* commonly referred to as Basel II, establishes a range of risk sensitive methods to be adopted by banks in their calculation of minimum capital requirements. The new framework places on supervisors the specific responsibility of reviewing the assessments carried out by banks in respect of their capital adequacy positions relative to their overall risks.

The *Core Principles for Effective Banking Supervision* are presently undergoing revision to incorporate the substantial developments that the banking industry has undergone since the Core Principles were first issued by BCBS in September 1997. The revised Basel Core Principles, a draft of which has already been released for consultation to the industry, place added responsibilities on supervisors to ensure that all banks are conducting their business in a proper manner at all times. The role of the supervisors, the degree of their responsibility, the extent and coverage of their work would thus have to be redefined.

The task of supervisors is becoming more and more demanding each day. The Bank recognises that an effective deployment of supervisory resources and skills is vital for meeting these new challenges. Staff of the Supervision Department is also undergoing continuous training and various working groups have been set up to start the groundwork for the implementation of Basel II.

# 5. Promoting Financial Stability

In the wake of globalisation and financial liberalisation, financial stability issues have come to the forefront. These issues have ranged from discussions on the definition of financial stability to issues of measurement and choice of instruments to achieve the objective of financial stability, as well as issues on the degree of involvement of central banks in pursuing this objective.

There is so far no widely accepted model or analytical framework for assessing or measuring financial stability. Financial indicators that could alert policymakers to potential problems in the real economy have only begun to be developed.

A starting point may be to consider the failure of financial institutions as defining episodes of instability but this is unlikely to be sufficient. In some circumstances, the failure of one or even a few financial institutions may be part of the normal market mechanism in that it represents the exit of unprofitable institutions. Under others, the failure of a single institution may be the trigger for significant financial turmoil.

Financial stability is often described as the absence of financial instability. Stability would be evidenced mainly by an effective regulatory infrastructure and financial markets; and sound financial institutions. Financial instability, on the other hand, would manifest itself through bank failures, intense asset-price volatility and a collapse of market liquidity.

According to Gary Schinasi of the International Monetary Fund (IMF) *"Financial stability means more than the mere absence of crises."* A financial system can be considered stable if it facilitates an efficient allocation of economic resources, geographically and over time, as well as other financial and economic processes (such as saving and investment, lending and borrowing, liquidity creation and distribution, asset pricing, and, ultimately, wealth accumulation and output growth); assesses, prices, allocates, and manages financial risks efficiently; and maintains its ability to perform these key functions even when faced with external shocks or a build-up of imbalances.

A sound financial sector is critical to an economy's well being because it is closely connected with every other sector of the economy through its role of providing credit. When large scale failures occur among financial institutions, the supply of credit dries up and this quickly leads to cutbacks in other industries. Further, the financial sector is that part of the economy that is most susceptible to crises of public confidence. Problems arising in one part of the finance sector quickly spread to the rest of the sector and ultimately to the economy as a whole.

Central banks are more concerned about the disruptions that can be brought about by financial instability to the process of financial intermediation and the significant effects it can have on the performance of the economy as a whole rather than its impact on individual financial institutions.

The objective of financial stability can be defined in broad terms as the avoidance of disruptions to the financial system that are likely to affect real output significantly.

The financial sector in Mauritius is made up of different financial players namely banks, non-bank deposit taking institutions, foreign exchange dealers and money changers, leasing companies, securities companies, insurance companies and global business companies. While banks, non-bank deposit taking institutions and foreign exchange dealers are regulated by the Bank of Mauritius (the Bank), the remaining non-bank financial sector is under the regulatory purview of the Financial Services Commission.

The local financial landscape is characterised by a strong presence of banking institutions. The strength and stability of our banking sector is constantly under the close scrutiny of the Bank, which is empowered by the Banking Act 2004 to carry out the supervision and regulation of banks in

Mauritius. The Bank, in its endeavour to promote stability of the system, continues to emphasise the need for banks to remain in line with world jurisdictions which benefit from a highly regulated market and which adopt best international practices.

## Price Stability v/s Financial Stability

Historically, central banks have been concerned with maintaining both price stability and financial stability, albeit not simultaneously. However, the last decades have witnessed the increasing recognition that price stability is a necessary but not sufficient condition for financial stability. A stable macroeconomic environment characterised by low and stable inflation, sustained growth and low interest rates can generate excessive optimism about the future economic prospects and very often risks are downplayed. Episodes of financial instability often have their origins in an environment of macroeconomic stability. Thus, macroeconomic stability needs not necessarily place an economy in financial stability in the medium/long term. Central banks have thus realised that a simultaneous pursuit of price and financial stability is warranted.

As Andrew Crockett, former Chairman of the Financial Stability Forum put it, *'In implementing prudential policies, supervisory authorities may require a keener recognition that some of the main roots of systemic instability have been macroeconomic. Likewise, in framing monetary policy, central banks may require a keener recognition of the role of monetary policy in unintentionally accommodating the credit expansion that contributes to the build up of financial imbalances'.*

## Financial Soundness Indicators

There is a range of Financial Soundness Indicators (FSIs), which provide detailed information on the general health of the financial system. They include a core set of aggregated prudential indicators of the banking sector and a broader set of indicators that cover the financial health of other sectors of the economy. The FSIs not only help countries assess the vulnerability of their banking systems but also allow them to take measures to prevent financial crises. The FSIs are categorised into a Core Set of indicators and the main components are defined as follows:

### *Capital Adequacy*

An adequate level of capital provides a source of funding for banks and a base for further growth. It also acts as a buffer for a variety of risks to which an institution is exposed, thereby maintaining the confidence of depositors, creditors and shareholders. The capital adequacy ratios indicate the ability of banks to cope with shocks to their balance sheets.

### *Asset Composition and Quality*

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 of and profitability of bank borrowers.

### *Earnings and Profitability*

Earnings and profitability ratios also indicate the quality of assets of banks as well as their sustainability of earnings.

### *Liquidity*

The liquidity ratios capture the ability of banks to meet deposits, withdrawals or large maturity mismatches.

### *Sensitivity to Market Risk*

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

These indicators may contain relevant information at the micro level and may help to predict which banks or types of banks would be more likely to increase their exposure to systemic risk or suffer from sizeable deposit withdrawals. However, they may prove to be less reliable if the economy were to be hit with a large systemic shock.

Appendix II provides the FSIs for the banking sector in Mauritius for the period 1998 to 2004.

## Main Determinants of Financial Stability

### *Prudential Regulation*

Due to the need to ensure safety and soundness of financial institutions, supervision

and regulation have been greatly strengthened in the past decade to address market distortions that are unavoidable consequences of the special benefits provided to banks. Those benefits were promulgated because of the tensions between banks contribution to growth and concerns about banks' role in economic instability. In addition, the increasing scale and diversity of non-bank financial institutions' activities are subjected to bank-like supervision and regulation since their risk taking, while contributing to economic growth, also has implications for stability.

Bank regulations prescribe what must be done to enhance the financial safety and soundness of financial institutions. Regulations can however sometimes be backward looking in that they are imposed under specific circumstances in response to specific problems. Such regulations sometimes remain in force even after resolution of the problem. In practice, very often, public comments and changing market realities help central banks to identify regulations that no longer serve public policy objectives. Central banks generally update or remove those regulations depending on market changes and innovations. Sometimes new regulations are also required to ensure that policy objectives continue to be achieved.

### *Internal Control Systems*

A system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations. It ensures banks' compliance with laws and regulations as well as policies, plans, internal rules and procedures to counter the risk of damage to their reputation. It may contribute to the realisation of the goals and objectives of a banking organisation, including its long-term profitability targets, and reliable financial and managerial reporting. Absence of sound internal control can seriously impair the financial condition of an institution and have damaging effects on its reputation and, through systemic risk, disturb the whole financial system.

### *Corporate Governance*

Sound corporate governance is the foundation of effective risk management and is essential to the well being of a financial institution and its stakeholders, particularly its shareholders and creditors. Good corporate governance is also critical in maintaining a sound financial system and a robust economy.

The fundamental importance of good corporate governance has been highlighted in cases where excessive exposure concentration, directed lending, excessive lending to connected parties, poor credit policy and inadequate management of foreign exchange risk have led to financial distress in a number of emerging economies. Accordingly, banking supervisors are placing greater emphasis on the role of corporate governance in promoting financial stability.

### *Market Discipline*

Market discipline is a necessary condition for financial stability. In the repressed financial systems that existed in many countries well into the 1980s, where there were many types of interest rates and capital controls, financial system instability could remain hidden for years. These repressed financial environments created ponderous inefficiencies, and stifled incentives to price and manage risks. This resulted in "covert" insolvencies that only became exposed, sometimes with severe financial consequences, once these systems were opened to the healthy rigours of competition. At present, there is a well-established consensus that strengthening market discipline within a clear prudential framework and improving the disclosure of the risk profile of individual financial institutions can help to achieve a better balance between financial system stability and economic efficiency. The steps taken by Basel Committee for Banking Supervision (BCBS) to strengthen Pillar 3 in the revised framework address the issue.

## International Convergence Towards Promoting Stability

Central banks recognise that good quality supervision strengthens banking systems, thereby contributing towards greater stability of financial systems. Supervisors around the world are putting concerted efforts towards promoting this objective at the individual country level and global level to enable the international financial architecture to

contain the risks. The BCBS issued in 1997 the *Core Principles for Effective Banking Supervision*, designed to provide an internationally agreed framework for effective and sound banking systems, which all supervisory authorities were invited to endorse.

Further, the international banking supervisory community has given significant attention to changes to the capital adequacy requirements originally proposed by the BCBS in1988 (Basel I). However, due to the increasing complexity of bank activities and their associated risks coupled with technological developments, the BCBS has designed a more risk sensitive regulatory framework, Basel II, that takes into account the evolution of risk management and the allocation of capital to cover those risks. The ultimate goal of Basel II is to strengthen financial systems, both in the Basel Committee member and non-member countries.

## Role of the Bank in Promoting Financial Stability

One of the priorities of the Bank is to promote and sustain public confidence in the financial system. Public confidence in the banking system is an essential element for the proper functioning of the financial system and for promoting financial stability.

The Bank has endorsed the *Core Principles for Effective Banking Supervision* issued by the BCBS in 1997. These principles embrace a wide range of international concerns regarding the governance of banks and serve as a benchmark to assess the effectiveness of national banking supervisory regimes. Further, the Bank has required banks to implement the 40 recommendations of the Financial Action Task Force on Money Laundering with the objective of preserving and strengthening the reputation of Mauritius as a financial centre.

With a view to promoting a financially stable environment, the Bank has issued a series of prudential guidelines. A list of those guidelines is given at Appendix I.

The supervisory system is based on both on-site inspections and regular off-site surveillance. The Bank also maintains regular contacts with bank management through trilateral meetings held every year and during on-site inspections carried out once a year. Other meetings and discussions held with bank management form an on-going process of consultation between the regulator and the banks.

Achieving financial stability is only possible with the participation and cooperation of banks. A Banking Committee has been set up and meets on a quarterly basis. Views and information on the wider financial sector are shared on an on-going basis with the chief executives of banks to ensure that these institutions are effectively meeting the demands placed on them by the Bank.

With the promulgation of the Banking Act 2004 and Bank of Mauritius Act 2004, the independence of the Bank has further been enhanced. The new legislations have consolidated the framework relating to the business of banking and have taken on board new aspirations of the evolving financial sector.

As a further step, the Bank launched the Mauritius Credit Information Bureau (MCIB) on 30 November 2005. The MCIB collects, stores and provides credit information to banks about customers' credit exposures. The objective of the MCIB is to promote an overall sound credit environment in Mauritius as well as fight the over-indebtedness of households, which can impact negatively on society and the economy at large.

Regional and international cooperation is necessary to avoid systemic risks, which can create serious imbalances in the global financial sector. To facilitate the sharing of supervisory information and promote cooperation in the field of supervision, the Bank entered into Memoranda of Understanding with a number of foreign supervisors.

