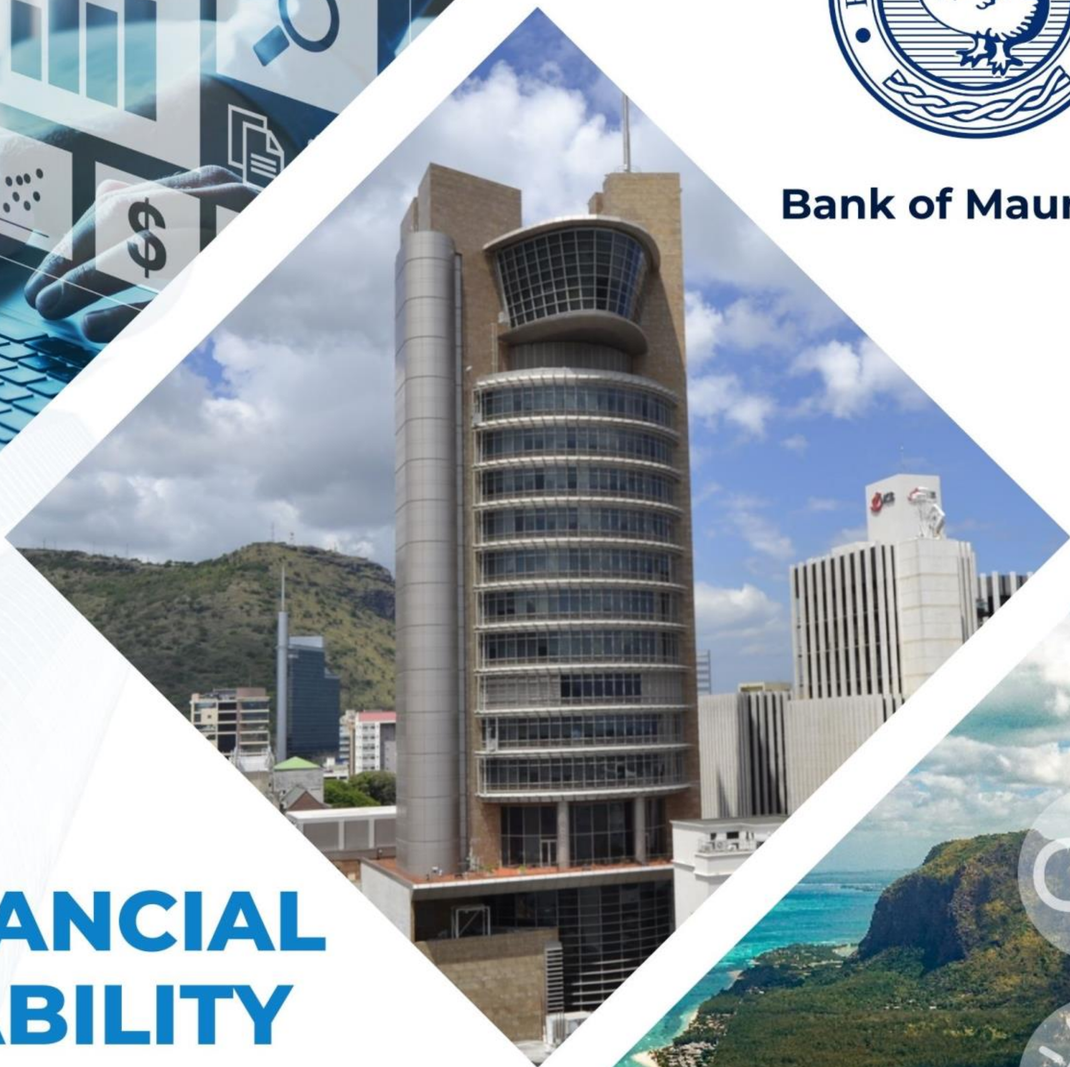

Bank of Mauritius

FINANCIAL STABILITY REPORT

December

2023

Financial Stability Report
December 2023

The Bank of Mauritius (hereafter referred to as the "Bank") is issuing the second edition of its Financial Stability Report for 2023, covering the first half of 2023, unless otherwise stated.

This Report is published pursuant to section 33(2)(b) of the Bank of Mauritius Act which stipulates that the Bank shall publish at least twice a year a report on financial stability. The Report includes a review of financial stability and an assessment of policies of the Bank in relation thereto.

In line with its mandate to ensure the stability and soundness of the financial system of Mauritius in terms of section 4(2)(b) of the Bank of Mauritius Act, the Bank makes an overall assessment in this report of the risks that can threaten the stability of the financial system and the measures taken to mitigate these risks. It evaluates the resilience of the system to the risks, as a stable and sound financial system is a prerequisite for financial intermediation in the economy and for creating conducive conditions for economic and financial development.

This Report is available on the Bank's website at https://www.bom.mu/publications-and-statistics/publications/financial-stability-report.

The Bank welcomes feedback from readers. Comments and suggestions should be forwarded to communications@bom.mu.

Financial Stability Report December 2023

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Executive summary

Global developments

Global economic and financial conditions were vulnerable in the first half of 2023. High inflation and rising interest rates persisted as the main predicaments to global economic growth. Central banks maintained a tightening approach to monetary policy as inflationary pressures lingered, though inflation had already peaked in many economies. Still, the global economy was resilient against the turbulent macroeconomic backdrop, prompting optimism about a soft landing of the global economy.

Risks to global financial stability stayed elevated, amid high interest rates and global economic uncertainties. The resilience of the global banking system was tested in the first half of 2023 as signs of stress emerged, induced by the aggressive tightening of monetary policy. Three United States (US) banks along with one global systemically important bank failed. The effects of the turmoil stretched to financial markets and triggered a shift in interest rate expectations. However, the stress in the global banking system was short-lived as risk of contagion was largely contained by the prompt response of financial regulators and authorities. The global banking system was broadly resilient, as evidenced by the International Monetary Fund`s (IMF) global stress tests in its Global Financial Stability Report (GFSR) of October 2023. The results also showed that banks with high exposures to mark-to-market securities were vulnerable to significant capital losses.

Risks to the household and corporate sectors were skewed to the downside. Households continued to face higher debt servicing burden, especially those highly indebted, coupled with an erosion of their real income. Tighter monetary policy also impacted the residential real estate market, cooling demand for mortgages and resulting in a fall in global house prices. Corporate earnings declined due to tighter funding conditions. Risks from the commercial real estate market were high, as tumbling transaction volumes translated into a sharp repricing across major markets.

The slowdown in the global economy was accompanied by declining, though still high, inflation and tight financial conditions. Household and corporate borrowers were confronted with an erosion of financial buffers as debt servicing burden stayed high. Nevertheless, the global economy and financial systems displayed remarkable resilience despite unprecedented tightening of global monetary conditions. Going forward, growing geo-economic fragmentation and the path of monetary policy could spur risks to the global economy and financial stability.

Domestic developments

The domestic economy maintained its robust growth momentum in the first half of 2023. The annual growth of quarterly Gross Domestic Product (GDP), in real terms, reached 7.1 per cent and 8.3 per cent in the first and second quarters of 2023, respectively. The economy was projected to grow by above 7 per cent in 2023. Economic growth remained firmly driven by the key sectors – the tourism industry, in particular, with tourist arrivals reaching 596,466 in the first semester of 2023 representing a 58.4 per cent growth over the corresponding period of 2022.

The other key sectors of the economy – namely, manufacturing, construction and financial services – also recorded commendable growth rates. The *'Construction'* sector recovered strongly in 2023 following a period of contraction in the second half of 2022. Major public and private sector infrastructure projects in the first half of 2023 provided considerable impulse to the sector with positive spillover effects on other related economic activities.

Labour market conditions have improved consistently since June 2021. The unemployment rate dropped to 6.4 per cent in June 2023, from 6.8 per cent in December 2022. Moreover, the Wage Rate Index (WRI) indicated a sustained rise in nominal wages and reached a new high in June 2023. These dynamics strengthened the financial resilience of households as they were faced with rise in cost of living along with high debt servicing costs.

The Monetary Policy Committee (MPC) left the Key Rate unchanged in the first half of 2023 as inflationary pressures retreated gradually throughout the semester combined with an improving inflation outlook. Headline inflation was on a downward trajectory since the beginning of 2023, reflecting the effectiveness of tighter monetary conditions as well as dwindling price pressures from external sources since March 2022. As a result, market interest rates – both savings and lending rates – stayed broadly stable throughout the first semester of 2023.

Steady interest rates stabilised debt servicing costs and, as a result, debt serviceability metrics gradually improved in the first half of 2023 as nominal income continued to grow. Households' finances were also propped up by various fiscal measures announced in the national budget for 2022-2023, which reinforced the debt servicing resilience of households. The ratio of non-performing loans (NPL) of the household sector fell to its lowest level over the past decade or so, confirming the sustained improvement in the financial soundness of households.

Household sector vulnerabilities subsided, as key indebtedness metrics improved further. Household indebtedness – comprising household debt with banks, Non-Bank Deposit-Taking institutions (NBDTI), insurance and leasing companies – rose in nominal terms but fell relative to GDP and income. Household debt to GDP and income stood at 35.0 per cent and 96.9 per cent as at end-June 2023, respectively. Both ratios were gradually returning to pre-pandemic levels, providing additional evidence that vulnerabilities from the household sector were moderating.

Financial stability risk from the corporate sector subsided as corporate earnings expanded in tandem with buoyant economic activity. Continuous improvement in economic conditions boosted the financial position of large corporates. The overall asset quality of the corporate portfolio of banks remained sound and even improved on a semester basis. Likewise, the NPL ratio of some key sectors such as '*Manufacturing*', '*Traders*' and *'Accommodation and food service activities'* dropped uniformly.

Domestic stock market indices retreated as investors showed greater appetite for fixed income instruments relative to equity instruments following the rise in interest rates in 2022. Nonetheless, foreign investors renewed interest in domestic equities. Net foreign investment attained Rs370.8 million in the first semester of 2023, a considerable improvement from the preceding semester.

Activities on the foreign exchange (FX) market maintained strong momentum in the first semester of 2023. Robust performance of the tourism and financial services sectors lifted the volume of FX purchases by banks and foreign exchange dealers. As a result, the total FX turnover rose to US$6.2 billion for the first semester of 2023, compared to US$5.3 billion in the second semester of 2022. The Bank scaled down the frequency and magnitude of its interventions on the FX market due to favourable progress in FX liquidity conditions. Sustained improvement on the FX market contributed towards alleviating risks to financial stability.

The Bank also took regulatory action to curb speculative behaviour on the FX market that created an artificial FX shortage despite growing inflows. Such speculative activities were harmful to the good functioning of the economy and stability of the financial system. The Bank fined several banks after which exchange rate movements were more aligned with actual market conditions.

The country`s Gross Official International Reserves (GOIR) remained adequate against potential external shocks. The GOIR stood at US$6.7 billion as at end-June 2023 and largely met the conventional measures of reserves adequacy – such as import cover and reserves-to-broad money ratio.