## CONCLUSION

Central banks, the world over, are anxious to maintain financial stability. The failure of one institution can result in the failure of the whole financial system even when the macroeconomic environment is stable. With this in mind, central banks and other policy makers are actively engaged in putting in place an effective regulatory framework to ensure that there are sound and efficient financial

institutions and effective financial markets. The Bank, like its foreign counterparts, is pursuing the same objective. To this end, it has adopted best international practices as recommended by the BCBS, for example the capital adequacy framework and the *Core Principles for Effective Banking Supervision*, and has put in place a series of measures to ensure that financial stability is achieved.

# 6. Supervisory Approach to Country Risk

## INTRODUCTION

Globalisation and liberalisation have resulted into an increase in the volume of international lending transactions by banks in Mauritius. Banks engaged in international lending have an additional risk component, that is, country risk, as compared to domestic lending. If such risk is not well managed, it may disturb the financial system. There are several examples of countries, which have not been able to meet their external debt obligations and creditors have had to negotiate terms on which the debts may be settled. Country risk assumes an even greater importance when several countries, which are identified as having some common links, simultaneously face an external crisis of confidence, the destabilising effect of which was seen during the Asian Crisis. Weaknesses in the banking system of one country associated with a state of unpreparedness to deal effectively with country risk can have a contagion effect on the financial systems of other related countries. This is a serious concern for regulators. They should ensure that banks follow certain key principles, which are central to the maintenance of financial stability.

The Bank of Mauritius (the Bank) has endorsed the *Core Principles for Effective Banking Supervision* issued by the Basel Committee on Banking Supervision (BCBS) in September 1997 and is fully committed to its implementation. It is recalled that Principle 11 of the Core Principles states that *"Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks"*. Furthermore, the Financial Sector Assessment Program Report recommended that there was need for additional prudential guidelines to address, *inter alia*, country risk. In that sense, country risk is an important issue that needs to be addressed by all stakeholders in the banking sector.

### Definition of Country Risk

Country risk is the risk that economic, social, and/or political conditions and events in a foreign country will adversely affect a bank's risk profile and financial interests. There are a number of factors that give rise to country risk. These range from deterioration in economic conditions, political and social unrests to largely unpredictable events such as natural disasters or external shocks.

Country risk should not be considered in isolation. It has associated risks which have the potential to adversely affect a bank's risk profile. Some of the associated risks are highlighted below:

- *Sovereign risk* is the likelihood that governments (domestic or foreign) will alter their debt service payments, thereby breaking the prearranged repayment schedule. Sovereign risk arises when a bank has any type of lending, extension of credit, or advance to a country's superior national-level government.
- *Political risk* occurs where political changes or trends, often accompanied by shifts in economic policy that may affect the availability of foreign exchange to finance private or public external obligations.
- *Transfer risk* is the risk that a borrower will be unable to convert its local currency income into the currency needed to repay the loan.
- *Foreign exchange risk* arises from changes in foreign exchange rates that affect the value of assets, liabilities, and off-balance sheet activities denominated in currencies other than the bank's domestic currency.

### Importance of Country Risk

Country risk has a direct bearing on the level of investment in a country. Not only does it determine the quantity of investment but also the quality and stability of the investment. During the Asian Crisis 1997, foreigners, having significant claims

denominated in foreign currency on Asian counterparties, experienced much difficulty in recovering their funds in the face of deteriorating economic environment.

Low-risk countries inspire greater confidence among foreign investors and create a platform for larger volumes of investment, longer-term and stable investment projects. As a consequence, increased investments help generate employment and contribute to the economic well being of the population and ultimately financial stability. As opposed to this, high-risk countries tend to attract shorter-term and more speculative type of investments.

The quality of rating acquired by a country will determine the capacity of both its government and private institutions to raise funds from the international financial community and bargain on the cost of funds.

## Country Risk Rating

The determination of country risk, which is the conclusion of the risk analysis process, may take the form of a rating or an index. The rating, thus obtained, establishes the degree of exposure to any prospective foreign investor. Country ratings are usually made publicly available and constitute a basis for comparison between countries. Ratings are usually calculated on an annual basis or more frequently if the situation so warrants. Banks may internally carry out country risk assessment of countries or may solicit external ratings.

## External Assessment

Measuring country risk may constitute a lengthy and expensive task depending upon the availability and accessibility to information in a given country. Actually, there is an increasing number of External Rating Agencies (ERAs), which specialise in country risk studies and issue assessments. Among the most widely known agencies are Moody's Investors Services, Standard and Poor's Rating Group, Fitch Ratings, Institutional Investor and Euromoney. The rating scale ranges between "A" and "C" with steps in between or from zero to 100 where a rating of 100 represents a low risk of default and zero indicates a high risk of default.

The ERAs use various methods to arrive at quantitative measures of country risk. However, each method has to assess the financial, economic and political risks of a country. The latest available country risk ratings that have been assigned to Mauritius by three of the ERAs are shown below:

| ***ERAs*** | ***Rating*** |
|---|---|
| Institutional Investor | 57.4 |
| Euromoney | 57.27 |
| Moody's Investors Services | Baa2 |

Other institutions that provide ratings are the Export Credit Agencies (ECAs). Many countries have established public- or state-backed ECAs to protect exporters against country risk and credit risk. Banks may use the country risk scores assigned by ECAs. However, the ECAs must have subscribed to the OECD agreed methodology under the *Arrangement on Officially Supported Export Credits*. The OECD methodology establishes eight risk score categories ranging from zero (low risk) to seven (high risk). The OECD granted a country risk rating of 'three' to Mauritius as at end of June 2005.

## Internal Assessment

Some banks have put in place appropriate systems to assess country risk internally. In such a case, banks have to carry out an evaluation of economic trends, political developments and the social fabrics within countries where their funds may be at risk. Information may be obtained from the borrowers, institutional lenders, social and political publications and other relevant sources. Based on these, banks assign internal ratings to countries. As a prudential measure, the rating accorded by a bank to any country should not be better than the rating of that country by an international rating agency.

Internal assessment has the advantage of including institution-specific information such as a bank's historical experience in lending to borrowers in certain countries.

## Supervisory Approach

The major concern of any supervisory authority regarding country risk would be whether or not banks can properly identify, measure, monitor and control country risk. The BCBS issued the first supervisory prudential guideline on country risk in March 1982. The document, *Management of Banks' International Lending*, was the basis on which most banks established their framework for country risk management.

Some of the elements that regulators would expect to be included in banks' country risk management framework are highlighted below:

### *Country Risk Policies and Procedures*

Supervisors have the responsibility to ensure that banks' country risk management policies and procedures are appropriate. These policies and procedures should be well documented and have the approval of their board of directors. In formulating their policies, banks should ensure that they are properly:

- identifying, measuring, monitoring and controlling country risk;
- evaluating economic trends, political developments and social aspects of countries where banks have exposures;
- defining the level of country exposure, banks are willing to assume;
- establishing proper internal reporting system to monitor and control country exposures; and
- dealing with country risk problems.

### *Responsibilities of Board of Directors*

The main responsibilities of a board of directors are to set the overall objectives, strategies and direction of an institution. Regarding country risk, the board should be responsible for:

- approving the written policies and procedures for country risk management;
- designing a committee responsible for the administration of country risk, which can be the board itself or a committee thereof;
- reviewing reports on country risk;
- setting and reviewing country exposure limits; and
- ensuring adherence to internal policies, practices, procedures and controls.

### *Country Exposure Measurement*

Banks should put in place a system for measuring country exposure having regard to the size and complexity of the international lending operations. The system should be comprehensive enough to capture all significant exposures. Some of the problems that banks may encounter are:

- the difficulty to determine where the final risk lies;
- the measurement of country exposure on a consolidated basis, including the operations of branches, subsidiaries, and significant investments; and
- the determination of the breakdown by residual maturity of claims in order to provide a comprehensive maturity profile of indebtedness.

Another important issue that banks need to take into consideration is the measurement of indirect country risk. Indirect country risk occurs when exposure to domestic borrowers is linked to economic dependence on other countries.

### *Country Exposure Limits*

Having put in place a system for measuring country exposure, banks may set limits and sub-limits to be applied to individual country exposures. Banks should spread their risks by diversifying their country exposures. The country exposure limits should take into account the size and nature of the banks and should be set in relation to the banks' capital base.

Moreover, banks may set up regional exposure limits for country groups. They may also establish limits for distribution of loans by type and maturity. In certain jurisdictions, regulators prescribe individual and aggregate country exposure limits based on country risk scoring.

### *Provisioning for Country Risk*

Banks should make adequate provisioning for country risk and maintain appropriate reserves against the identified risk. This provisioning should be made in addition to the provisions required for non-performing assets. In some countries, the regulators require banks to make provisions on the net funded country exposure on a graded scale according to the country risk profile. For instance,

in India, country exposures are classified into seven risk categories and the provisioning requirements are set out below:

| Risk Category | Provisioning Requirement (%) |
|---|---|
| Insignificant | 0.25 |
| Low | 0.25 |
| Moderate | 5 |
| High | 20 |
| Very High | 25 |
| Restricted | 100 |
| Off-credit | 100 |

The risk category is based on the country rating provided by the Export Credit Guarantee Corporation of India Ltd. Banks in India may also use their own internal rating systems of country risk for provisioning purposes subject to the regulator's approval.

### *Disclosure*

In order to promote market discipline, banks are required to disclose information on their country risk profile such as the risk category-wise exposures and the aggregate provisions held by way of buffer against country exposures, in their audited financial statements.

## Challenges Ahead

The new Capital Accord calls for more discipline in the risk management approach of banks. The Accord will require banks to set aside capital, as relevant, for country risk. In particular, banks having large exposures to sovereigns will have to maintain minimum required capital depending on their ratings.

Banks in Mauritius have been expanding their networks through establishing subsidiaries and branches overseas. As a result, they are exposed to increased country risk and this situation calls for more effective risk management. It is the responsibility of regulators to set minimum prudential requirements regarding the overall risk management framework.

## CONCLUSION

Assessing country risk is a more complex issue than the assessment of an individual's risk of default. The effective measurement of country risk may be hindered by various unpredictable events. However, if banks want to protect themselves from country risk, they have no alternative than to put in place proper policies and procedures for monitoring country risk. While they may rely on external rating there is no substitute for developing direct risk insights into the country risks being taken. Banks can achieve this by keeping close to the beneficiaries of facilities and by taking anticipated actions to minimise the impact of country risk on their good standing.

# APPENDIX I

# Guidelines

# 1. List of Guidelines/Guidance Notes

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

# 2. Guideline on Operational Risk Management and Capital Adequacy Determination

## 1.0 Introduction

This Guideline applies to all banks. It is issued under the authority of the Bank of Mauritius Act 2004 and the Banking Act 2004, in particular Section 50 of the former and Sections 20 and 100 of the latter. In the determination of capital adequacy, the requirements of the Guideline are supplementary to those of the Guidance Notes on Risk Weighted Capital Adequacy Ratio (hereinafter called Guidance Notes), which pertain to credit risk.

The wide spectrum of services provided by banks, together with increasing application of sophisticated financial technology, makes risks inherent in banking operations more diverse and complex. Additional risks exist, over and above those related to credit, interest rate and market environment. The risks related to the operational environment are designated 'operational risk(s)'. Operational risks, if not controlled, can lead to major losses, resulting from, for example, internal fraud, external malfeasance (forgery, computer hacking), systems failures, improper handling of business practices (misuse of confidential information, improper trading activities) and damage to physical assets.

In the new capital adequacy framework entitled *'International Convergence of Capital Measurement and Capital Standards'* [1], the Basel Committee on Banking Supervision (BCBS) has defined operational risk as

"The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk, but excludes strategic and reputational risks."

Operational risk would, in fact, vary from bank to bank, making it necessary for the institution to further refine the definition in the context of its operations.

Banks have traditionally relied on broad systems of internal control and the audit function to control and manage operational risk. In recent years, however, many banks across the world have installed more specific structures and processes aimed at managing the risk. In recognition of the evolution, BCBS now gives operational risk similar importance and stature as credit and market risks, requiring banks to apply similar level of rigour and resources to controlling and managing operational risk.