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largely met the conventional measures of reserves adequacy – such as import cover and reserves-to-broad money ratio. A strong correlation was noted between the rapid rise in short-term non-resident deposits and short-term external debt. While this impacted the more stringent metrics of reserve adequacy that use short-term external debt, it is important to highlight that these assessments do not take into consideration the sizeable net foreign assets held by banks, which can be used to meet non-residents deposit outflows. In addition, the Bank has set in place robust regulations for the banking sector to manage liquidity risk efficiently. As such, the level of external vulnerability was assessed to be low given the external buffers held by the Bank and the banking system.

Risk to financial stability arising from the banking system was assessed to be low in the first semester of 2023. This assessment was supported by the range of indicators used to gauge the degree and direction of systemic risk in the banking sector. The significant rise in profitability of banks strengthened their capital and liquidity buffers, whilst the degree of interconnectedness within the financial system remained low. The relentless expansion of the size of the banking sector continued, while banks' adherence to prudential standards was closely monitored.

The expansion of the banking sector was bolstered by cross-border activities. The total assets of the banking sector rose to Rs2.3 trillion in June 2023, representing an annual growth of 9.4 per cent. Strong profitability in the first half of 2023 strengthened banks' capital and solvency buffers. The aggregate Capital Adequacy Ratio (CAR) rose to 19.9 per cent in June 2023. The asset quality of banks stayed broadly sound, reflecting manageable level of credit risk in the banking sector. The liquidity buffers of banks remained strong, providing adequate buffer against liquidity risk.

The banking sector continued to support the flow of credit to the economy. Corporate credit grew consistently in the first semester of 2023. In contrast, household credit growth decelerated towards the end of the first half of 2023, as high interest rates and elevated cost of living reduced its pace of expansion. Tighter financial conditions have moderated demand for residential real estate projects. This development was expected to stabilise residential property prices in the short to medium term, easing the procyclical vulnerabilities.

The banking sector proved resilient under various stress tests scenarios. The results showed that banks were able to continue providing financial services and carry out financial intermediation activities under stressed economic and financial conditions. Higher capital and solvency buffers amplified the capacity of banks to absorb various shocks. Nonetheless, a few banks exhibited signs of vulnerability, mostly under severe stressed settings. The resilience of the banking sector was, moreover, expected to strengthen further as macrofinancial conditions improve, contributing to contain risks to financial stability.

NBDTIs were sound and their elevated capital levels ensured robust loss-absorption capacity. The aggregate CAR of NBDTIs stood at 50.3 per cent in June 2023, well above the minimum regulatory requirement of 10 per cent. The aggregate assets of NBDTIs grew at an annual rate of 6.4 per cent to reach Rs72 billion as at end-June 2023, while their NPL ratio was at manageable level.

The non-bank financial services sector, comprising mainly insurance and pension fund providers, continued to grow soundly. The aggregate assets of insurance companies remained strong whilst they benefit from the high interest rate environment. The pensions fund industry recovered in the first half of 2023, after facing headwinds in the preceding semester, and their aggregate assets maintained an expansionary trend.

The global business (GB) sector stayed resilient, even though uncertainties persisted in the global economic and geo-political environment. The number of active GBCs in the Mauritius International Financial Centre (MIFC) reached a six-year high. The aggregate assets of GBCs remained robust. Bank deposits from GBCs fell slightly in the first half of 2023, without any liquidity strains on banks since they prudently manage liquidity risks. Funding vulnerabilities from the GB sector declined further, as banks continued to diversify their funding sources for FX deposits, in particular by focusing on the non-resident sector. Banks maintained high and adequate level of provisioning against NPL in the GB sector. Overall, risk to financial stability from the GB sector was well contained in the first semester of 2023.

Systemic risk in the financial system moderated in the first semester of 2023 relative to 2022. The Systemic Risk Indicator (SRI), which measures the degree and direction of systemic risk, signalled a drop in risk from several key sources that are closely monitored. In particular, continuous progress in economic conditions, greater resilience of the banking sector and a deceleration in household credit growth largely influenced the improvement in the systemic risk landscape.

Overall, risks to financial stability moderated in the first semester of 2023. Favourable developments in the macrofinancial landscape and improving global conditions were expected to continue supporting the sound expansion of the banking sector. Moreover, based on the Bank's annual survey on *Financial Stability Risk Assessment for 2023/24* conducted in October 2023, banks were confident about the stability of the financial sector over the coming year. Looking ahead, risks to the stability of the financial system were expected to recede further, while threats from the global environment would be monitored closely.

1. Macrofinancial environment

Global economic conditions remained vulnerable to high inflation and rising interest rates in the first semester of 2023. Global financial stability was tested, following strains in the banking sector after the failure of three US banks. The low fiscal space available to governments complicated their ability to protect vulnerable households against elevated cost of living. High debt servicing costs led to a slowdown in the residential property sector.

Strong dynamism in the first half of 2023, bolstered by robust performance of key traditional sectors, supported the resilience of the domestic economy to elevated inflation and interest rate. Continued improvement in labour market conditions helped to contain financial strains in the household sector. Conditions on the FX market strengthened further with growing inflows, with the FX reserves hovering around a comfortable level. The monetary policy stance was kept unchanged, thus stabilising debt servicing costs. The SRI indicated receding risk to financial stability on the back of improving domestic economic conditions, robust banking sector performance and deceleration in household credit growth.

Tighter financial conditions impacted global financial stability

The global economic landscape continued to be influenced by high inflation and rising interest rates in the first semester of 2023. Economic prospects were challenged by sharp tightening of financial conditions and elevated commodity prices. Persistently high inflation compelled central banks to maintain a tight monetary policy stance for the foreseeable future with repercussions on the economic outlook. In its October 2023 World Economic Outlook, the IMF projected global economic growth to slow down to 3.0 per cent for 2023 and to 2.9 per cent in 2024.

On the fiscal front, concerns about heightened debt vulnerabilities in most parts of the world persisted amid an uncertain macroeconomic outlook and tight financing conditions. Many countries were confronted with an erosion of fiscal buffers, elevated debt levels as well as a mismatch between high demand for state-related support measures and available fiscal resources. Moreover, persistent inflation complicated the debt sustainability strategy of fiscal authorities. Low fiscal space was a major hurdle for governments to maintain support measures to vulnerable households.

Global financial stability was tested during the first semester of 2023. Tighter financial conditions primarily caused by rising interest rates led to a challenging environment for banks having large concentration in securities portfolio, as asset values declined and were

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Financial soundness of deposit-taking institutions
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accompanied by a rise in unrealised losses. Interest rate risk was analysed in the financial stability reports of several central banks – such as by the Bank of England, the European Central Bank (ECB), the Bank of Japan and the US Federal Reserve – as well as by the IMF in its GFSR. Overall, banking systems were assessed to be resilient against interest rate risk given robust capital requirements and extra buffers, though some banks showed vulnerabilities.

Two US banks – namely, the Silicon Valley Bank and Signature Bank of New York – failed in March 2023 and another bank – First Republic Bank – failed in May 2023 following rapid outflows of deposits, amplified by easy access to 24/7 online digital banking facilities. The outflows were mainly driven by worries over weak management of interest rate and liquidity risks. Credit Suisse – a global systemically important bank – faced a loss of market confidence in March 2023 due to a series of scandals over the last two decades and required a state-supported merger with the Union Bank of Switzerland to prevent a potential collapse. While the financial stresses sparked by these banks were largely contained, lessons could be drawn in respect of risk management processes and corporate governance in banking institutions, which called for remedial actions.

Households and corporates continued to face the burden of high debt servicing costs. Mortgage interest rates stayed elevated, leading to lower loan demand and weaker repayment capacity among households. Higher borrowing costs also caused a global slowdown in housing activity, as demand for residential projects receded. House prices adjusted accordingly. As discussed in the IMF's October 2023 GFSR, global house prices were on a declining trend since late 2022.

On the other hand, tighter financial conditions tested the resilience of corporates, especially those heavily leveraged. The large cash buffers accumulated by corporates during the pandemic started to wane, especially among small and medium businesses. As a result, the proportion of corporates with low cash-to-interest expense ratios continued to rise as firms faced tighter funding conditions and could encounter financial strains to service their debt.

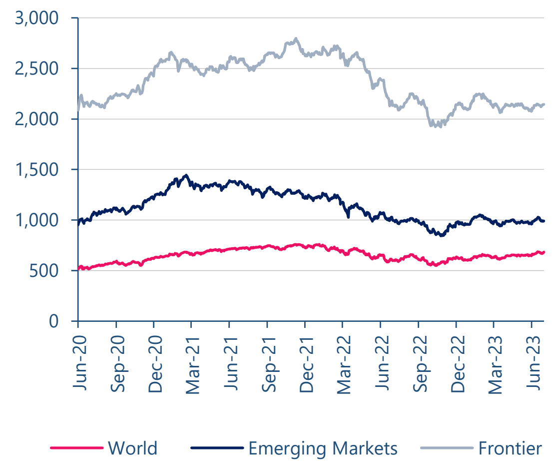
Global financial markets improved

The performance of global financial markets improved in the first half of 2023 relative to the preceding semester, despite concerns of stresses in the banking system in some countries. The driving force was more favourable outlook for the US central bank policy rate, decelerating inflation in many advanced and emerging economies, and better investor appetite for certain growth stocks. Financial market volatility dropped slightly – in equity markets, in particular – while investor confidence was well supported.

The improvement in financial markets was affirmed by the rise in the Morgan Stanley Capital International (MSCI) World Index, the MSCI Emerging Market Index and the MSCI Frontier Index by 12.8 per cent, 3.5 per cent and 2.1 per cent, respectively, between end-December 2022 and end-June 2023 (Chart 1.1).

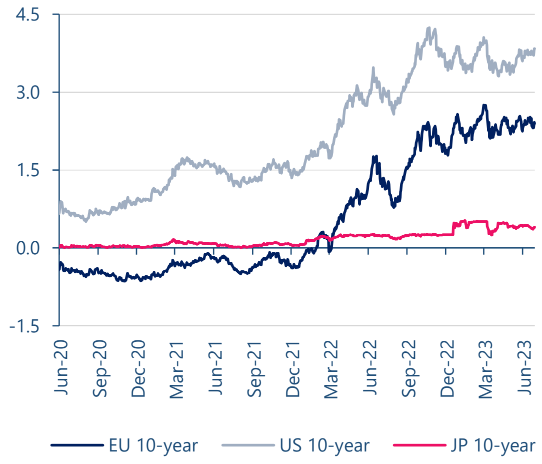
Government bond yields moved in line with the interest rate cycle as well as expectations on the monetary policy stance by major central banks. The US 10-year yield edged down to 3.8 per cent in June 2023, from 3.9 per cent in December 2022. Similarly, the EU 10-year yield declined to 2.4 per cent in June 2023, from 2.6 per cent in December 2022, while the JP 10-year yield remained unchanged at 0.4 per cent (Chart 1.2).