Consistent with the recommendations made by the BCBS, the Bank of Mauritius, through this Guideline, requires each bank to establish an appropriate, comprehensive approach to the identification, measurement, monitoring and control of operational risk. It further requires each bank to make an adequate provision of capital to protect against operational risk.

The Guideline is divided into four principal sections, dealing with operational risk management framework, computation of capital charge for operational risk, minimum eligibility criteria for the more advanced approaches and information returns.

## 2.0 Operational Risk Management Framework

BCBS in its report entitled "Sound Practices for the Management and Supervision of Operational Risk" has identified ten principles for an effective operational risk management framework. Annexure 1 sets out these principles. The boards of directors of a bank and senior management are responsible for creating an environment and culture that emphasizes high standards of ethical behaviour at all levels of the bank's organisation. The following describes the essential elements of the principles and their application to banks in Mauritius.

### 2.1 Establishment of an Operational Risk Management Policy

Each bank shall establish a written policy on operational risk management, which shall clearly set out:

[1] Available on: http://www.bis.org

- an appropriate definition of what constitutes operational risk;
- its appetite and tolerance for operational risk;
- the principles for identifying, assessing, monitoring and controlling/mitigating operational risk; and
- policies for managing risks associated with outsourcing activities.

### 2.2 Responsibilities and Accountabilities of the Board of Directors

In accordance with the requirements of Section 18(6) of the Banking Act 2004 which states that the board of directors of a financial institution shall approve its major policies, the board shall, in respect of operational risk management,

- give clear guidance to senior management regarding the principles underlying the risk management framework, appetite and tolerance for operational risk;
- approve, if acceptable, the operational risk management policy prepared by senior management of the bank;
- establish adequate management structure (lines of responsibility, accountability and reporting), including strong internal controls with appropriate segregation of responsibilities between operational risk control functions and the line functions, to ensure effective implementation of the risk management framework; the board shall define and communicate to the chief executive officer his accountabilities for operational risk management;
- review, at least once a year, the established framework to ensure its continued adequacy and effectiveness in the light of changing market environment and any special operational risk factors associated with new products, services or systems;
- expand the mandate of the existing Conduct Review and Risk Policy Committee of the board, to assume responsibility for the overview of operational risk management;
- require the chief executive officer to submit a comprehensive written report to the board on the management of operational risk at least once every six months, and submit such other reports at such intervals as the board may specify;
- require effective and comprehensive internal audit of the operational risk management framework by well trained, competent auditors, who are independent of the risk management function, and who are responsible for periodically validating adherence to the established framework;
- ensure that outsourcing activities, if any, are carried out in a safe and sound manner and in compliance with applicable laws and regulations; and
- approve the bank's contingency and business continuity plan.

Foreign banks having branch operations in Mauritius shall implement a management framework for operational risk as required under this Guideline. The head office of the branch shall ensure, at the consolidated level, that the branch complies with the capital adequacy requirements for operational risk as well as other applicable regulations, guidelines and instructions. The situation may, however, be reviewed in the light of Basel II.

### 2.3 Responsibilities and Accountabilities of Senior Management

Senior Management of a bank shall:

- develop an appropriate operational risk management framework for approval by the board;
- clearly assign responsibilities and accountabilities of staff in the implementation of the framework;
- initiate a comprehensive operational risk identification process by product or business

line, followed by an assessment of the organization's vulnerability to the identified risks and the effectiveness of controls installed to mitigate risk;

- ensure that the operational risk management framework is implemented in a consistent, uniform manner throughout the bank's organization, employing well documented policies, processes and procedures;

- establish an effective risk monitoring system, with frequency of monitoring determined in the light of the risks involved, the changing environment, and each business unit's strengths and weaknesses in mitigating risks;

- establish a system of regular reporting (specifying contents and structure of reports) to senior management and the board, by appropriate areas, such as business units and group functions, on a regular basis to permit timely corrective action;

- ensure that all levels of staff throughout the organization understand their responsibilities for operational risk management and possess necessary skills and experience to identify, assess and control risks;

- establish a communication system for the effective dissemination of operational risk policies and procedures to employees involved in activities exposed to operational risk; and

- ensure that remuneration policies do not reward any practices that detract from the bank's established operational risk management framework.

Paragraphs 2.4 to 2.7 provide further amplification of certain selected responsibilities of senior management of a bank.

### 2.4 Operational Risk Identification / Assessment

Banks shall establish adequate processes for identifying operational risks inherent in their significant products, activities, processes and systems. The identification process must incorporate both internal factors (such as the bank's structure, systems and controls, and generally the nature of its activities) and external factors (such as changes in the industry, global environment and advances in financial technology). Banks should then assess, in depth, their vulnerability to the identified risks.

Before initiating any new products, activities, processes or systems, banks must ensure that there is adequate identification and assessment of the underlying operational risks and controls in place to mitigate the impact of risks.

### 2.5 Operational Risk Monitoring / Reporting

Banks must regularly monitor their operational risk profiles and any material exposures to losses. The frequency of monitoring will depend on the nature and changes in the operating environment and on the risks involved. Early warning indicators for alerting the bank of any potential loss situations should be identified and regularly monitored.

Banks must establish systems to ensure that significant information arising from the monitoring activities and any compliance reviews respecting adherence to the operational risk management framework (including assigned risk limits or thresholds) is reported to senior management and the board in a timely manner. Reports should be sufficiently complete to permit adequate appreciation of the bank's overall operational risk profile and the resulting strategic implications.

### 2.6 Operational Risk Control / Mitigation

Banks must establish formal, written internal controls and procedures for controlling and mitigating the effects of operational risks. In the event the risks cannot be controlled, banks must decide whether to accept the risks, reduce the level of affected business activities, or withdraw from the activities. Insurance policies should be considered as complementary rather than substitutes for prudential operational risk management, including effective internal control structure. Internal control framework and risk management processes must stay abreast of any expansion in business activity such as the introduction of new products or entry into new markets.

More specifically, internal control systems in a bank must ensure:

(i) appropriate segregation of duties among staff to prevent assignment of conflicting duties, inhibiting timely reporting of actual or potential losses arising from errors or inappropriate actions;

(ii) proper documentation of approvals and authorisations to establish accountability;

(iii) adherence to set risk thresholds or limits;

(iv) appropriate control of access to and the use of bank's assets and records;

(v) adequate investigation of unexpectedly high returns (particularly from activities with low margins normally);

(vi) regular reconciliation of accounts with the underlying transactions;

(vii) support of outsourcing activities by robust contracts and/ or service level arrangements that clearly set out the responsibilities of the bank and the external service provider, whilst any residual risk associated with outsourcing arrangements is appropriately managed; and

(viii) proper monitoring of services provided by external vendors or any other third-party or intra-group service provider.

### 2.7 Contingency and Business Continuity Planning

A bank must put in place a well designed, realistic contingency and continuity plan, approved by the board. The plan must include at least the following elements:

(i) identification of critical business processes, including those where there is dependence on external vendors or other third parties;

(ii) identification of alternative mechanisms for rapid resumption of services, with special focus on critical business processes;

(iii) location of off-site back-up facilities at a reasonable distance from the impacted operations to reduce risk of having both primary and back-up records and facilities unavailable simultaneously; and

(iv) regular reviews and testing of the contingency plans.

## 3.0 Capital Charge for Operational Risk

Under the new capital adequacy framework, BCBS has identified three alternative approaches for calculating operational risk capital charge, based on a continuum of increasing complexity and risk sensitivity, of a bank's operations. These are:

- The **Basic Indicator Approach** - which requires an allocation of capital based on an average of positive annual gross income[2] of the bank over the past three years;

- The **Standardised Approach** - which requires the activities of a bank to be split into eight lines of business. BCBS has identified two sub-approaches namely:

  (a) Standardised Approach; and

  (b) Alternative Standardised Approach.

The Alternative Standardised Approach allows several other variations as discussed in section 3.1.3.

- The **Advanced Measurement Approach** - which involves the calculation of capital based on a bank's internal operational risk measurement system, using the past loss experience as a guide.

Banks in Mauritius will have the flexibility of choosing one of the above three approaches. They will be encouraged to move along the ascending spectrum of approaches as they achieve increasing sophistication in their operational risk systems and processes. However, banks must obtain prior approval of the Bank of Mauritius if they intend to use any one of the advanced approaches namely

[2] Refer to subsection 3.1.1 for the definition of gross income

Standardised Approach, Alternative Standardised Approach or Advanced Measurement Approach. Furthermore, if a bank has adopted any one of these approaches and wants to revert to the use of a simpler approach, it must seek prior approval of the Bank of Mauritius. As from the effective date of the Guideline, banks shall, as a minimum, implement the Basic Indicator Approach.

## 3.1 Calculation of Capital Charge for Operational Risk

Principles underlying the computation of capital charges under the three approaches are set out below, in brief (for details, refer to the new capital adequacy framework).

### 3.1.1 The Basic Indicator Approach

Under this approach, the capital charge is equivalent to 15% of average annual positive gross income over the previous three years. When the annual gross income for a year is negative or zero, it must be excluded from both the numerator and denominator in computing the average.

Gross income is defined as the sum of net interest income and net non-interest income and shall be arrived at before accounting for:

(i) Provisions, including those for credit impairment;

(ii) operating expenses (including fees in respect of outsourced services)

(iii) realised profits/losses from the sale of securities held to maturity and available for sale;

(iv) extraordinary items, classified as such by accounting standards and conventions; and

(v) income derived from insurance.

### 3.1.2 The Standardised Approach

Under this approach, a bank's activities are divided into eight business lines: corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management and retail brokerage. A description of these business lines is given in Annexure 2.

The capital charge for each business line is calculated by multiplying gross income[3] by a beta factor assigned to that business line. Beta serves as a proxy for industry-wide relationship between the operational risk loss experience in a business and the aggregate level of gross income generated by the business line. Beta factor varies from 12% to 18%, as follows.

- Corporate finance 18%
- Trading and sales 18%
- Retail banking 12%
- Commercial banking 15%
- Payment and settlement 18%
- Agency services 15%
- Asset management 12%
- Retail brokerage 12%

The total capital charge is calculated as the three-year average of the simple summation of the regulatory capital charges across each of the business lines in each year. In any given year, negative capital charge (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit. However, where the aggregate capital charge across all business lines within a given year is negative, then the input to the numerator for that year will be zero but in calculating the average, the denominator will remain unchanged, i.e., three.

### 3.1.3 The Alternative Standardised Approach (ASA)

The computational framework under the ASA is the same as under the Standardised Approach except for retail banking and commercial banking. The Beta factors for these two business lines remain unchanged but the gross income is replaced by the

[3] Refer to subsection 3.1.1 for the definition of gross income.

outstanding balance of loans and advances multiplied by a factor which has been fixed at 0.035. Banks can choose to compute an aggregate capital charge for retail and commercial banking using the total outstanding balance as the exposure indicator and a single beta of 15%.

Similarly, those banks that are unable to disaggregate their gross income into the other six business lines can aggregate the total gross income for these six business lines using a beta of 18%. Negative gross income may be used to offset positive income in any one year.

#### 3.1.4 Advanced Measurement Approach

The regulatory capital requirement under this approach shall equal the risk measure resulting from the bank's internal operational risk measurement system, using the specified qualitative and quantitative criteria. The approach is designed to produce a reasonable estimate of unexpected losses based on the combined use of internal and relevant external contingencies and loss data. The approach also factors in the bank specific business environment information systems, practices and controls in place.

### 3.2 Determination of Capital Adequacy Ratio

Banks shall henceforth compute a composite capital adequacy ratio, encompassing both credit risk and operational risk. The principles and methodology for calculating capital adequacy ratio for credit risk (i.e. capital base and risk-weighted assets), contained in the existing Guidance Notes, will remain unchanged. Information requirements for the calculations are specified in Part A of the existing capital adequacy return. The components of the capital base (Tier 1 capital and Tier 2 capital) and the approach for their calculation, contained in the Guidance Notes, will remain unchanged. This Guideline deals with the methodology for assessing operational risk and calculating the composite capital adequacy ratio.

In order to ensure consistency in the calculation of capital charge between credit risk and operational risk, a numerical link between the two will be established. This will be done by multiplying the capital charge for operational risk (calculated under this Guideline) by a factor of 10 (the reciprocal of the minimum capital ratio of 10 per cent) and adding the resulting figure to the risk based assets calculated under the Guidance Notes. The ratio is then calculated by dividing the capital base by the sum of total risk weighted assets (credit risk assets plus operational risk assets). Banks are required to maintain a minimum composite capital adequacy ratio, so determined, of 10 per cent.

## 4.0 Minimum Eligibility Criteria for Advanced Approaches

### 4.1 General Minimum Eligibility Criteria

A bank opting to use the Standardised Approach or the Advanced Measurement Approach for assessment of operational risk shall meet the following general criteria.

- The bank's board of directors and senior management are actively involved in the oversight of the operational risk management framework;
- The bank has a risk management system that is conceptually sound and is implemented with integrity;
- The bank has deployed sufficient resources in the implementation of the approach in its major business lines as well as in the control and audit functions.

### 4.2 Specific Minimum Eligibility Criteria

BCBS has outlined at length the specific minimum eligibility criteria for the use of the Standardized Approach and the Advanced Measurement Approach. These criteria, contained in its new capital adequacy framework, shall apply to banks in Mauritius which plan to use one of the advanced approaches. Banks will also be permitted to make partial use of any of the three approaches for different parts of their operations provided certain minimum criteria are met and prior written approval of the Bank of Mauritius is obtained.

The criteria are not reproduced in the Guideline but banks are invited to refer to the new capital adequacy framework for the purpose.

### 5.0 Information Returns

All banks shall complete and submit information on:

(i) Capital adequacy computation for operational risk, as specified in the returns in Annexures 3, 4, 5 or 6 depending on the approach used. The returns shall be completed on a quarterly basis and as an addendum (Part F) to the existing return required under the Guidance Notes on Risk Weighted Capital Adequacy Ratio.

(ii) Historical internal loss experience resulting from operational risk as set out in Annexure 7. This return shall be submitted by end February of each year, setting out information for the preceding calendar year.

### 6.0 Commencement

The Guideline shall come into effect on 1 April 2005.

**Bank of Mauritius**
**February 2005**

# Annexure 1
# Principles for Sound Management and Supervision of Operational Risk

### *Developing an Appropriate Risk Management Environment*

**Principle 1:** The board of directors[4] should be aware of the major aspects of the bank's operational risks as a distinct risk category that should be managed, and it should approve and periodically review the bank's operational risk management framework. The framework should provide a firm-wide definition of operational risk and lay down the principles of how operational risk is to be identified, assessed, monitored, and controlled/mitigated.

**Principle 2:** The board of directors should ensure that the bank's operational risk management framework is subject to effective and comprehensive internal audit by operationally independent, appropriately trained and competent staff. The internal audit function should not be directly responsible for operational risk management.

**Principle 3:** Senior management should have responsibility for implementing the operational risk management framework approved by the board of directors. The framework should be consistently implemented throughout the whole banking organisation, and all levels of staff should understand their responsibilities with respect to operational risk management. Senior management should also have responsibility for developing policies, processes and procedures for managing operational risk in all of the bank's material products, activities, processes and systems.

### *Risk Management: Identification, Assessment, Monitoring, and Mitigation/Control*

**Principle 4:** Banks should identify and assess the operational risk inherent in all material products, activities, processes and systems. Banks should also ensure that before new products, activities, processes and systems are introduced or undertaken, the operational risk inherent in them is subject to adequate assessment procedures.

**Principle 5:** Banks should implement a process to regularly monitor operational risk profiles and material exposures to losses. There should be regular reporting of pertinent information to senior management and the board of directors that supports the proactive management of operational risk.

**Principle 6:** Banks should have policies, processes and procedures to control and/ormitigate material operational risks. Banks should periodically review their risk limitation and control strategies and should adjust their operational risk profile accordingly using appropriate strategies, in light of their overall risk appetite and profile.

**Principle 7:** Banks should have in place contingency and business continuity plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

### *Role of Supervisors*

**Principle 8:** Banking supervisors should require that all banks, regardless of size, have an effective framework in place to identify, assess, monitor and control/mitigate material operational risks as part of an overall approach to risk management.

**Principle 9:** Supervisors should conduct, directly or indirectly, regular independent evaluation of a bank's policies, procedures and practices related to operational risks. Supervisors

[4] The BCBS refers to a management structure composed of a board of directors and senior management. The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, the board has a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the terms 'board of directors' and 'senior management' are used in this paper not to identify legal constructs but rather to label two decision-making functions within a bank.

should ensure that there are appropriate mechanisms in place which allow them to remain apprised of developments at banks.

*Role of Disclosure*

**Principle 10:** Banks should make sufficient public disclosure to allow market participants to assess their approach to operational risk management.

***(Source : The BCBS Sound Practices for the Management and Supervision of Operational Risk issued in February 2003)***

# Annexure 2
# Business Lines

| Business Lines | Sub-Categories | Activities Groups |
|---|---|---|
| Corporate Finance | Corporate Finance | Mergers and acquisitions, underwriting, privatizations, securitisation, research, debt, equity, syndications, IPO, secondary private placements. |
| | Municipal/Government Finance | |
| | Merchant Banking | |
| | Advisory Services | |
| Trading & Sales | Sales | Fixed income, equity, foreign exchanges, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage |
| | Market Making | |
| | Proprietary Positions | |
| | Treasury | |
| Retail banking | Retail Banking | Retail lending and deposits, banking services, trust and estates |
| | Private Banking | Private lending and deposits, banking services, trust and estates, investment advice |
| | Card Services | Merchant/commercial/corporate cards, private labels and retail |
| Commercial banking | | Project finance, real estate, export finance, trade finance, factoring, leasing, lending, guarantees, bills of exchange |
| Payment and Settlement | External Clients | Payment and collections, funds transfer, clearing and settlement. |
| Agency services | Custody | Escrow, depository receipts, securities lending (customers), corporate actions |
| | Corporate Agency<br>Corporate Trust | Issuer and paying agents |
| Asset Management | Discretionary Fund Management | Pooled, segregated, retail, institutional, closed, open, private equity |
| | Non-Discretionary Fund Management | |
| Retail brokerage | | Execution and full service |

Source: Basel Committee on Banking Supervision (2004), *International Convergence of Capital Measurement and Capital Standards*

# Annexure 3
# Basic Indicator Approach

**Capital Adequacy Return for the quarter ended ……**
**PART F**
**('000)**

| | Financial Year Ended 01 | Financial Year Ended 02 | Financial Year Ended 03 |
|---|---|---|---|
| Annual Gross Income (X) | $X_1$ | $X_2$ | $X_3$ |

| | | |
|---|---|---|
| (1) Number of Years with **positive** income | : | N |
| (2) Average Gross Income | : | (sum of positive values of X) ÷ N |
| (3) Capital charge for Operational Risk | : | 15 % x (2) |
| (4) Risk Weighted Assets for operational risk | : | 10 x (3) |
| (5) Risk Weighted Assets for credit risk | : | Calculated as per Guidance Notes on Risk Weighted Capital Adequacy Ratio (Part A-subsection II, of the capital adequacy returns) |
| (6) Total Risk Weighted Assets | : | (4) + (5) |
| (7) Total Capital Base | : | Calculated as per Guidance Notes on Risk Weighted Capital Adequacy Ratio (Part A-subsection I(C), of the capital adequacy returns) |
| (8) Capital Adequacy Ratio (%) | : | [(7) ÷ (6)] x 100 |

# Annexure 4
# Standardised Approach

**Capital Adequacy Return For the quarter ended ......**
**PART F**
**('000)**

**Part A**

| **Line of Business** | **Beta Factor** | **Gross Income for previous 3 years** | | | **Weighted Gross Income** | | |
|---|---|---|---|---|---|---|---|
| | | **FY 01** | **FY 02** | **FY 03** | **FY 01** | **FY 02** | **FY 03** |
| | **_** | **A1** | **A2** | **A3** | **A1 x _** | **A2 x _** | **A3 x _** |
| (1) Corporate Finance | 18% | | | | | | |
| (2) Trading and Sales | 18% | | | | | | |
| (3) Commercial Banking | 15% | | | | | | |
| (4) Retail Banking | 12% | | | | | | |
| (5) Payment and Settlement | 18% | | | | | | |
| (6) Agency Services | 15% | | | | | | |
| (7) Asset Management | 12% | | | | | | |
| (8) Retail Brokerage | 12% | | | | | | |
| Total Yearly Weighted Gross Income (A4) | | | | | A41 | A42 | A43 |

**Part B**

| | | |
|---|---|---|
| (9) | Aggregate of positive value of Total Yearly Weighted Gross Income over the three years | : Sum of **positive** values of A4 |
| (10) | Capital charge for Operational Risk | : (9) ÷ 3 |
| (11) | Risk Weighted Assets for <u>Operational Risk</u> | : 10 x (10) |
| (12) | Risk weighted assets for Credit Risk | : Calculated as per Guidance Notes on Risk Weighted Capital Adequacy Ratio (Part A-subsection II, of the capital adequacy returns) |
| (13) | Total Risk Weighted Assets | : (11) + (12) |
| (14) | Total Capital Base | : Calculated as per Guidance Notes on Risk Weighted Capital Adequacy Ratio (Part A-subsection I(C), of the capital adequacy returns) |
| (15) | Capital Adequacy Ratio (%) | : [(14) ÷ (13)] x 100 |

# Annexure 5
# Alternative Standardised Approach

**Capital Adequacy Return For the quarter ended ……**
**PART F**
**('000)**

**Part A**

I Capital Charge for the six business lines (excl. retail and commercial banking)[5]

| | | | | |
|---|---|---|---|---|
| (1) Corporate Finance | 18% | | | |
| (2) Trading and Sales | 18% | | | |
| (3) Payment and Settlement | 18% | | | |
| (4) Agency Services | 15% | | | |
| (5) Asset Management | 12% | | | |
| (6) Retail Brokerage | 12% | | | |
| (7) Total Gross income1 | 18% | | | |
| (8) Capital charge for each year (A4) | | A41 | A42 | A43 |
| (9) Aggregate capital charge | | C1 = (Sum of positive values of A4) ÷ 3 | | |

**Part B**

II Capital Charge for retail and commercial banking [6]

| | Beta Factor | Fixed Factor | Outstanding balance of loans and advances as at end of past 3 years | | | Average | Capital Charge |
|---|---|---|---|---|---|---|---|
| | | | FY 01 | FY 02 | FY 03 | | |
| | _ | M | A7 | A8 | A9 | A10[7] | A11[8] |
| (9) Retail Banking | **12%** | **0.035** | | | | | |
| (10) Commercial Banking | **15%** | **0.035** | | | | | |
| (11) Aggregated Retail & Commercial Banking | **15%** | **0.035** | | | | | |
| Total | | | | | | **C2** | |

5 Depending on the approach adopted, gross income from the six lines of business should **either** be disaggregated into items 1 to 6 **or** aggregated into line 7. In case aggregate figure is used a beta of 18% should be applied.

6 Depending on the approach being used, outstanding balances for retail and commercial banking should **either** be disaggregated into items 9 and 10 **or** aggregated into line 11. In case aggregate figures are used a beta of 15% should be applied.