Chart 1.1: MSCI Indices



Source: Bloomberg

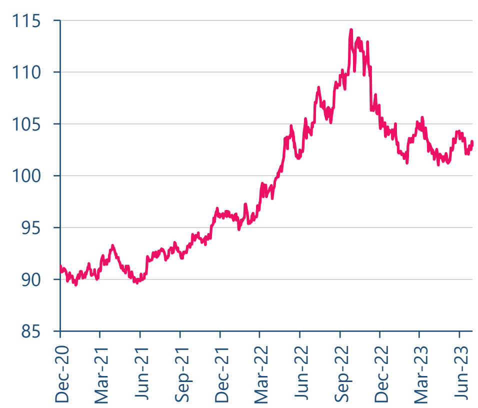
Chart 1.2: Selected government bond yields



Source: Bloomberg

After sustained appreciation in 2022, the US dollar strength waned in the first half of 2023 pressurised by an uncertain macroeconomic outlook. The US dollar index tumbled in April 2023 and traded at 102.9 in June 2023, compared to 103.5 in December 2022 (Chart 1.3). The performance of the US dollar index reflected the pace at which the US Federal Reserve pursued its aggressive interest rate hikes and how other major central banks – such as the ECB – were responding. Persistent weakness of the US dollar index signalled a reversion to past trend from the US currency's significant gains in 2022.

Chart 1.3: US dollar index



Source: Bloomberg

Domestic macro conditions continued to improve

The domestic economy maintained strong growth trajectory in the first semester of 2023, bolstered by buoyant tourism, financial services and manufacturing sectors. The economy recorded an annual real GDP growth of 7.1 per cent and 8.3 per cent in the first and second quarters of 2023, respectively. On the expenditure side, consumption and pent-up external demand contributed significantly to economic growth. The Bank projected the economy to grow by 7 per cent in 2023.

Labour market conditions improved, with the unemployment rate falling to 6.4 per cent in June 2023, from 6.8 per cent in December 2022. The WRI showed sustained rise in average wages during the first semester of 2023, indicative of a rise in nominal income of households to compensate for the loss of real income sparked by high inflation.

The tourism sector showed substantial dynamism. Tourist arrivals reached 596,466 during the first semester of 2023 which represent a nearly 60 per cent jump over the figure recorded during the same period of 2022 (Chart 1.14). The strong performance of the tourism industry was expected to consolidate the financials of businesses operating in the *'Accommodation and Food service activities'* sector.

Chart 1.4: Monthly tourist arrivals and tourism earnings

Source: Bank of Mauritius

Elevated inflation and high interest rates remained the main sources of risk to macrofinancial stability in the first semester of 2023. The increase in interest rates towards the end of the second half of 2022 led to a rise in debt servicing costs for households and corporates alike. However, a set of targeted state-supported measures to households along with an increase in nominal income have, to some extent, protected their financial soundness. Moreover, the strong performance of key economic sectors contributed to safeguarding the financial strength of the corporate sector.

Headline inflation took a downward trajectory throughout the first half of 2023 and was expected to recede further in the coming quarters. The MPC left the Key Rate unchanged during the first half of 2023, as cost-push pressures on inflation were anticipated to continue easing. The MPC was ready to adjust the monetary policy stance, depending on the inflation outlook.

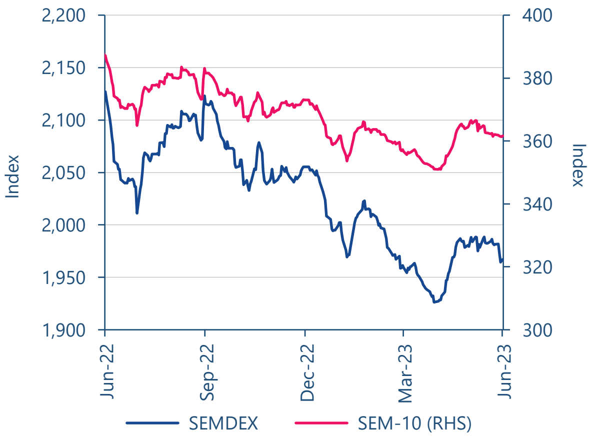
Looking ahead, the macroeconomic environment was projected to improve further in the second half of 2023 as inflation was forecast to decline to around 7 per cent and economic growth would be sustained. Key economic sectors – such as '*Accommodation and Food service activities*', *'Construction'* and *'Manufacturing'* – were expected to support the growth momentum. Public sector investments announced in the national Budget for 2023-2024 were also anticipated to give further impetus to growth dynamics. The favourable macroeconomic outlook was expected to alleviate macrofinancial stability concerns in the medium term, although risks from external shocks remained present.

Stock market activities retreated

The stock market indices lost some ground in the first four months of 2023 but picked up thereafter. Equity prices retreated as investors shifted away towards fixed-income instruments following an upward adjustment in money market yields towards the end of December 2022, in anticipation of the introduction of the new monetary policy framework in January 2023. After declining at the start of 2023, stock market indices rebounded in May 2023 and remained broadly stable in June 2023. Corporate entities, especially those engaged in the tourism and banking sectors, published strong financial results for the first quarter leading to a rise in the SEMTRI by 2.5 per cent.

The economy remained on a positive track and investors had better visibility on interest rate increases by the US Federal Reserve and other major central banks, which stabilised the domestic stock market towards the end of the semester. Hotel stocks performed well as tourist arrivals attained pre-pandemic levels in the second quarter of 2023. Other equity prices, however, moved downwards adding pressure to the stock market indices. The SEMDEX closed at 1,967 points in June 2023, lower than the 2,055 points as at end-

Chart 1.5: Domestic stock market performance

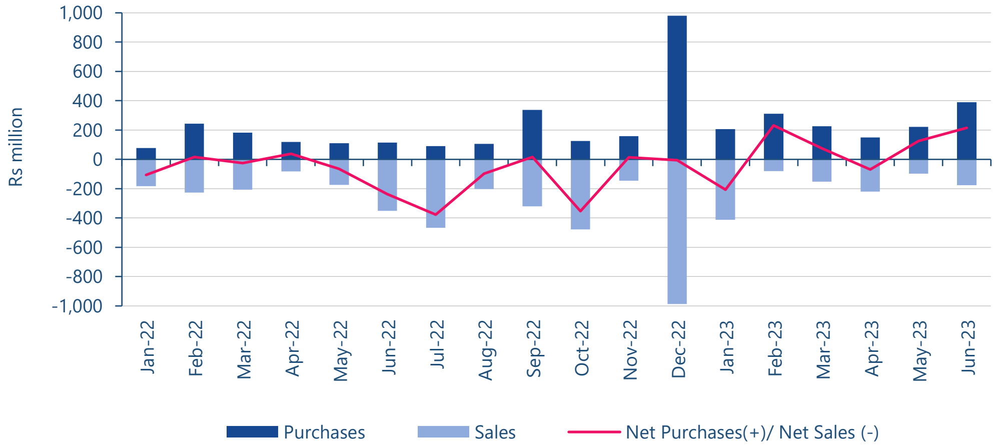


Source: Stock Exchange of Mauritius

December 2022. Similarly, the SEM-10 dropped to 362 points in June 2023, from 373 points in December 2022 (Chart 1.5).

Foreign investments on the stock market picked up, displaying improved confidence among foreign investors. Net foreign investor inflow reached Rs370.8 million in the first half of 2023, a significant improvement from the net disinvestment of Rs802.9 million in the second semester of 2022 (Chart 1.6).

Chart 1.6: Investment by foreigners on the SEM and DEM



Source: Stock Exchange of Mauritius

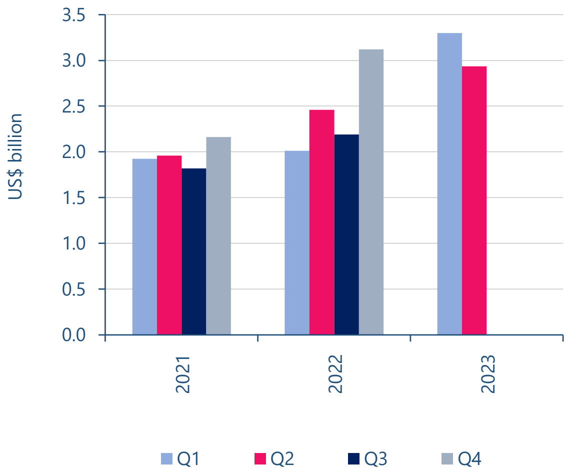
Higher foreign exchange market turnover

Activity on the FX market gathered further momentum in the first half of 2023, with a surge in both purchases and sales of FX. Total FX turnover amounted to US$6.2 billion during the first half of 2023 as compared to US$5.3 billion recorded during the second semester of 2022, representing a jump of 17.4 per cent (Chart 1.7).

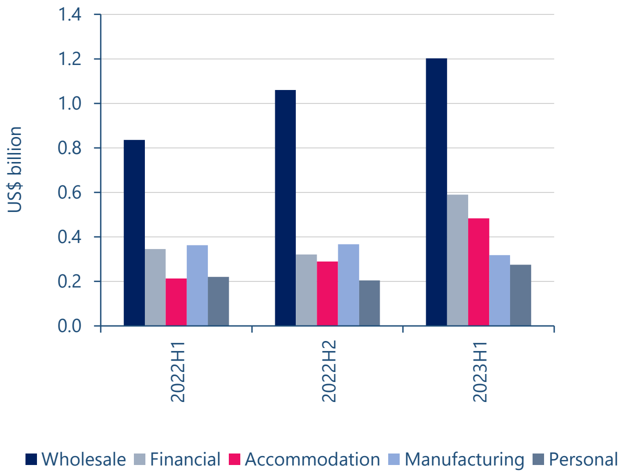
The volume of FX transactions by both banks and FX dealers went up. They acquired a total of US$3.0 billion from the market in the first half of 2023, up from US$2.4 billion in the last semester of 2022. This increase of 28.8 per cent was mainly driven by transactions with the 'Financial and insurance activities' and 'Accommodation and food service activities' sectors. In addition, the sustained improvement in economic conditions triggered a rise in the volume of FX sales to importers. Banks and FX dealers sold US$3.2 billion during the six-month period ended June 2023, a 9.1 per cent rise from US$2.9 billion in the second half of 2022.

Chart 1.7: FX turnover

a: Aggregate quarterly FX turnover



b. Sector-wise FX turnover



Source: Bank of Mauritius

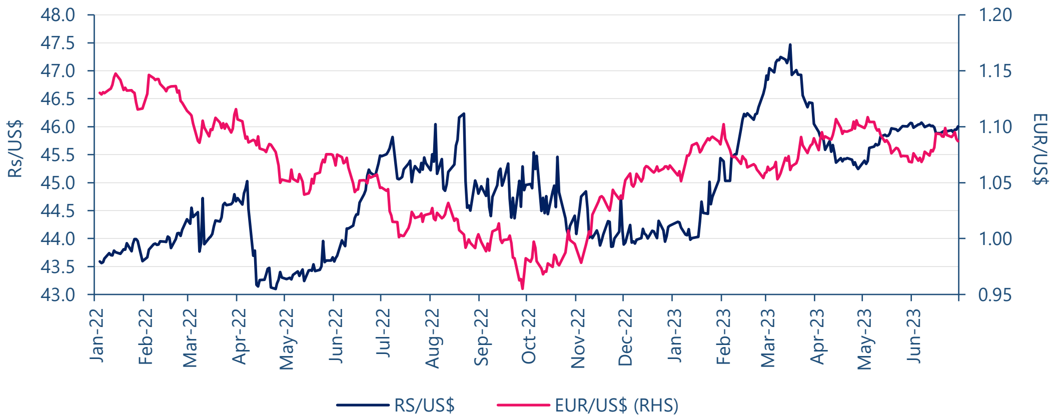
Based on regular surveys carried out by the Bank on the FX market, it was found that some economic operators – including banks – were withholding FX in anticipation of a depreciation of the domestic currency. Such speculative behaviour created an artificial shortage on the FX market, despite growing FX inflows. To curb this behaviour, in March 2023, the Bank cautioned banks and economic operators alike against such speculative activities that were detrimental to the good functioning of the economy. The Bank fined several banks for speculative activity on the FX market, following which exchange rate movements became more aligned with actual market conditions and became less volatile.

The Bank substantially scaled down the frequency and magnitude of its interventions on the market given the improvement in FX liquidity conditions. The Bank sold only US$50 million to banks in the first half of 2023, compared to US$505 million during the last semester of 2022.

The US dollar depreciated by 2.8 per cent against the Euro during the first half of 2023, prompted partly by more aggressive monetary policy tightening by the ECB as compared to the US Federal Reserve. The US Federal Reserve raised its federal funds rate by 75 basis points while the ECB hiked its main interest rate by 150 basis points cumulatively. Further interest rate hikes were expected, but with less aggressivity, as the two central banks continued to maintain their hawkish stand in their effort to bring inflation back to their respective targets.

The Rupee continued to be swayed by the evolution of major currencies on international markets as well as domestic demand and supply conditions. It depreciated by 3.7 per cent against the US dollar, on a weighted average dealt selling rate basis, between January to June 2023 (Chart 1.8).

Chart 1.8: Evolution of Rs/US$ selling dealt rate and EUR/US$



Source: Bank of Mauritius

Volatility on the FX market can be a source of risk to financial stability. Unfavourable FX movements can induce borrower-based risks with implications on the asset quality of banks that are exposed to vulnerable firms. For instance, businesses with high debt denominated in FX – and without a natural hedge in the form of income flows in FX – may face debt servicing stress in case of a sharp depreciation of the domestic currency or a rise in interest rates abroad. Of note, corporate credit in FX represented 30.1 per cent of total bank credit to corporate sector as at end-June 2023. To manage borrower-based FX risk, banks generally adopt a prudent approach by lending in FX to borrowers whose income streams are in FX.

New Monetary Policy Framework sets explicit inflation target

The Bank introduced its new monetary policy framework in January 2023 with the main objective of improving the transmission mechanism of monetary policy and anchoring inflation expectations. The Key Rate replaced the Key Repo Rate (KRR) as the policy rate to signal the stance of monetary policy. A key feature of the framework is the explicit definition of price stability, which is set at an inflation rate ranging between 2 per cent and 5 per cent with the aim of keeping inflation close to the mid-point of 3.5 per cent over the medium-term. Liquidity management is conducted daily, with banks having access to the Overnight Deposit Facility and Overnight Lending Facility set at 100 basis points below and above the Key Rate, respectively, in addition to the weekly issuance of 7-Day Bank of Mauritius Bills at the prevailing Key Rate.

Monetary policy stance unchanged

The monetary policy stance was kept unchanged by the MPC in the first half of 2023. After successive policy rate hikes aggregating to 265 basis points between March and December 2022, the MPC opted to maintain the policy rate unchanged at 4.50 per cent in the first semester of 2023. This decision was taken in the light of easing domestic inflationary pressures, declining global inflationary impulses and interest rate hikes still working their way into the economy to establish a balance between demand and supply.

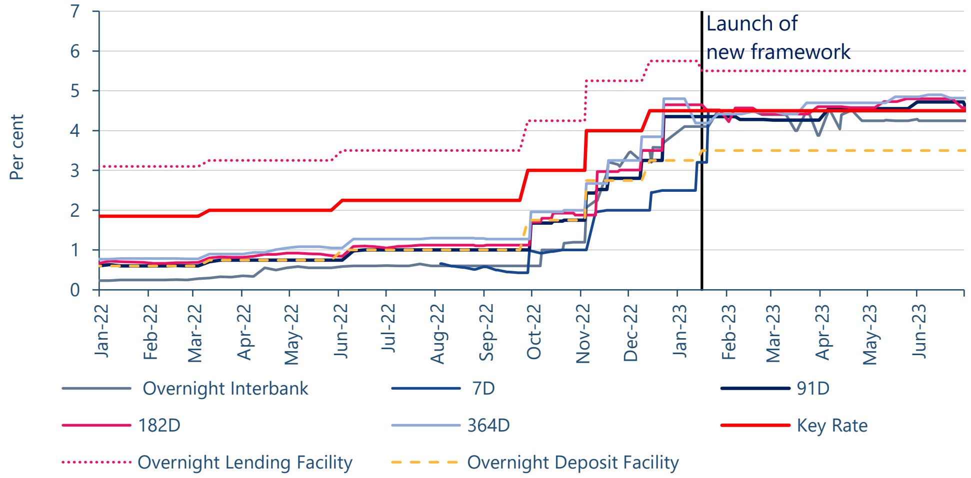
The Bank managed liquidity closely to ensure money market interest rates move within the interest rate corridor. Banks availed of the Overnight Deposit Facility for a daily average amount of Rs6.4 billion at the Key Rate minus 100 basis points between January and June 2023. They did not have recourse to the Overnight Lending Facility.

The main instrument of the new monetary policy framework is the 7-Day Bank of Mauritius Bills issued on weekly to all banks at the Key Rate. A weekly average amount of Rs64.7 billion of 7-Day Bills was issued between January and June 2023. As part of the longer-term operations, the Bank also issued an amount of Rs2.0 billion of 182-Day Bank of Mauritius Bills in February 2023. In the context of the 55th Anniversary of the Independence of Mauritius, the Bank issued a One-Year Certificate at 4.60 per cent and a Two-Year Note at 4.75 per cent for an aggregate amount of Rs7.5 billion to individuals, non-bank corporates and Non-Profit Making Organisations in April and May 2023, respectively.

As a result of the scaled-up open market operations, the level of outstanding Bank of Mauritius instruments surged to Rs138.5 billion as at end-June 2023, from Rs95.1 billion as at end-December 2022. Furthermore, the Bank mopped up an amount of Rs2.3 billion through the sale of US dollar during its FX interventions. Overall, excess Rupee liquidity dropped significantly to Rs2.0 billion as at end-June 2023, from Rs36.8 billion as at end-December 2022.

Money market yields gradually went up as the level of excess Rupee liquidity dropped. The weighted average yield on 91-Day Bills picked up by 37 basis points to stand at 4.72 per cent as at end-June 2023, from 4.35 per cent as at end-December 2022. During the same period, the 182-Day yield dropped by 7 basis points to reach 4.58 per cent, while the 364-Day yield edged up slightly by 2 basis points to reach 4.82 per cent (Chart 1.9). The new operational target, the overnight interbank rate, hovered between 3.88 per cent and 4.50 per cent, close to the mid-point of the interest rate corridor.

Chart 1.9: Evolution of money market interest rates



Source: Bank of Mauritius

International reserves remained adequate

The degree of external vulnerability of an economy is often measured by the adequacy of the international reserves held, which is predicated on the characteristics of the economy. Reserves are essentially maintained as an external liquidity buffer. Holding adequate reserves lowers the probability of balance of payments strains and supports orderly conditions on the FX market, all of which contribute towards maintaining economic and financial stability.

The domestic economy remained shielded against external shocks by its robust FX reserve buffers. The GOIR stood at USD$6.7 billion as at end-June 2023, compared to US$7.8 billion as at end-December 2022, reflecting a drawdown of FX balances held by commercial banks at the Bank. Conventional measures of reserve adequacy – such as import cover and reserves-to-broad money ratio – were largely met. The June 2023 import cover of 10.1 months was at a comfortable level and the reserves-to-broad money ratio was at 37 per cent, above the IMF's recommended range of 5-20 per cent, denoting the ability of the economy to tackle external imbalances. The GIOR was further assessed using two stringent measures of reserve adequacy – notably the ratio of reserves to short-term external debt (Greenspan-Guidotti rule) and the IMF Assessing Reserve Adequacy (ARA) methodology.

Non-resident short-term deposits amounted to Rs397 billion and represented 97.2 per cent of short-term external debt as at end-June 2023. The short-term external debt component of the ARA metric has been increasing consistently over the years and is set to expand further, given the outward-looking business model of most banks operating in the Mauritius International Financial Centre. As a result, the ratio of reserves to short-term external debt was 75 per cent as at end-June 2023.[1] Also, the GOIR-to-ARA metric ratio – another stringent assessment of the adequacy of the reserves – stood at 92.6 per cent in June 2023.[2]

The large FX buffers held by banks are not considered in the two stringent measures of reserve adequacy. These sizeable FX buffers provide significant insurance and cushion against FX outflows. For instance, the net foreign assets held by the banking sector amounted to Rs623 billion as at end-June 2023 and a mere 4 per cent of these assets would suffice to satisfy the more stringent ratios. Therefore, the degree of external vulnerability was assessed to be low when the external buffers held by the banking system are accounted for.

It is noteworthy that, in past years, deposits outflows by non-residents and even GBCs have not led to any FX market stress since banks have been managing liquidity risk prudently. On the basis of both historical patterns and prudential standards in place for the banking sector, banks have neither relied nor are expected to rely on the central bank's reserves to fund outflows of FX deposits.

The Bank's guideline on liquidity management – fully aligned with the liquidity standards of Basel III – requires banks to establish robust liquidity risk management framework to ensure they hold sufficient liquidity (both in Rs and FX) to withstand a range of liquidity stress events.[3] For instance, banks are required to maintain the Liquidity Coverage Ratio – i.e., they must hold adequate amount of high-quality liquid assets to fund cash outflows over 30 days, both in domestic as well as material foreign currencies. Moreover, some banks also have access to credit lines from their parent banks as part of their internal liquidity risk management policy. In addition, the overall net open FX position of banks should not exceed 15 per cent of their Tier 1 capital.[4] In practice, banks have historically kept a much lower net open FX position, which contributed towards mitigating FX liquidity risk.