7 A10 = (A7+A8+A9) ÷ 3

8 A11 = A10 x _ x M

# Annexure 5 Cont'd
# Alternative Standardised Approach

**Capital Adequacy Return For the quarter ended ......**
**PART F**
**('000)**

**Part C**

| | | |
|---|---|---|
| (12) Total Capital Charge for Operational Risk | : | Sum of C1 and C2 |
| (13) Risk Weighted Assets for Operational Risk | : | 10 x (12) |
| (14) Risk weighted assets for Credit Risk | : | Calculated as per Guidance Notes on Risk Weighted Capital Adequacy Ratio (Part A-subsection II, of the capital adequacy returns) |
| (15) Total Risk Weighted Assets | : | (13) + (14) |
| (16) Total Capital Base | : | Calculated as per Guidance Notes on Risk Weighted Capital Adequacy Ratio (Part A-subsection I(C), of the capital adequacy returns) |
| (17) Capital Adequacy Ratio (%) | : | [(16) ÷ (15)] x 100 |

# Annexure 6
# Advanced Measurement Approach

**Capital Adequacy Return For the quarter ended ……**
**PART F**
**('000)**

| | | |
|---|---|---|
| (1) Total Capital Charge for Operational Risk | : | To be determined using internal operational risk measurement system approved by the Bank of Mauritius |
| (2) Risk Weighted Assets for Operational Risk | : | 10 x (1) |
| (3) Risk weighted assets for Credit Risk | : | Calculated as per Guidance Notes on Risk Weighted Capital Adequacy Ratio (Part A-subsection II, of the capital adequacy returns) |
| (4) Total Risk Weighted Assets | : | (2) + (3) |
| (5) Total Capital Base | : | Calculated as per Guidance Notes on Risk Weighted Capital Adequacy Ratio (Part A-subsection I(C), of the capital adequacy returns) |
| (6) Capital Adequacy Ratio (%) | : | [(5) ÷ (4)] x 100 |

# Annexure 7
# Internal Loss Data

**For the year ended ……**

This return shall be submitted for each of the eight lines of business set out in Annexure 2. Examples of the types of loss for each category are provided in Annexure 8.

| Event Type | Categories | Amount of loss (before accounting for income derived from insurance)[9] Rs'000 | Income derived from insurance Rs'000 |
|---|---|---|---|
| Internal Fraud | Unauthorised Activity | | |
| | Theft and Fraud | | |
| External fraud | Theft and Fraud | | |
| | Systems Security | | |
| Employment practices and Workplace safety | Employee Relations | | |
| | Safe environment | | |
| | Diversity & discrimination | | |
| Clients, Products and Business practices | Suitability, disclosure and fiduciary | | |
| | Improper Business or Market Practices | | |
| | Product Flaws | | |
| | Selection, Sponsorship & Exposure | | |
| | Advisory Activities | | |
| Damage to Physical Assets | Disasters and other events | | |
| Business disruption and system failures | Systems | | |
| Execution, Delivery & Process Management | Transaction Capture, Execution & Maintenance | | |
| | Monitoring & Reporting | | |
| | Customer Intake and Documentation | | |
| | Customer/ Client Account management | | |
| | Trade counterparties | | |
| | Vendors & Suppliers | | |

[9] Breakdown of losses, briefly explaining nature of each loss, have to be provided separately

# Annexure 8
# Detailed Loss Event Type Classification

| Event-Type Category (Level 1) | Definition | Categories (Level 2) | Activity Examples (Level 3) |
|---|---|---|---|
| Internal fraud | Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/ discrimination events, which involves, which involves at least on internal party | Unauthorised Activity | ■ Transactions not reported(intentional)<br>■ Transaction type unauthorized<br>■ Intentional mismarking of positions |
| | | Theft and Fraud | ■ Fraud/ credit card/ worthless deposits<br>■ Theft / extortion / embezzlement / robbery<br>■ Misappropriation of assets<br>■ Malicious destruction of assets<br>■ Forgery<br>■ Check kiting<br>■ Smuggling<br>■ Account take-over / impersonation / etc.<br>■ Tax non-compliance / evasion (wilful)<br>■ Bribes / kickbacks<br>■ Insider trading (not on firm's account) |
| External fraud | Losses due to acts of a type intended to defraud, misappropriate property or circumvent the law, by a third party | Theft and Fraud | ■ Theft/Robbery<br>■ Forgery<br>■ Check kiting |
| | | Systems security | ■ Hacking damage<br>■ Theft of information |
| Employment Practices and Workplace Safety | Losses arising from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity/discrimination events | Employee Relations | ■ Compensation, benefit, termination issues<br>■ Organised labour activity |
| | | Safe environment | ■ General liability (slip and fall, etc)<br>■ Employee health & safety rules events<br>■ Workers compensation |
| | | Diversity & Discrimination | ■ All discrimination types |

# Annexure 8 Cont'd
# Detailed Loss Event Type Classification

| Event-Type Category (Level 1) | Definition | Categories (Level 2) | Activity Examples (Level 3) |
|---|---|---|---|
| Clients, Products & Business Practices | Losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature or design of a product | Suitability, Disclosure & Fiduciary | ■ Fiduciary breaches/ guideline violations<br>■ Suitability/ disclosure issues (KYC, etc)<br>■ Retail customer disclosure violations<br>■ Breach of privacy<br>■ Aggressive sales<br>■ Accounting churning<br>■ Misuse of confidential information<br>■ Lender liability |
| | | Improper Business or Market Practices | ■ Antitrust<br>■ Improper trade/ market practices<br>■ Market manipulation<br>■ Insider trading (on firm's account)<br>■ Unlicensed activity<br>■ Money laundering |
| | | Product Flaws | ■ Product defects(unauthorized, etc)<br>■ Model errors |
| | | Selection, Sponsorship & Exposure | ■ Failure to investigate client per guidelines<br>■ Exceeding client exposure limits |
| | | Advisory Activities | ■ Disputes over performance of advisory activities |
| Damage to Physical Assets | Losses arising from loss or damage to physical assets from natural disaster or other events | Disaster or other events | ■ Natural disaster losses<br>■ Human losses from external sources (terrorism, vandalism) |

# Annexure 8 Cont'd

# Detailed Loss Event Type Classification

| Event-Type Category (Level 1) | Definition | Categories (Level 2) | Activity Examples (Level 3) |
|---|---|---|---|
| Business disruption and system failures | Losses arising disruption of business or system failures | Systems | ■ Hardware<br>■ Software<br>■ elecommunications<br>■ Utility Outage/disruption |
| Execution, Delivery & Process Management | Losses from failed transaction processing or process management, from relations with trade counterparties and vendors | Transaction Capture, Execution & Maintenance | ■ Miscommunication<br>■ Data entry, maintenance or loading error<br>■ Missed deadline or responsibility<br>■ Model / system misoperation<br>■ Accounting error / entity attribution error<br>■ Other task misperformance<br>■ Delivery failure<br>■ Collateral management failure<br>■ Reference Data Maintenance |
| | | Monitoring and Reporting Customer Intake and Documentation | ■ Failed mandatory reporting obligation<br>■ Inaccurate external report<br>■ Client permissions/disclaimers missing<br>■ Legal documents missing/incomplete |
| | | Customer/ Client Account Management | ■ Unapproved access given to accounts<br>■ Incorrect client records<br>■ Negligent loss or damage of client assets |
| | | Trade Counterparties | ■ Non-client counterparty misperformance/ disputes |
| | | Vendors & Suppliers | ■ Outsourcing<br>■ Vendor disputes |

Source: Basel Committee on Banking Supervision (2004), *International Convergence of Capital Measurement and Capital Standards*

# 3. Guideline on Segmental Reporting under a Single Banking Licence Regime

## 1.0 Introduction

The Banking Act 2004 eliminated separate licensing of Category 1 banks and Category 2 banks and provided for a single banking licence to cover both activities. Accordingly, all banks are free to transact in all currencies, including the Mauritian rupee.

This Guideline lays down in the context of the single licensing regime:

(i) the several choices that banks have respecting their principal lines of business;

(ii) the concept of 'foreign source income' for tax purposes;

(iii) the treatment of specific deposit liabilities for the cash reserve ratio requirement under Section 49 (1) of the Bank of Mauritius Act 2004;

(iv) the exemption from the maintenance of the capital adequacy ratio under Section 20 (2) of the Banking Act 2004; and

(v) the reliance on home regulator global capital adequacy assessment in respect of banking business when conducted by an unincorporated branch of a foreign bank.

International Accounting Standards require disclosure of financial information on distinguishable segments of business of an enterprise. Banks will need to comply with this requirement.

Although the entire banking business will henceforth be conducted by one entity operating under a single banking licence, it is imperative that appropriate accounting systems and controls are installed to ensure the accuracy and integrity of information, which will, for example, determine the 'foreign source income'. Additionally, such systems and controls must facilitate efficient flow and extraction of information for reporting to the Bank of Mauritius in connection with its supervisory and monetary control responsibilities.

The banking business of a licensed bank is divided into two segments to implement the above requirements. Segment B relates to the banking business that gives rise to "foreign source income". All other banking business will be classified under Segment A. It is recognized that some banks will operate exclusively in Segment A while others exclusively in Segment B, and still others in both.

While the core business of the former Category 1 banks was with residents, their books showed that they did accept funds from non-residents by way of deposits, borrowings or investments. They also had claims on non-residents, consisting of loans/advances, placements, or investments. They did not benefit from the special tax regime applicable to what is termed as "foreign source income" for income tax purposes. All their deposits, whether for residents or non-residents and GBLs, were subject to the minimum cash reserve ratio. They were also subject to the capital adequacy ratio on the totality of their risk-weighted assets. Some of these banks might now find sufficient business reasons to opt for segmental segregation in compliance with the requirements of the International Accounting Standards for establishing a Segment B activity to be conducted side by side with the Segment A activity.

This Guideline is issued under the authority of Section 50 of the Bank of Mauritius Act 2004 and Section 100 of the Banking Act 2004.

## 2.0 Interpretation

In this Guideline,

"foreign source income" is as defined in the Income Tax (Foreign Tax Credit) Regulations 1996, as subsequently amended by Section 103 of the Banking Act 2004;

"non-resident" is as defined in Annexure 1of the Guideline;

"global business licence" means Category 1 Global Business Licence or a Category 2 Global Business Licence issued under the Financial Services Development Act 2001.

## 3.0 Income tax

Regulation 2 of the Income Tax (Foreign Tax Credit) Regulations, as amended, defines 'foreign source income' as

"income which is not derived from Mauritius and includes in the case of a bank holding a banking licence under the Banking Act 2004 income derived from its banking transactions with-

(i) non-residents; or

(ii) corporations holding a Global Business Licence under the Financial Services Development Act 2001."

The assets generating "foreign source income" must come from non-residents and/or GBL holders. However, the liabilities employed to support such assets may come from either non-residents/GBLs or residents.

Former Category 2 banks have, in the past, been accepting foreign currency deposits from residents. When such deposits were deployed to generate 'foreign source income', the income received the benefit of lower tax. This practice will be continued.

## 4.0 Segmentation of Banking Activities

This section sets out the essential components of Segment A and Segment B. In order to ensure that there are no regulatory gaps, Segment B will be dealt with first, and by deduction the rest of the banking business will belong to Segment A.

### 4.1 Segment B

Segment B activity is essentially directed to the provision of international financial services that give rise to "foreign source income". Such services may be fund based and/or non-fund based.

Segment B assets will generally consist of placements with and advances to foreign financial institutions, notably associated companies, parents or overseas correspondents, and investments in foreign securities, stocks and debt instruments and claims on non-residents and/or GBLs. Segment B liabilities will normally arise from deposits, borrowings, funds deposited by non-residents, GBLs and residents and capital. These liabilities must be used exclusively to provide international financial services that generate "foreign source income".

The previous restriction on former Category 2 banks to conduct their banking transactions only in foreign currencies no longer exists and Segment B activity can now be conducted in foreign currencies or Mauritian rupee.

### 4.2 Segment A

Segment A activity relates to all banking business other than Segment B activity. The financial services provided under Segment A may be fund and/or non-fund based.

Segment A business will essentially consist of transactions with residents of Mauritius, both on the liability side and the assets side, even though banks conducting Segment A business are at liberty to take on deposits from non-residents and GBLs.