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[1] *The reserves-to-short term external debt ratio measures the potential short-term demand for foreign assets from domestic sources.*

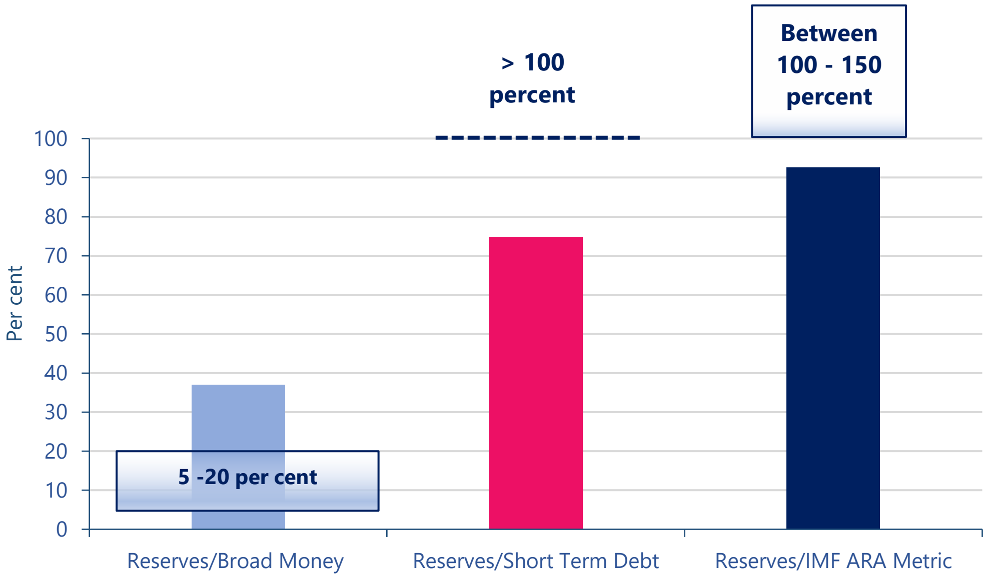
[2] *The ARA takes account of several economic variables, namely exports of goods and services, short-term external debt, broad money liabilities, non-GBC portfolio and other investment liabilities position, as well as GBC deposits of non-DSIBs. Refer to IMF Policy Paper, Assessing Reserve Adequacy–Specific Proposals (https://www.imf.org//media/Files/Publications/CR/2019/1MUSEA2019001.ashx). The ARA methodology applied for Mauritius was revised by the IMF following its Article IV Consultation Mission of January 2024.*

[3] *The Guideline on Liquidity Risk Management includes a set of minimum standards that banks must adhere to when managing liquidity risk. The Guideline has been consistently upgraded with improvements brought in 2009, 2010, 2017, 2019, 2020, 2021 and 2023 since its introduction in January 2000. It was overhauled in 2017 to introduce the LCR standard for the banking sector. The IMF acknowledges the stringent regulations in place for the banking sector to manage liquidity risk efficiently (including FX liquidity risk) in its Staff Report for the 2024 Article IV Consultation.*

[4] *The Net Open Position in foreign currency measures the mismatch (i.e., the open position or gap) of foreign currency asset and liability positions of banks in order to assess the potential vulnerability to exchange rate movements. This mismatch is generally assessed against banks' capital. In technical terms, the computation of the Net Open Position in foreign currency is the sum of the net position for each foreign currency converted into a single unit of account (the*

It is acknowledged that the higher the level of international reserves, the better it is for the economy as a shield against potential adverse external shocks. The Bank has already embarked on a programme to consolidate its international reserves, including buying FX from the market as and when conditions permit.

Chart 1.10: Select reserve adequacy metrics rates



Source: Bank of Mauritius

Review of the Systemic Risk Indicator

The regular assessment and close monitoring of systemic risk, which can arise in one part of the financial industry and spread to the whole financial system, has gained prominence since the global financial crisis (GFC) in 2008. Macroprudential authorities have since developed various toolkits to identify, track and respond to the build-up of systemic risk in the financial system, one of which is the SRI.

The SRI is a barometer of systemic risk and is designed by financial sector regulators to monitor risks and vulnerabilities from various segments of the economy. The complex and constantly evolving nature of financial systems have led to the adoption of various approaches and methodologies to construct the SRI. The Bank devised an SRI in 2018 and has since been using this indicator for monitoring systemic risk. The assessment of systemic risk is regularly published in its Financial Stability Reports.

The dynamic economic and financial landscape of Mauritius prompted an overhaul of this important tool. A comprehensive review of the SRI toolkit was carried out in 2023 to align it

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with the latest trends in the fields of systemic risk measurement. This review led to the adoption of a new methodology, a different risk guide along with a larger coverage of the sources of systemic risk. The new SRI toolkit supports the continuous upgrading of the financial stability toolkit used by the Bank to meet the objective of safeguarding financial stability.

The new indicator comprises the six core elements and drivers of systemic risk: namely, the banking sector, the household sector, the corporate sector, financial markets, macrofinancial indicators, and external component. It is an important barometer for guiding policy decisions to attain the intermediate macroprudential policy objectives. The review of the SRI is extensively covered in *'Box 1 – A new Systemic Risk Indicator'* of the June 2023 edition of the Financial Stability Report.

Systemic risk subsided further with economic expansion

The SRI indicated a moderation in systemic risk during the first semester of 2023.[5] The dynamics in the systemic risk landscape was largely influenced by improving economic conditions, financial market dynamics, robust banking sector performance and a deceleration in household credit growth. The macroprudential measures in place in the banking sector were viewed as broadly adequate in the circumstances.

Sustained economic growth contributed to containing risks in the macrofinancial environment, although risk from elevated inflation remained high. The continuous improvement in aggregate output boosted the government`s fiscal position whilst at the same time curtailed risk from private sector credit growth. The slowdown in domestic stock market indices signalled lower vulnerabilities from financial markets. Profitability figures of banks improved considerably in the first half of 2023, reflecting a compression of risks from the banking system. Importantly, risk from the household sector subsided significantly following a retreat in the pace of household credit growth, including housing credit. Also, the rise in the aggregate nominal income of households supported their capacity to honour their debt repayment obligations.

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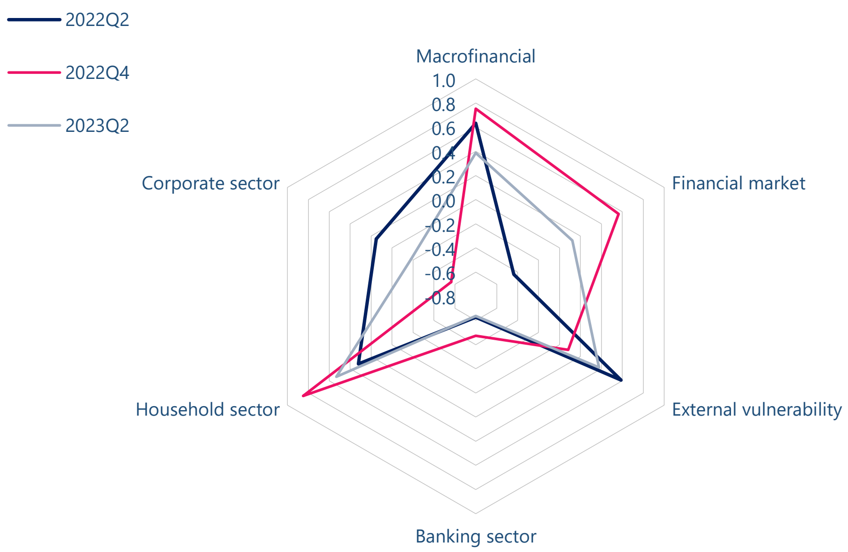
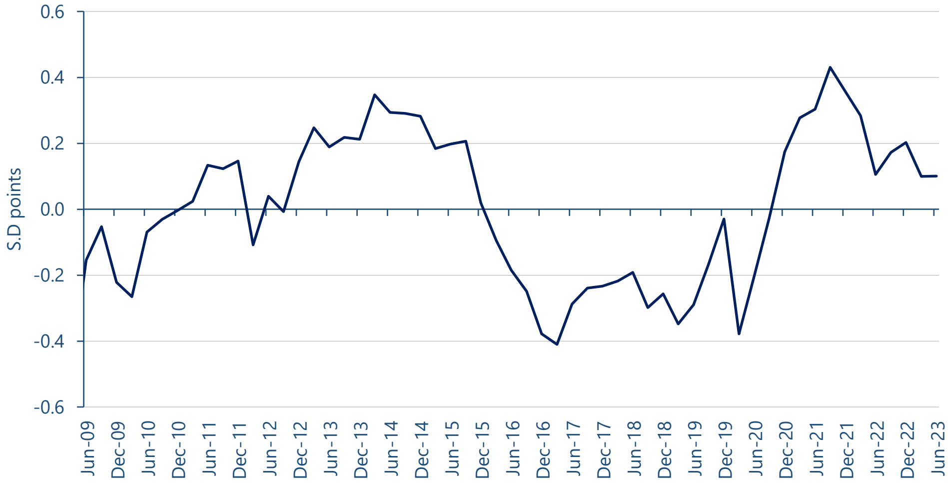
[5] *The SRI gives an indication of the overall degree of systemic risk in the financial system. The SRI model was reviewed in July 2023 to improve its effectiveness in signalling the build-up of systemic vulnerabilities. It covers the period from the first quarter of 2009 to second quarter of 2023. As the indicator moves further upwards, the level of risk increases and vice versa.*

Chart 1.11: Systemic Risk Indicator





Source: Bank of Mauritius

2. Financial soundness of households and corporates

Risks to financial stability from the household and corporate sectors eased in the first semester of 2023. There were no signs of widespread debt servicing stress in the two sectors. Borrowing costs were at levels comparable to the pre-pandemic period. As the economy expanded and labour market conditions improved, the debt servicing burden diminished since interest rates remained unchanged. The rise in borrowing costs in 2022 had slowed the pace of growth of housing loans, contributing towards stabilising the procyclical feedback between housing loan growth and property prices. Conditions in the corporate sector continued to improve as the strong momentum in the domestic economy was sustained. Risks from the household and corporate sectors were expected to continue subsiding as macroeconomic conditions remain upbeat.

Risks to financial stability from households and corporates moderated in the first half of 2023 relative to 2022. The rise in the WRI in concert with broadly unchanged market interest rates and declining inflationary pressures contributed to containing risks from materialising in the household sector.[6] Moreover, the strong momentum displayed by some key sectors of the economy along with relatively low corporate sector leverage supported the financial soundness of corporates. The asset quality of the household and corporate sectors improved further.

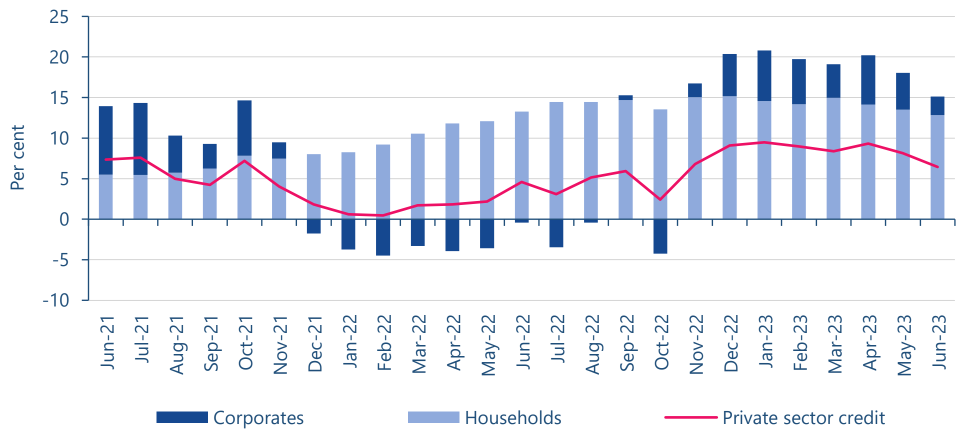
The hike in interest rates during the second half of 2022 together with the erosion of real income had a dampening effect on the demand for new loans in the household sector. In particular, the pace of housing loans growth decelerated in the first half of 2023 as households adjust their appetite for residential real estate projects following the rise in borrowing costs along with increasing construction costs. This deceleration has to some extent reduced the risk of macrofinancial feedback between the household sector and the banking system. As a result, both structural and cyclical risk factors from the household sector eased. Moreover, corporate borrowings picked up in the first semester of 2023, following a period of deleveraging from the banking system in 2022. The consistent improvement in aggregate demand has strengthened business confidence in the corporate sector.

[6] *The WRI, published by Statistics Mauritius, maintained a general upward movement to reach its highest point in June 2023.*

Bank credit to private sector grew but at a slower pace

Bank credit to the private sector maintained its growth trajectory in the first semester of 2023, though it decelerated due to household and corporate credit dynamics, to reach 6.5 per cent as at end-June 2023 (Chart 2.1). Corporate credit grew consistently during the first semester of 2023, albeit at a declining pace in the second quarter, to reach an annual rate of 2.3 per cent as at end-June 2023. Similarly, credit to the household sector increased steadily throughout the first semester of 2023 but moderated in the second quarter. Household sector credit rose, on an annual basis, by 12.8 per cent as at end-June 2023, from 15.2 per cent as at end-December 2022.

Chart 2.1: Annual growth of private sector credit



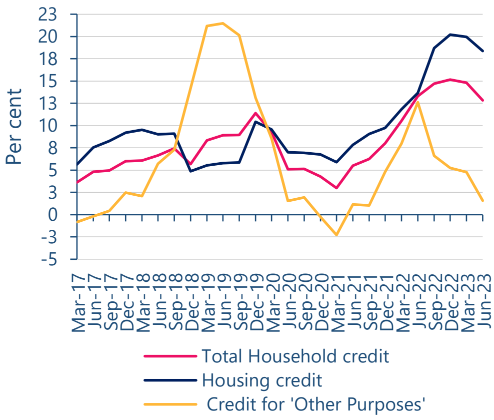
Source: Bank of Mauritius

Household credit growth moderated

The growth impetus in household credit decelerated, in the second quarter of 2023 in particular, as high interest rates and inflation compelled households to adjust their pace of debt accumulation. The 150 basis points increase in the KRR in the last quarter of 2022 had a noticeable effect on the growth momentum of household credit, as new loans were repriced to factor in the rise in the KRR. Borrowing costs rose to levels comparable to the pre-pandemic period. The deceleration was observed in both credit facilities extended for residential property purposes, which represents by far the predominant share of household credit, as well as for '*other purposes*'.

Household credit for *'other purposes'*, representing around one-third of total credit to households, grew sluggishly in the first half of 2023.[7] Elevated cost of living alongside the rise in interest rates have reduced demand for consumption credit as financial margins were squeezed, the more so as such credit facilities carry higher interest rates as they are mostly unsecured.[8] On an annual basis, credit for *'other purposes'* grew by 1.6 per cent as at end-June 2023 (Chart 2.2).

Chart 2.2: Annual growth of credit to households



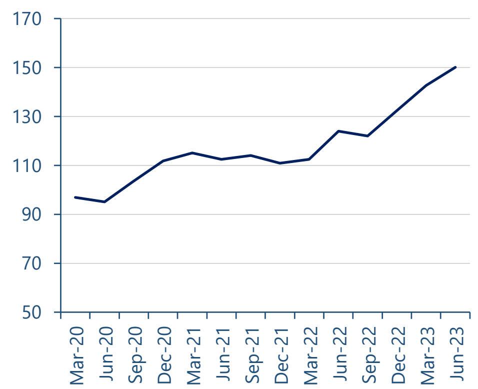
Source: Bank of Mauritius

Growth of housing loan slowed

Demand for housing loans decelerated in the first half of 2023, though it continued to grow at a relatively high rate compared to historical trends. Housing loans expanded by 18.4 per cent on an annual basis as at end-June 2023, compared to 20.2 per cent as at end-December 2022 (Chart 2.2). The conducive macrofinancial environment for investing in residential properties had supported demand for housing loans since March 2021. But high borrowing and construction costs were expected to dampen households' investments in residential projects in coming quarters.

In addition, residential property prices in Mauritius surged steadily over the last four quarters as demand for residential properties remained elevated. The Residential Property Price Index (RPPI), which measures residential real estate price movements in Mauritius, has been trending upward.[9] The four quarters cumulative average of the RPPI signalled a general uptick in residential property prices

Chart 2.3: 4-quarters cumulative average RPPI



Source: Statistics Mauritius

[7] *Credit extended to households for 'other purposes' includes purchase of other consumer durable goods, purchase of motor vehicles, education purposes, medical purposes, investment purposes, and other unspecified purposes.*

[8] *Financial margin refers to the difference between a household's monthly net income and the sum of basic living costs and regular debt repayment.*

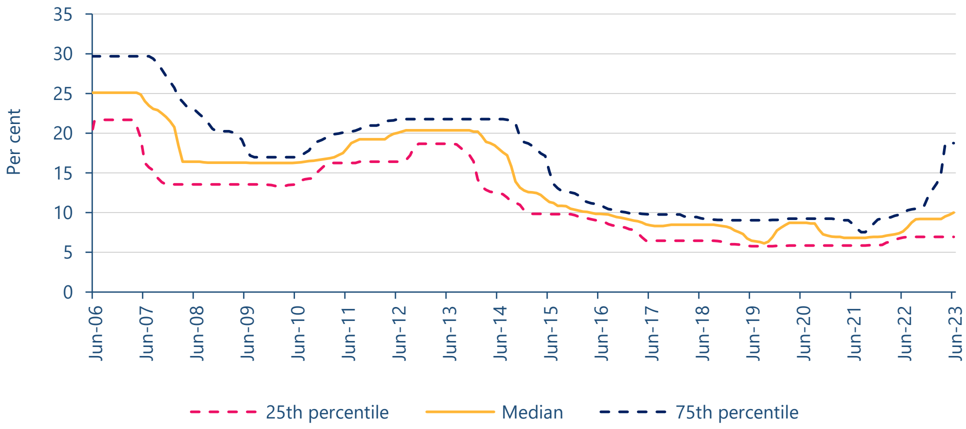
[9] *The Residential Property Price Index (RPPI), published by Statistics Mauritius, is an indicator of how the prices of transacted residential properties (houses and apartments) have evolved over time. The index has some shortcomings as volatility can be expected due to considerable heterogeneity within the level of stratification (IMF Technical Assistance Report, August 2018). Thus, the magnitude and direction of changes in the RPPI have to be taken with caution.*

over the last four quarters, reaching 150.1 in June 2023 from 132.4 in December 2022 (Chart 2.3).

The moderation in residential property loan growth is expected to stabilise property prices. Risks to financial stability are anticipated to be mitigated as property price pressures subside in the short to medium term against the backdrop of current macrofinancial developments as well as by the macroprudential measures banks follow. The household debt servicing metrics and asset quality of the household credit portfolio have continued to improve, which would contribute to ease risk to financial stability.

While housing loans registered rapid expansion since September 2021, its median annual growth ranged between 6.1 to 10.0 per cent for the period June 2019 to June 2023, well below the alarming range (Chart 2.4). As per the IMF Staff Guidance Note on Macroprudential Policy (2014), the median annual growth for housing loans in countries that witnessed a banking crisis ranged between 12-15 per cent for the three consecutive years preceding the crisis.[10]

Chart 2.4: Annual housing loan growth



Source: Bank of Mauritius

Asset quality of household sector improved further

The credit quality of the household sector improved further and displayed resilience against elevated inflation and debt servicing costs. The NPL ratio for households fell to 1.9 per cent as at end-June 2023, compared to 2.1 per cent as at end-December 2022. The continuous improvement of the asset quality of the sector positively suggests the absence of signs of financial strain from households to repay their debt obligations.

[10] *IMF Staff Guidance Note on Macroprudential Policy, 2014, pg 35.*

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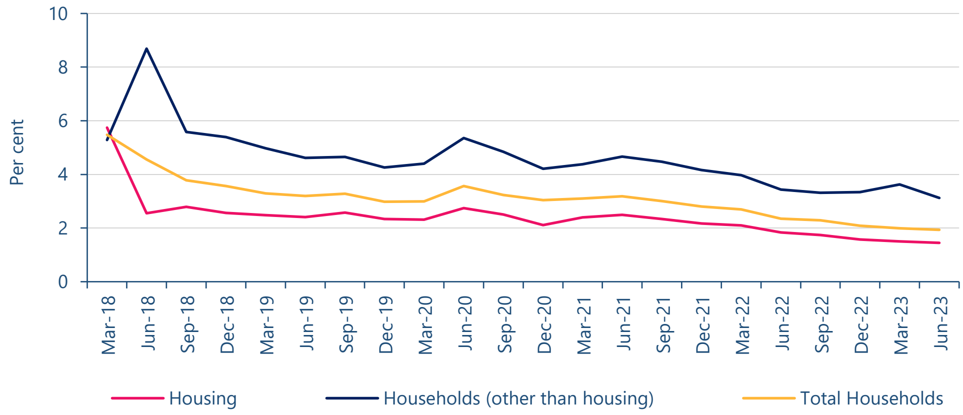
The quality of the housing credit portfolio was better as well, with the share of NPL dropping to 1.4 per cent from 1.6 per cent during the same period. Similarly, the NPL ratio for household credit granted for *'other purposes'* receded to 3.1 per cent from 3.3 per cent (Chart 2.5).

Chart 2.5: NPL ratio for households



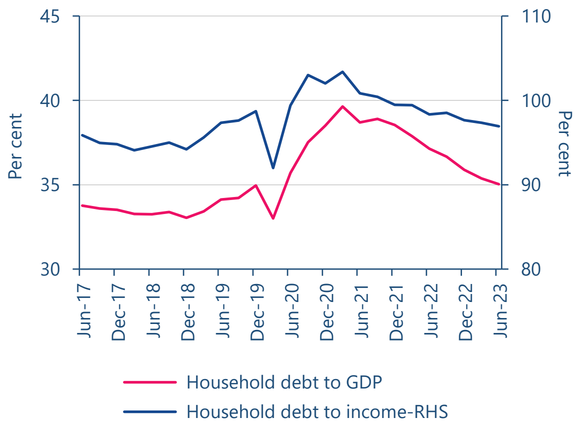
Source: Bank of Mauritius

Key metrics on household indebtedness improved

Household indebtedness metrics have continued to improve during the first semester of 2023, supported by economic expansion and growing household income. Sustained recovery in labour market conditions also contributed to a surge in household income. Receding inflation, as depicted by the decline in year-on-year inflation as from January 2023, also helped limit the erosion of real income.