### 4.3 Accounting and Control Systems

A bank may engage in both Segment A and Segment B activities. Only income derived from Segment B activity will be eligible for "foreign source income" treatment for tax purposes. In this respect, banks shall require their auditors to review the effectiveness of the accounting systems and controls to ensure the reliability and accuracy of 'foreign source income', and report thereon annually to management.

The auditor is also required under section 18(5) of the Income Tax Act to certify that any expenditure incurred by the bank but which is not directly attributable to its income derived from Mauritius or its foreign source income has been apportioned in a fair and reasonable manner.

## 5.0 Cash Reserve Ratio

The minimum cash reserve ratio requirement on a bank's deposits and other liabilities under Section 49 (1) of the Bank of Mauritius Act 2004 has been set at 5.5 per cent.

Currently, deposits of residents, non-residents and GBLs with the former Category 1 banks are subject to the minimum cash reserve ratio requirement. Deposits of residents, non-residents and GBLs with the former Category 2 banks are not subject to the minimum cash reserve ratio requirement.

### 5.1 Segment B

As from the effective date of this Guideline, all deposits of non-residents and/or GBLs, which are used exclusively for financing Segment B activity, will not be subject to the minimum cash reserve ratio requirement.

Deposits of residents with the former Category 1 banks will continue to be subject to the minimum cash reserve ratio requirement even if they are used for financing Segment B activity.

As deposits of residents with the former Category 2 banks are currently not subject to the minimum cash reserve ratio requirement, these banks will be given a transitional period to adjust their business so as to be in line with the new regime governing the treatment of deposits from residents used for financing Segment B activity. Accordingly, all existing deposits of residents with the former Category 2 banks will be subject to the minimum cash reserve ratio requirement with effect from 1 July 2006, even if they are used for financing Segment B activity. Fresh deposits raised from residents as from the effective date of this Guideline for financing Segment B activity will, however, be subject to the minimum cash reserve ratio requirement forthwith.

### 5.2 Segment A

As from the effective date of this Guideline, all deposits of residents, non-residents and GBLs with the former Category 1 banks, which are used for financing Segment A activity, will be subject to the minimum cash reserve ratio requirement.

As the deposits of residents, non-residents and GBLs with the former Category 2 banks are currently not subject to the minimum cash reserve ratio requirement, these banks will be given a transitional period to adjust their business so as to be in line with the new regime governing the treatment of deposits used for financing Segment A activity. Accordingly, all existing deposits of residents, non-residents and GBLs with the former Category 2 banks, which are currently being used for financing Segment A activity, will be subject to the minimum cash reserve ratio requirement with effect from 1 July 2006. Fresh deposits raised from residents, non-residents and GBLs as from the effective date of this Guideline for financing Segment A activity will, however, be subject to the minimum cash reserve ratio requirement forthwith.

Category 1 banks have in the past accepted deposits from the Government of Mauritius, although such deposits were insignificant in amount. Government deposits are of a different character because they do not respond to economic activity, interest rates and exchange rates in the same manner as deposits of other units. As such, government deposits will be excluded from the deposit base of Segment A in computing the minimum cash reserve ratio.

### 5.3 Infringement

It should be pointed out that any deliberate shifting of deposit liabilities by banks with a view to avoiding the minimum cash reserve ratio requirement will be dealt with as an infringement in the manner prescribed under section 49 (6) of the Bank of Mauritius Act 2004.

## 6.0 Capital Adequacy Ratio

### 6.1 Segment B

Category 2 banks, which are unincorporated branches of foreign banks were not required to maintain the minimum risk-weighted capital adequacy ratio of 10 per cent as they were considered to be falling under the responsibility of the home regulator of their parent bank. The maintenance of the minimum capital adequacy

ratio is based, in their case, on the consolidated position of the group as a whole in terms of the prescribed ratio for them by their home regulator. This treatment shall continue.

On the other hand, if Segment B business is carried out through an incorporated subsidiary of a foreign bank, the present practice of subjecting the subsidiary (Segment B) to the minimum capital adequacy ratio in Mauritius, shall continue.

The next step in the area of capital adequacy ratio in Mauritius is to move towards the implementation of Basel II in a framework adapted to our environment. Work has already begun in this respect. It is expected that banks operating in Mauritius and which are related to large global banks may eventually opt for specific approaches to capital adequacy under the different options available under Basel II, as decided for the group as a whole. Any option adopted in this regard should, however show an improvement on the current Basel Accord approach in terms of capital adequacy determination.

While maintaining flexibility with regard to the model to be adopted by banks, which belong to the larger global banking groups, the approaches to the maintenance of capital adequacy described above shall continue until further notice in the context of consultations to be held with the banking sector on Basel II implementation.

### 6.2 Segment A

There will be no change from the present situation. All banks, other than branches of foreign banks, will be subject to the minimum capital adequacy requirement that will apply to the consolidated business of the entire bank. There will be no need to allocate capital between Segment A and Segment B businesses of the bank for capital adequacy purposes.

For branches of foreign banks, the capital adequacy ratio will apply only to their Segment A type of business, as before.

## 7.0 Segmental Reporting

Segmental reporting calls for proper formatting of bank data to meet three main objectives:

(i) meeting offsite prudential supervisory data requirements;

(ii) furnishing information to enable identification of items which directly impact on monetary policy formulation; and

(iii) laying down a correct basis for drawing up a bank's financial statements.

Banks furnish regular data reports to the Bank of Mauritius for the purposes of prudential regulation and compilation of monetary aggregates and their sub-components. A list of data reports being currently furnished to the Bank and the frequency thereof is shown in Annexure 2. As a number of these reports have a direct bearing on monetary policy formulation, the bulk of data reporting in this respect currently lies with banks undertaking Segment A type of activities. The field of data reporting will be extended to Segment B banking activity, as appropriate. The Bank of Mauritius will shortly outline the reports to be submitted by banks, together with their format. Data reporting, in the final format, shall become effective as of 1 July 2005.

## 8.0 Financial Disclosure

Section 34(2) of the Banking Act 2004 empowers the central bank to require a financial institution to prepare in respect of its distinct types of business its financial statements in such distinct basis as may be determined. Accordingly, segmental financial statements, as set out in this Guideline, will be drawn up by banks, commencing with the next financial year as from 1 July 2005.

The Guideline on Public Disclosure of Information already sets out the financial disclosure requirements for banks. In addition, the International Accounting Standard (IAS) 14 specifies the principles for reporting financial information by segments to enable the users of financial statements to better assess the enterprise's risks and returns, and its past performance with a view to making more informed judgment about the enterprise as a whole. It requires disclosure of financial information by business segments that represent distinguishable components of the enterprise. If a segment is not significant in relation to the entire business of the enterprise, the disclosure is not needed.

The financial disclosure envisaged in IAS 14 is by way of notes to the financial statements. The disclosure requirements of IAS 14 apply to enterprises whose securities are publicly traded. However, if an enterprise does not have its securities traded but prepares financial statements in accordance with the International Accounting Standards, it is encouraged to disclose information by segments. The Bank of Mauritius endorses this policy and requires all banks that have both Segment A and Segment B activities to prepare financial statements in accordance with the format shown at Annexure 3, which supersedes the formats furnished previously as part 2 of the Guideline on Public Disclosure of Information.

## 9.0 Commencement

This Guideline shall come into effect on 1 July 2005.

**Bank of Mauritius**
**June 2005**

# APPENDIX II

# Financial Soundness Indicators[1] for the Banking Sector[2], 1998-2004

*(In per cent, unless otherwise indicated)*

| | Dec-98 | Dec-99 | Dec-00 | Dec-01 | Dec-02 | Dec-03 | Dec-04 |
|---|---|---|---|---|---|---|---|
| ***Capital Adequacy*** | | | | | | | |
| Regulatory capital to risk-weighted assets ratio[3] | 11.9 | 13.2 | 12.3 | 13.0 | 12.3 | 14.2 | 15.0 |
| Regulatory Tier I capital to risk-weighted assets ratio[4] | 11.8 | 12.6 | 12.5 | 12.7 | 13.0 | 13.7 | 13.7 |
| Total (regulatory) capital to total assets ratio | 7.1 | 8.1 | 7.6 | 8.4 | 7.2 | 8.0 | 7.8 |
| ***Asset Composition and Quality*** | | | | | | | |
| Share of loans per risk weight (RW) category | | | | | | | |
| *RW=0 per cent* | *4.9* | *6.1* | *7.0* | *6.8* | *9.5* | *5.2* | *6.4* |
| *RW=20 per cent* | *0.7* | *0.6* | *0.6* | *0.4* | *0.4* | *4.8* | *6.7* |
| *RW=50 per cent* | *11.2* | *10.9* | *9.9* | *8.9* | *7.0* | *7.9* | *9.6* |
| *RW=100 per cent* | *83.2* | *82.4* | *82.5* | *83.8* | *83.2* | *82.1* | *77.3* |
| Total exposures to total assets | 54.6 | 54.8 | 56.5 | 59.2 | 51.6 | 47.8 | 45.9 |
| Sectoral distribution of loans to total loans[5] | | | | | | | |
| *Agriculture of which:* | *7.8* | *6.7* | *8.6* | *8.3* | *9.7* | *9.1* | *7.5* |
| *Sugar* | *6.7* | *5.8* | *7.7* | *7.0* | *8.6* | *8.0* | *6.4* |
| *Manufacturing of which:* | *27.4* | *24.6* | *24.4* | *18.2* | *16.1* | *14.8* | *13.6* |
| *Export Enterprise Certificate Holders* | *13.2* | *10.9* | *10.7* | *10.8* | *9.4* | *7.5* | *6.1* |
| *Traders* | *19.9* | *18.6* | *15.8* | *14.1* | *14.1* | *14.9* | *14.5* |
| *Personal and Professional* | *13.1* | *13.3* | *12.3* | *9.5* | *9.2* | *9.8* | *10.0* |
| *Construction of which:* | *17.7* | *18.7* | *16.9* | *14.2* | *13.9* | *14.2* | *16.2* |
| *Housing* | *12.2* | *12.8* | *11.6* | *11.0* | *10.5* | *9.0* | *10.8* |
| *Tourism /Hotels*[6] | *4.4* | *7.3* | *8.3* | *14.1* | *15.0* | *15.9* | *15.4* |
| *Other* | *9.6* | *10.8* | *13.6* | *21.6* | *21.3* | *21.2* | *22.8* |
| FX loans to total loans | 10.6 | 10.1 | 10.6 | 13.1 | 10.3 | 10.9 | 12.2 |
| NPLs to gross loans[7] | 9.1 | 8.3 | 7.0 | 8.0 | 8.3 | 9.6 | 8.1 |
| NPLs net of provisions to capital | 40.5 | 34.3 | 28.7 | 37.8 | 34.0 | 28.1 | 22.4 |
| Large exposures to capital | 212.4 | 248.6 | 225.6 | 270.1 | 263.7 | 220.9 | 200.0 |
| ***Earnings and Profitability*** | | | | | | | |
| Return on assets | 2.4 | 2.2 | 2.3 | 2.3 | 2.0 | 2.1 | 2.1 |
| Return on equity | 23.9 | 20.7 | 22.1 | 20.6 | 18.1 | 19.2 | 19.2 |
| Interest margin to gross income | 28.3 | 27.4 | 27.2 | 30.1 | 32.6 | 32.1 | 34.7 |
| Noninterest expenses to gross income | 22.3 | 20.8 | 20.6 | 20.8 | 23.1 | 23.9 | 27.7 |
| Expenses to revenues ratio | 10.5 | 10.3 | 9.9 | 10.3 | 10.5 | 10.6 | 10.2 |
| Average earnings per employee (in Rs'000) | 1,371 | 1,401 | 1,718 | 1,670 | 1,819 | 2,212 | 2,433 |
| ***Liquidity*** | | | | | | | |
| Liquid assets to total assets ratio | 28.4 | 31.2 | 28.5 | 29.2 | 32.7 | 36.6 | 37.9 |
| Liquid assets to total short-term liabilities ratio | 63.1 | 73.2 | 67.0 | 60.2 | 65.3 | 71.0 | 71.7 |
| Funding volatility ratio | 16.4 | 11.6 | 14.1 | 21.1 | 16.4 | 13.9 | 14 |
| Demand deposits to total liabilities ratio | 6.5 | 6.0 | 6.1 | 10.9 | 10.3 | 10.3 | 10.7 |
| FX deposits to total deposits ratio | 9.6 | 11.3 | 12.1 | 12.1 | 11.7 | 11.0 | 13.8 |
| ***Sensitivity to Market Risk*** | | | | | | | |
| Net open positions in FX to capital | 3.6 | 9.2 | 5.0 | 3.2 | 7.5 | 20.8 | 1.9 |

**Notes:**

1 The ratios were computed using the standard definition provided in the IMF's Financial Soundness Indicators Manual. The ratios may be different from those used in other parts of the report.
2 Banking sector refers to former Category 1 banks.
3 Regulatory capital refers to Total of Tier 1 capital and Tier 2 capital less investments in subsidiaries and associates.
4 Tier 1 capital does not reflect deductions for investments in subsidiaries and associated companies.
5 The definition used for sectoral classification was amended in 2001. The ratios were adjusted where possible to reflect the amendments.
6 Up to 2000 the defintion was limited to exposure towards hotels and hotel management certificate companies. As from 2000, the definition encompasses all exposures towards the tourism industry.
7 Gross loans exclude accrued interest.