Total household debt to the financial system – comprising banks, NBDTIs, insurance and leasing companies – as a ratio to GDP is estimated to have fallen on a semester basis, signalling subsiding debt vulnerabilities from the household sector. In particular, the ratio declined to 35.0 per cent in June 2023 as compared to 35.9 per cent in December 2022, suggesting better debt sustainability of the household sector.

Chart 2.6: Indicators of household indebtedness to deposit-taking institutions



Source: Bank of Mauritius

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Similarly, the ratio of household indebtedness to income is estimated to have fallen to 96.9 per cent in June 2023, from 97.7 per cent in December 2022 (Chart 2.6). As a comparison, the ratios of household debt to GDP and income averaged 33.7 per cent and 95.7 per cent, respectively, three years prior to the pandemic. The household indebtedness metrics are, therefore, gradually returning to pre-pandemic levels. The ratio of household debt to deposit-taking institutions relative to GDP and income fell during the first half of 2023, 33.5 and 92.7 per cent in June 2023, respectively. Overall, aggregate household debt is estimated to have reached Rs213.8 billion as at end-June 2023.

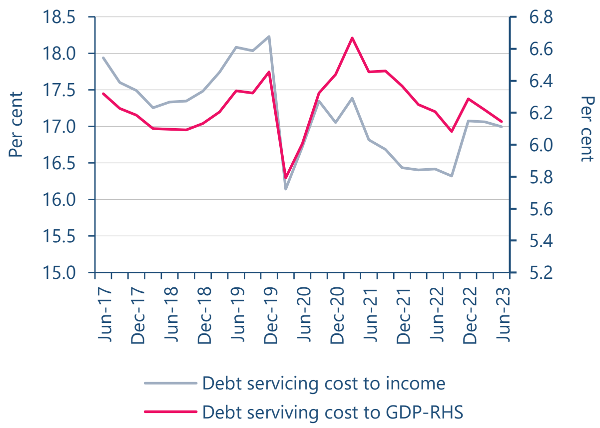
Overall, financial stability risks from household sector indebtedness remained moderate and eased further in the first semester of 2023, given the downward trend displayed by debt metrics. The household sector was broadly more resilient to high interest rate and inflation, as evidenced by the lower rate of impairment in the households' credit portfolio in the banking sector.

Income growth supported household debt servicing capacity

The debt servicing capacity of households was supported by a number of factors in the first semester of 2023, such as growing income, better labour market conditions, unchanged interest rates in the first half of 2023 and falling inflation. The statutory salary compensation together with the monthly income allowance by the fiscal authority, that became effective January 2023, provided financial relief to households. Moreover, some banks offered preferential interest rates to eligible households, aimed at supporting vulnerable borrowers.

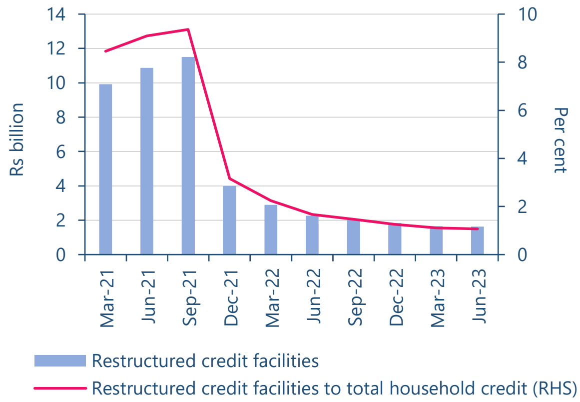
Debt serviceability metrics of the household sector, namely, debt servicing cost to income and to GDP, improved in the first half of 2023. Debt servicing cost relative to income and GDP fell to 17.0 per cent and 6.1 per cent, respectively, below pre-pandemic levels (Chart 2.7).

Chart 2.7: Estimated debt servicing cost to income



Source: Bank of Mauritius

Chart 2.8: Households' restructured credit facilities



Source: Bank of Mauritius

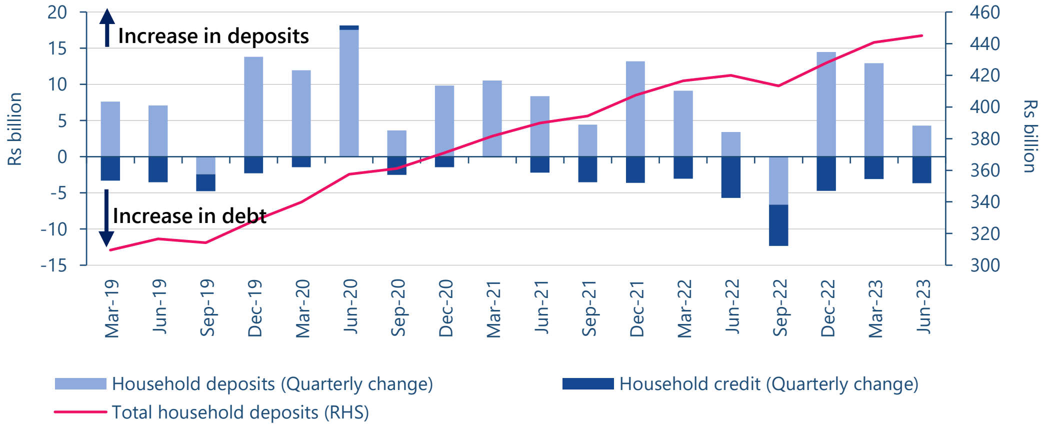
Moreover, the consistent drop in the amount of household restructured facilities over the past year showed little evidence of debt servicing strains from households. The ratio of household restructured facilities to total household credit dropped to 1.2 per cent as at end-June 2023, from 1.3 per cent as at end-December 2022 (Chart 2.8). The steady decline in the value of restructured facilities indicated that signs of debt servicing stress among households remained moderately low, even among those household borrowers that were at the lower rung of the income ladder and who borrowed at high debt-service-to-income ratios during the period of low interest rates.

Accumulated household deposits continued to grow

Financial wealth of households, such as bank savings, is a barometer of their financial soundness. The quarterly change in household deposits hovered in positive territory in the first semester of 2023, whilst credit growth slowed down (Chart 2.9). Households were, therefore, more inclined to accumulate deposits rather than debt. In effect, higher interest rate on deposits induced households to park more funds in time deposits, which grew by 31.0 per cent from December 2022 to June 2023. In contrast, household savings deposits rose marginally by 0.6 per cent. Total household deposits with the banking sector represented 72.8 per cent of GDP as at end-June 2023, making savings an important buffer against financial strains.[11] From a financial stability standpoint, the combination of growing financial wealth together with slower expansion of debt has potentially strengthened the resilience of households.

[11] The lack of suitable data precludes an analysis of household deposit concentration, which would support the inference that the most households saw an improvement in their financial resilience.

Chart 2.9: Quarterly change in total household bank deposits and borrowings



Source: Bank of Mauritius

Risks from the household sector moderated and expected to ease further

Overall, risk to financial stability from the household sector moderated in the first semester of 2023 and is expected to ease further with the favourable macroeconomic outlook. Sustained improvement in labour market conditions and household income combined with the shift in household borrowing and savings patterns as well as the decline in inflation altogether reinforced the financial resilience of the household sector. From a systemic risk perspective, cyclical vulnerabilities from the household sector started to recede as household credit, in particular, housing credit, decelerated and was expected to slow down further in coming quarters.

Prudent lending standards adopted by banks have mitigated credit risk. The credit quality of the household sector even improved. The macroprudential policy tools currently in place, such as the Loan-to-Value (LTV) ratio and Debt-Service-to-Income (DSTI) limit, supported borrower-based resilience.

Risks from the corporate sector dwindled further

Corporate sector vulnerabilities subsided in the first half of 2023, as the economy continued to expand. The strong growth momentum in some key economic sectors from last year – notably, the *'Accommodation and food service activities'*, *'Manufacturing'*, *'Construction'* and *'Financial and Insurance activities'*, was sustained in the first half of 2023, boosting business confidence and earnings. The financial position of large corporates remained generally sound, with barely any signs of debt servicing distress. Corporate sector leverage to the banking sector expanded reflecting improvement in aggregate demand. The asset quality of corporates to the banking sector stayed healthy.

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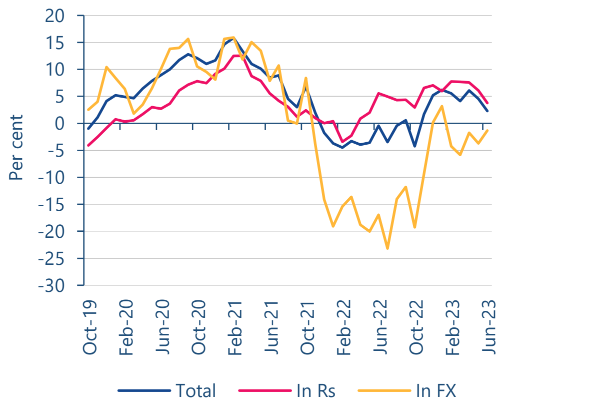
Corporate credit growth trended in positive territory throughout the first half of 2023, following deleveraging during the corresponding period of the preceding year. Bank credit to the corporate sector rose at an annual rate of 2.3 per cent as at end-June 2023 (Chart 2.15). This expansion was principally led by an increase in bank loans extended to non-financial sectors: namely, *'Wholesale and retail trade'*, *'Real estate activities'* and *'Professional, scientific and technical activities'*. A few sectors, such as *'Accommodation and food service activities'*, *'Manufacturing'* and *'Transportation and storage'*, reduced their debt obligations to the banking sector.

Bank loans prevailed as the main source of credit facility for the corporate sector, as compared to debt securities acquired by banks. The share of bank holdings of corporate debt securities relative to total corporate credit increased during the first semester of 2023, reaching 16.9 per cent in June 2023. In nominal terms, bank credit to the corporate sector amounted to Rs211.3 billion, as at end-June 2023. In terms of sectoral concentration, the *'Accommodation and food service activities sector'*, *'Wholesale and retail trade'* and *'Real estate activities'* sectors were the top three beneficiaries of funds from the banking sector.

The corporate sector relied less on credit in FX in the first half of 2023. Specifically, corporates have consistently reduced their exposure in FX with the banking system since November 2021, with exceptions noted in December 2022 and January 2023. The growth of corporate credit in FX was in negative territory. On an annual basis, corporate credit in FX contracted by 1.3 per cent as at end-June 2023 (Chart 2.10). The lower exposure of corporates in FX entail lower risks to financial stability, though a large share of these borrowings is naturally hedged.