# APPENDIX III

# 1. Legislative Changes

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.

## A. The Bank of Mauritius Act 2004

The Bank of Mauritius Act 2004 was enacted on 12 October 2004 to repeal and replace the law establishing and relating to the Bank of Mauritius and to provide for related matters.

The Bank of Mauritius Act 2004 endows the central bank with more powers and independence. Some of the amended/new sections are given below.

### *Section 33 – Transparency*

For better transparency, the Bank shall in the conduct of its operations promote open discussions and comments on its monetary and financial stability policies. The Bank shall publish at least once a year, statements on its monetary policy and at least twice a year, statements on price stability and on the stability and soundness of the financial system.

### *Section 52 – Credit Information Bureau*

For the purpose of ensuring the operation of a sound credit information system in Mauritius, the Bank may establish, in conjunction with banks, a Credit Information Bureau and require, on such terms and conditions as it may deem fit, any bank or other financial institution to furnish at such time and in such manner such credit information as it may need for the purpose of, inter alia, maintaining a data base on borrowers and guarantors.

### *Section 54 – Monetary Policy Committee*

For the conduct of the Bank's monetary policy and management of the exchange rate of the rupee and for the purpose of determining, with the concurrence of the Minister of Finance, the accepted range of the rate of inflation, section 54 provides for the setting up of a Monetary Policy Committee consisting of the Governor, as Chairperson of the Committee, two Deputy Governors, 2 other Directors appointed by the Minister of Finance and 3 other persons who are not directors or employees of the Bank appointed by the Minister of Finance.

### *Section 60 – Deposit Insurance*

The Bank may advance funds to the deposit insurance scheme to be established pursuant to section 93 of the Banking Act 2004, on such repayment terms and conditions as it deems fit for the administration of the scheme.

In the circumstance that the deposit insurance scheme is to be administrated by a company, the Bank may contribute to the share capital of that company.

## B. The Banking Act 2004

The Banking Act 2004 was enacted on 12 October 2004 to amend and consolidate the laws relating to the business of banking and other financial institutions and to provide for related matters. The main changes are as follows: -

### *Section 13 – Licensing of Cash Dealers*

No person shall engage in the business of cash dealer in Mauritius without an appropriate licence granted by the central bank. 'Cash dealer' is interpreted in the Act as meaning a person licensed by the central bank to carry on the business of foreign exchange dealer or money-changer.

### *Section 19(b) – Other Restrictions*

No financial institution shall cause or permit any person to hold any significant interest in any class of shares in its stated capital, except with the prior approval of the central bank.

'Significant interest' is interpreted in the Act as owning, directly or indirectly, 10 per cent or more of the capital or of the voting rights of a financial institution or, directly or indirectly, exercising a significant influence over the management of the financial institution, as the central bank may determine.

### *Section 20 – Minimum Capital Requirements of Banks*

Banks should maintain an amount paid as stated capital or an amount of assigned capital of not less than 200 million rupees or the equivalent amount in any freely convertible currency held in assets in or outside Mauritius, as may be approved by the central bank or such higher amount as may be prescribed, after deduction of the accumulated losses of the bank.

### *Section 36 – Credit Assessments and Asset Appraisals*

The central bank may, by notice to any bank, require the bank to undergo an independent assessment of credit worthiness on financial stability by a person or organisation nominated or approved by the central bank to assess the value of the bank's assets.

### *Section 43 – Special Examinations*

In order to determine whether a financial institution is in a sound financial condition and is complying with the banking laws or any enactment relating to anti-money laundering or prevention of terrorism or guidelines and instructions issued by the central bank, as the case may be, the central bank may appoint one or more of its officers or such other duly qualified person to conduct a special examination in respect of the affairs of the financial institution.

### *Section 52 – Electronic Delivery Channel*

Banks may provide services to customers through electronic delivery channels such as the Internet. Banks should have such systems to identify, monitor and control transactional risk from the bank's use of technology and also systems for customer authentication and for physical and logical protection against unauthorised external access by individual penetration attempts, computer viruses, denial of service, and other forms of electronic access, as the central bank considers adequate.

### *Section 57 – Bank's obligations towards customers*

A bank upon which cheques have been drawn by its customer shall send or make available to the customer a statement of account in written or electronic form, showing payment of the cheques for the account and shall either return or make available to the customer the cheques paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the cheque paid

### *Section 93 – Deposit Insurance Scheme*

Provision is made for the establishment and maintenance of a deposit insurance scheme to provide insurance against the loss of part or all of deposits in a bank in a manner that will contribute to the stability of the financial system in Mauritius and minimize the exposure to loss.

Under subsection (3), the central bank may advance funds to the deposit insurance fund on such repayment terms and conditions as it deems fit for the administration of the deposit insurance scheme.

### *Section 96 – Ombudsperson for Banks*

The Board of Directors of the central bank shall, with the concurrence of the Minister of Finance, designate an officer of the central bank to be the Ombudsperson for banks.

The Minister of Finance shall, after consultation with the central bank, make such regulations as may be necessary concerning the functions, duties and powers of the Ombudsperson and for dealing with complaints against financial institutions by their customers.

### *Section 100 – Guidelines or Instructions*

The Central Bank may make such guidelines or instructions as it thinks fit and any person who fails to comply with such guidelines or instructions shall commit an offence and shall, on conviction, be

liable to a fine not exceeding Rs100,000 and to imprisonment for a term not exceeding 2 years.

*Sections 65 to 89 – Conservatorship and Liquidation*

To assist the Bank in its function of safeguarding the interest of depositors, the Act gives wide powers regarding conservatorship and liquidation of financial institutions.

## C. The Financial Reporting Act 2004

The Financial Reporting Act 2004 was enacted on 10 December 2004 to regulate the reporting of financial matters and to establish the Financial Reporting Council, the Mauritius Institute of Professional Accountants and the National Committee on Corporate Governance. The Act provides for the signing of memorandum of understanding between the Bank and the Financial Reporting Council.

## D. The Finance Act 2005

The Finance Act 2005, enacted on 20 April 2005, brought the following amendments to the Banking Act 2004, Bank of Mauritius Act 2004, Companies Act 2001, Financial Intelligence and Anti-Money Laundering Act 2002, Prevention of Corruption Act 2002 and Prevention of Terrorism Act 2002.

*The Banking Act 2004*

Section 7(6)(a) has been amended so that a Banking Licence shall specify only the name of the licensee and the place or places at which the licensee is authorised to conduct banking business.

The heading of Section 14 has been changed from 'Granting of cash dealer licences' to 'Granting of licences to cash dealers'. The words 'for a cash dealer licence' in subsection 14(1) have been replaced by the words 'for a foreign exchange dealer licence or a money-changer licence, as the case may be'.

The words 'in Mauritius' in section 33(3)(c) have been deleted so that records of every transaction that a financial institution conducts shall be kept at the principal office of the financial institution, or at such other place, as may be approved by the central bank.

The words 'a bank' and 'the bank' wherever they appear in section 59 have been respectively replaced by the words 'a financial institution' and 'the financial institution'.

*The Bank of Mauritius Act 2004*

The words 'provide advice to the Bank in the discharge of its functions' in section 25(1) have been deleted and replaced by the words 'provide such services to the Bank as it thinks fit'.

*The Financial Intelligence and Anti-Money Laundering Act 2002*

The definitions of 'bank', 'Bank of Mauritius' and 'cash dealer' in section 2 have been deleted and replaced by the following definitions.

- 'bank' has the same meaning as in the Banking Act 2004 and includes any person licensed under the Banking Act 2004 to carry on deposit taking business.

- 'Bank of Mauritius' means the Bank of Mauritius established under the Bank of Mauritius Act 2004.

- 'cash dealer' has the same meaning as in the Banking Act 2004.

The words 'the Banking Act', and the 'Bank of Mauritius Act' in the definition of 'relevant enactments' in section 2 have been replaced by the words 'the Banking Act 2004 and 'the Bank of Mauritius Act 2004'.

Paragraphs (a), (b) and (c) of section 18(2), which relate to regulatory action in the event of non-compliance by any bank or cash dealer, have been repealed and replaced by two new paragraphs. As per the new paragraphs, the Bank of Mauritius, in the absence of any reasonable excuse, may in the case of a bank, proceed against the bank under sections 11 and 17 of the Banking Act 2004 on the ground that it is carrying on business in a manner which is contrary to the interest of the public and in the case of a cash

dealer or a person licensed to carry on deposit taking business, proceed against him under sections 16 and 17 of the Banking Act 2004 on the ground that he is carrying on business in a manner which is contrary to the interest of the public.

### *The Prevention of Corruption Act 2002*

The definitions of 'bank' and 'cash dealer' at section 2 of each of the Prevention of Corruption Act 2002 and Prevention of Terrorism Act 2002 have been deleted and replaced by new definitions. As per the new definitions 'bank' has the same meaning as in the Banking Act 2004 and includes any person licensed under Banking Act 2004 to carry on deposit taking business. 'Cash dealer' has the same meaning as in the Banking Act 2004.

# 2. Compliance

In February 2004, the Banking Committee, under the chairmanship of the Governor, decided to set up a Committee between the Regulator and Compliance Officers of banks. The Committee has been meeting regularly since its inception and serves as an interactive platform for discussion between the Central Bank and banks on issues relating to Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) and other compliance matters as well.

The Committee keeps in view progress both locally and internationally at the level of the FATF, BCBS, OGBS and the ESAAMLG, amongst others, and decides how best to improve AML/CFT standards and maintain a good compliance culture within the banking system in line with internationally accepted norms and best practices.

The Bank has issued to the industry Guidance Notes on AML/CFT which contain legislative requirements, best international practices as well as good practice guidance in matters relating to AML/CFT. With a view to enhancing the effectiveness of the Guidance Notes, the Committee regularly reviews the provisions thereof to bring them in accord with prevailing laws and the changing commercial environment.

# 3. Memorandum of Understanding and Agreement for Information Sharing

| | Effective Date |
|---|---|
| **FOREIGN SUPERVISORS** | |
| • Jersey Financial Services Commission | 15 January 1999 |
| • Commission Bancaire | 2 November 1999 |
| • State Bank of Pakistan | 26 January 2004 |
| • Banco de Moçambique | 15 March 2004 |
| • The Bank Supervision Department of the South African Reserve Bank | 25 January 2005 |
| **LOCAL SUPERVISOR** | |
| • Financial Services Commission | 5 December 2002 |

**WORK IN PROGRESS**

- Commission de Supervision Bancaire et Financière de Madagascar
- Central Bank of Seychelles
- Financial Services Authority
- Central Bank of Malaysia
- Reserve Bank of India

# 4. Communiqué

## Confidentiality of Regulatory Report

In a communiqué dated 26 March 2004, following the investigation of nTan Corporate Advisory Pte Ltd into irregularities at the Mauritius Commercial Bank Ltd (MCB Ltd), the public was informed that the Report arising from this investigation dwelt comprehensively on certain irregular practices and that fixed deposit accounts had been tampered with to execute transfers of funds.

2. The above investigation was carried out pursuant to section 27 of the Banking Act 1988. It has never been the practice of the Bank of Mauritius to make public the report of any of its findings following the inspection or investigation of any bank. The nTan Report was similarly brought into existence pursuant to the statutory duty of the Bank of Mauritius and the exercise of its powers under strict terms of confidentiality provided for both in the Banking Act and the Bank of Mauritius Act. The Bank of Mauritius is thus not empowered to make public the Report. **However, the Bank underlines that only the Governor, the First Deputy Governor and the other members of the previous Board of Directors have had access to the nTan Report on the MCB Ltd. in their official capacity.**

3. In view of the privileged nature of the findings contained in the nTan Report, the Bank of Mauritius, after taking legal advice, has not considered it appropriate to initiate any action other than executing its duties as a regulatory and supervisory authority for the maintenance of integrity of the banking system and the preservation of public confidence in our financial system. The Bank of Mauritius does not propose to travel outside the ambit of its regulatory and supervisory powers.

4. In the said communiqué, the Bank of Mauritius did draw attention that "the anatomy of the irregularities reveals techniques that have been employed for tampering with fixed deposit accounts and executing transfers of funds". As already pointed out in the said communiqué, some of the irregularities dated as far back as the early 1990's. **The Bank of Mauritius has not come across any post-nTan Report case of tampering with fixed deposit accounts and unauthorized transfers of funds concerning customers' accounts at the MCB Ltd.**

5. The public is advised that, as part of its regulatory and supervisory duties, the Bank of Mauritius has been constantly monitoring, through onsite and offsite inspections, the measures put in place by the MCB Ltd to avert any abuse of its systems and procedures such as those that had led to the irregularities uncovered by the nTan Report.

6. Further, the Banking Supervision Department of the Bank of Mauritius carried out a thorough on-site inspection of MCB Ltd from 18 March to 25 June 2004. A further regular on-site inspection is being conducted at the MCB Ltd. since 19 January 2005.

7. The Bank of Mauritius wishes to reaffirm that it is fully conscious of its regulatory and supervisory responsibilities. In this connexion, the Bank of Mauritius seizes this opportunity to state that the Governor and the First Deputy Governor visited in person the vault area of the MCB Ltd. and assessed the situation following the tragic events that took place on 11 February, 2005.

**Bank of Mauritius**
3 March 2005

# 5. Notice

## Revocation of Authorisation to carry on business as money-changer

Grand Bay Helipad Co. Ltd was granted on 17 June 2002 an authorisation by the Minister of Finance to carry on the business of money-changer at 2, Quay Street, Port Louis, under the provisions of the Foreign Exchange Dealers Act 1995 and the terms and conditions set out in the Foreign Exchange Dealers Regulations 1995.

Under the powers conferred upon the Bank of Mauritius by section 16 of the Banking Act 2004, following the repeal of the Foreign Exchange Dealers Act 1995, the Bank, on 9 September 2005, revoked the authorisation granted to Grand Bay Helipad Co. Ltd to carry on the business of money-changer with effect from 10 September 2005 for failure to comply with regulatory requirements.

The public is hereby informed that Grand Bay Helipad Co. Ltd of 2, Quay Street, Port Louis, has ceased to be authorised to carry on the business of money-changer as from 10 September 2005.

**Bank of Mauritius**
16 September 2005

# 6. Communiqué

## Press Articles on First City Bank

The Bank of Mauritius has become aware of internal conflicts involving the top management and certain board members of the First City Bank Ltd (FCB). There has been public disclosure of customer information in the press. In fact, part of the Bank of Mauritius Management Report issued to the FCB dated 18 May 2004, was published in this context in the press as a so-called report from the FCB's auditors.

The Management Report issued by the Bank of Mauritius to the FCB is a confidential document protected by the provisions of the Banking Act 2004 and it is intended for the sole use of the bank and its board. The Bank of Mauritius has requested the FCB to explain the leakage of extracts from this confidential document and to initiate appropriate action against any person who may have been at the source of this leakage.

It has been reported in the press that certain decisions taken by the board of the FCB would have been improperly executed by FCB staff in 2003. The overseeing of execution of decisions is an area of responsibility for the FCB's board. The Bank of Mauritius has however, asked the FCB to furnish explanations and to ensure compliance with legal provisions in this regard.

The Bank of Mauritius, as regulator of the banking system, is monitoring closely the situation at the FCB and will take all necessary action to maintain the confidence of the public in the FCB and the banking sector as a whole.

**Bank of Mauritius**
25 October 2005

# 7. Public Notice

***Surrender of Banking Licence***
***by Mascareignes International Bank Ltd***

In January 1991 Banque Internationale des Mascareignes Limitée was authorised by the Bank of Mauritius to carry on offshore banking business in Mauritius.

The bank changed its name to Mascareignes International Bank Ltd in January 2004. At that time, the bank had become a wholly-owned subsidiary of Financière Oceor, itself a subsidiary of Groupe Caisse d'Epargne.

Banque des Mascareignes Ltée, another wholly-owned subsidiary of Financière Oceor, was issued a banking licence in January 2004 to carry out domestic banking business.

Mascareignes International Bank Ltd has, with the approval of the Bank of Mauritius, merged with Banque des Mascareignes Ltée with effect from 28 November 2005. All customer information pertaining to Mascareignes International Bank Ltd is currently under the safe custody of Banque des Mascareignes Ltée.

In the context of its amalgamation with Banque des Mascareignes Ltée, Mascareignes International Bank Ltd has surrendered its banking licence and has ceased operation as from 28 November 2005.

The Bank of Mauritius has accepted the surrender of the banking licence by Mascareignes International Bank Ltd under section 11 of Banking Act 2004.

**Bank of Mauritius**
22 December 2005

# 8. 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 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 31 December 2005.

### Banks Licensed to carry Banking Business

1. Bank of Baroda
2. Banque des Mascareignes Ltée
3. Barclays Bank PLC
4. Deutsche Bank (Mauritius) Limited
5. First City Bank Ltd
6. Habib Bank Limited
7. Indian Ocean International Bank Limited
8. Investec Bank (Mauritius) Limited
9. Mauritius Post and Cooperative Bank Ltd
10. P.T Bank Internasional Indonesia
11. RMB (Mauritius) Limited
12. SBI International (Mauritius) Ltd.
13. SBM Nedbank International Limited
14. South East Asian Bank Ltd
15. Standard Bank (Mauritius) Limited
16. Standard Chartered Bank (Mauritius) Limited
17. State Bank of Mauritius Ltd
18. The Hongkong and Shanghai Banking Corporation Limited
19. The Mauritius Commercial Bank Ltd.

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

1. ABC Finance & Leasing Ltd.
2. Barclays Leasing Company Limited
3. Capital Leasing Ltd
4. Finlease Company Limited
5 Cim Leasing Ltd
6. Global Direct Leasing 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. Change Express Ltd.
2. Max & Deep Co. Ltd
3. Gowtam Jootun Lotus Ltd

### Foreign Exchange Dealers

1. British American Exchange Co. Ltd
2. Edge Forex Limited
3. Rogers Investment Finance Ltd
4. Thomas Cook (Mauritius) Operations Company Limited
5. Shibani Finance Co. Ltd

# 9. Glossary of Abbreviations

| Abbreviation | | Details |
|---|---|---|
| AML/CFT | : | Anti-Money Laundering and Combating the Financing of Terrorism |
| APG | : | Asia/Pacific Group on Money Laundering |
| ATM | : | Automated Teller Machine |
| BANK | : | Bank of Mauritius |
| BCBS | : | Basel Committee on Banking Supervision |
| BIS | : | Bank for International Settlements |
| BOM Bills | : | Bank Of Mauritius Bills |
| CAMEL | : | Capital, Asset Quality, Management, Earnings and Liquidity |
| CPLG | : | Core Principles Liaison Group |
| ECAs | : | Export Credit Agencies |
| ECAIs | : | External Credit Assessment Institutions |
| ERAs | : | External Rating Agencies |
| ESAAMLG | : | Eastern and Southern Africa Anti-Money Laundering Group |
| FATF | : | Financial Action Task Force |
| FIAML Act 2002 | : | Financial Intelligence and Anti Money Laundering Act 2002 |
| FSI | : | Financial Stability Institute |
| GAFISUD | : | Groupe d'Action Financiere sur le blanchiment de capitaux en Amerique du Sud |
| GDP | : | Gross Domestic Product |
| IAIS | : | International Association of Insurance Supervisors |
| IAS | : | International Accounting Standards |
| IASB | : | International Accounting Standards Board |
| IFRS | : | International Financial Reporting Standards |
| IMF | : | International Monetary Fund |
| IOSCO | : | International Organisation of Securities Commissions |
| KYC | : | Know Your Customer |
| MBA | : | Mauritius Bankers Association Ltd |
| MCIB | : | Mauritius Credit Information Bureau |
| ML | : | Money Laundering |
| OECD | : | Organisation for Economic Cooperation and Development |
| QIS | : | Quantitative Impact Study |
| SBI | : | State Bank of India |
| TF | : | Terrorist Financing |

# 10. List of Charts


| Page | | |
|---|---|---|
| 10 | 1 | *Balance Sheet Structure* |
| 11 | 2 | *Banks' Capital Adequacy Ratio in terms of Total Asset Value* |
| 12 | 3 | *Minimum Required Capital v/s Actual Capital* |
| 13 | 4 | *Comparative Increase in Capital Base and Risk Weighted Assets* |
| 16 | 5 | *Composition of Advances* |
| 17 | 6 | *Sectorwise Distribution of Credit to Private Sector* |
| 21 | 7 | *Components of Income* |
| 21 | 8 | *Components of Expenses* |
| 22 | 9 | *Evolution of Net Interest Income, Other Income, Operating Income and Operating Profit* |
| 22 | 10 | *Components of Net Interest Income* |
| 23 | 11 | *Operating Profit and Profit After Tax* |
| 23 | 12 | *Return on Equity and on Average Assets* |
| 24 | 13 | *Fluctuations in Monthly Average Cash Holdings and in Monthly Average Cash Ratio* |
| 28 | 14 | *Former Category 2 Banks - Placements with Banks and Loans and Advances to Non-Bank Customers* |
| 29 | 15 | *Former Category 2 Banks - Non-Bank Deposits and Borrowings from Banks* |
| 30 | 16 | *Former Category 2 Banks - Total Funds and Net Profits* |

# 11. List of Tables


| Page | | | |
|---|---|---|---|
| Page | 13 | 1 | *Comparative Change in the Riskiness of Former Category 1 Banks' Portfolios of On-balance Sheet Assets* |
| | 13 | 2 | *Total On- and- Off Balance Sheet Assets of Former Category 1 Banks, Equivalent Risk-weighted Assets and Average Combined Risk Weighting* |
| | 18 | 3 | *Provision for Credit Losses by Industry Sectors* |
| | 20 | 4 | *Consolidated Profit Performance* |
| | 21 | 5 | *Growth in Interest Income v/s Growth in Non-Interest Income* |
| | 23 | 6 | *Growth in Interest on Advances v/s Growth in Interest on Treasury Bills, Bank of Mauritus Bills and Government Securities* |
| | 23 | 7 | *Interest Spread* |
| | 25 | 8 | *Deposit Structure* |
| | 26 | 9 | *Value Range of Deposits* |
| | 26 | 10 | *Maturity Structure of Time Deposits* |
| | 27 | 11 | *Electronic Banking Transactions* |
| | 30 | 12 | *Profit Performance of Former Category 2 Banks* |
| | 31 | 13 | *Former Category 2 Banks - Total Advances, Non-performing Advances and Provision for Bad and Doubtful Debts* |

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