Chart 2.10: Growth of credit to the corporate sector



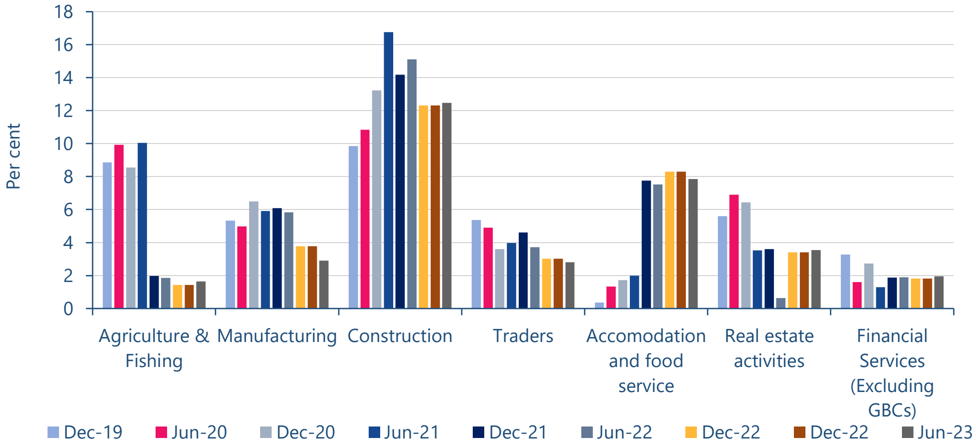
Source: Bank of Mauritius

Sustained improvement in corporate sector asset quality

The asset quality of the corporate sector improved further during the first half of 2023, indicating that businesses remained resilient to higher borrowing and operating costs. The robust growth in nominal earnings bolstered by sustained expansion in aggregate demand upheld the financial resilience of corporates. The NPL ratio of the corporate sector improved marginally to reach 5.2 per cent as at end-June 2023, from 5.3 per cent as at end-December 2022.

The drop in the NPL ratio was mainly led by an improvement in credit impairment of some key economic sectors namely *'Accommodation and food service activities sector'*, *'Manufacturing'* and *'Traders'*. In contrast, the *'Construction'* and *'Real estate activities'* sectors registered additional NPLs (Chart 2.11). It should nevertheless be underscored that credit impairment in the *'Construction'* sector was specific to two banks rather than a system-wide issue.

Chart 2.11: Sector-wise NPL ratio for selected key sectors

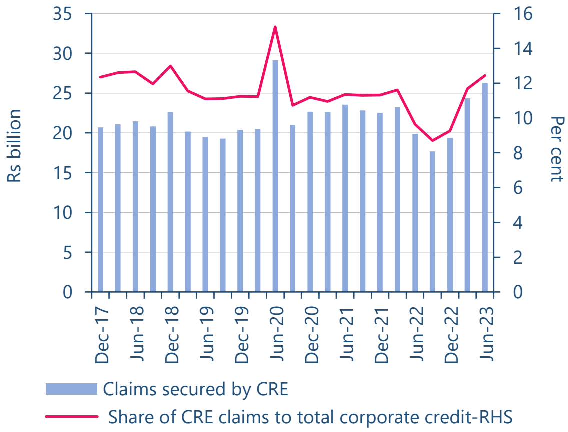


Source: Bank of Mauritius

Credit to commercial real estate sector picked-up

The exposure of the banking system to the commercial real estate (CRE) market went up in the first half of 2023, but risks were prudently managed. In nominal terms, loans secured by CRE grew at an annual rate of 32.1 per cent to reach Rs26.2 billion as at end-June 2023. As a consequence, the share of loans secured by CRE to corporate credit rose to 12.4 per cent in June 2023 (Chart 2.12). The sustained improvement in aggregate demand along with favourable conditions in the corporate sector translated into renewed appetite for CRE investments.

Chart 2.12: Share of claims secured by commercial real estate to total bank credit to the corporate sector



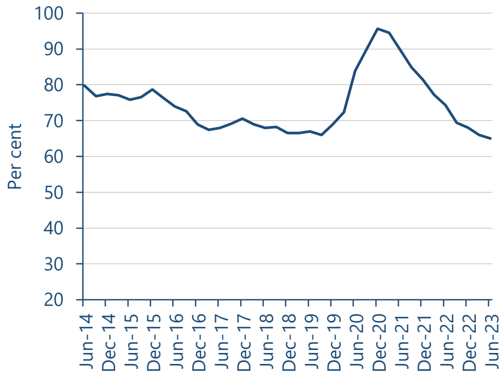
Source: Bank of Mauritius

The CRE encompasses a wide range of real estate assets that are owned by firms – such as office, retail, industrial and other properties but also multiple occupancy residential properties purchased by economic operators other than households. Corporates use CRE as collateral to secure funding from banks. The macroprudential policy instruments currently in place contribute to safeguard the resilience of banks against credit risks arising from CRE collaterals such as higher risk weights.

Better repayment capacity of the corporate sector

The debt repayment capacity of businesses has gradually improved during the first semester of 2023 and is analogous to pre-pandemic levels. The ratio of corporate sector debt relative to earnings receded further to reach 65.0 per cent as at end-June 2023 (Chart 2.13).[12] The ratio has consistently regressed since December 2020 as earnings grew faster than debt – confirming the sound financial position of the corporate sector.

Chart 2.13: Share of corporate credit to operating surplus



Source: Bank of Mauritius

Risks from the corporate sector expected to subside further

Improving economic conditions have largely contributed to ease risks to the stability of the financial system from the corporate sector. Corporate earnings continued to grow, and have strengthened the financial soundness of businesses thus enhancing their capacity to adapt to higher debt servicing costs. The asset quality of the corporate sector has, as a result, improved over the first half of 2023.

Going forward, financial margins of businesses are expected to recover further as operating costs stabilise with falling inflation. Asset quality of corporates was projected to remain sound. Overall, financial stability risk from the corporate sector was anticipated to moderate further with the favourable macroeconomic outlook.

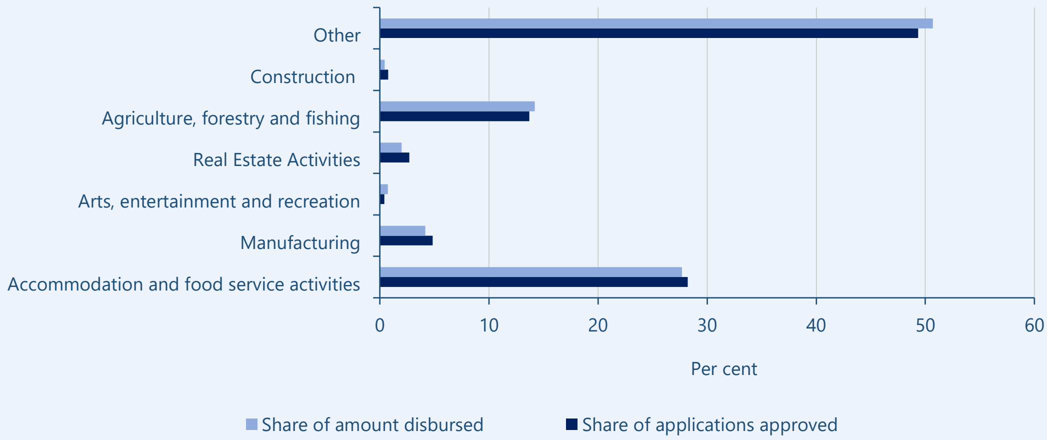
[12] *Corporate earnings are proxied by Gross Operating Surplus compiled and published by Statistics Mauritius.*

Box 1 - The Mauritius Investment Corporation Ltd and financial stability

The Mauritius Investment Corporation Ltd (MIC) continues to play an important role to safeguard macrofinancial stability. The MIC pursued its objective to provide financial support to systemically important and viable domestic companies in the first half of 2023. The MIC has approved a total amount of Rs54.0 billion as credit facilities as at end-June 2023, out of which Rs50.0 billion have already been disbursed (Chart I). These funds were mostly intended to financially stressed but operationally sound firms.

From a sectoral perspective, corporates operating in the *'Accommodation and food service activities'*, *'Manufacturing'*, *'Construction'*, *'Agriculture, forestry and fishing'* and *'Real Estate activities'* received additional financial support during the first semester of 2023. Financial assistance of the MIC has reduced corporate sector vulnerabilities. Its contribution to maintaining macrofinancial stability remained important, against the uncertain global macroeconomic backdrop.

Chart I: Sectoral share of applications and disbursement by the MIC as at end-June 2023



Source: Bank of Mauritius

3. Financial soundness of deposit-taking institutions

Deposit-taking institution accumulated capital and liquidity buffers in the first half of 2023, reinforcing their resilience to stresses. Higher net interest income boosted profitability, contributing to capital growth. Concurrently, the increase in investments in low-risk securities supported their liquidity buffers. The asset quality of banks was broadly sound, though a slight deterioration was noted driven mainly by a rise in impairment in the external credit portfolio. The banking sector pursued its expansion of cross-border activities, as risks in the global economic and financial environment receded. The non-bank deposit-taking sector grew further, supported by its sound financial performance. These positive developments contributed to safeguarding the resilience of the banking system and non-bank deposit-taking institutions in an environment of moderating risks to financial stability.

Structure of the deposit-taking financial sector unchanged

Deposit-taking institutions, comprising banks and NBDTIs, demonstrated sustained resilience based on Financial Soundness Indicators (FSI).[13] The deposit-taking institutions remained financially sound and stable despite rising interest rates abroad, persistent high inflation and turbulences in the banking industry in some advanced economies. High interest rates had a positive impact on these institutions, supporting them to consolidate their profitability and thus, their capital buffers primarily through higher net interest income. Investments in government/Bank of Mauritius securities also boosted the liquidity buffers of these entities.

The deposit-taking sector continued to be bank-driven, with the aggregate assets of the 19 banks growing at an annual rate of 9.4 per cent in June 2023 to reach Rs2.3 trillion or around 350 per cent of GDP.[14] The level of banks' assets concentration was maintained at moderate level. The Herfindahl-Hirschman Index (HHI) was 1,799 in June 2023.[15] The two largest banks, which are Domestic-Systemically Important banks (D-SIBs), accounted for around 46.8 per cent of all deposits, 49.7 per cent of all advances, and 47.2 per cent of all assets as at end-June 2023.

[13] Financial Soundness Indicators (FSIs) of deposit-taking institutions have been computed based on the IMF Guide (2019).

[14] The ratio of banking sector assets to GDP fell to around 350 per cent in June 2023 from around 380 per cent in December 2022 due to the robust economic growth in 2023 relative to a 3.1 per cent growth in banks' assets.

[15] The Herfindahl-Hirschman Index (HHI) assesses market competitiveness. A market with an HHI of less than 1,500 is considered a competitive marketplace, an HHI of 1,500 to 2,500 is moderately concentrated, and an HHI of 2,500 or greater is highly concentrated.

The capital buffers of the five D-SIBs were well above their respective minimum regulatory requirements, inclusive of D-SIB capital surcharge ranging from 1.0 per cent to 2.5 per cent.[16] Strong capital buffers supported the capacity of the D-SIBs to absorb potential shocks. Moreover, with high interest rates, the D-SIBs have registered significant improvement in profitability which stimulated capital accumulation. The credit and liquidity risk management frameworks of the D-SIBs are closely monitored. The frameworks implemented by the D-SIBs are deemed to be robust for effective management of potential materialisation of losses.

NBDTIs were the second largest players in the deposit-taking financial sector, with assets representing around 11 per cent of GDP in June 2023. The six NBDTIs operating in Mauritius focussed their operations towards mobilising deposits and extending lease and loan facilities. Similar to their banking counterparts, the performance of NBDTIs was sound and healthy in the first half of 2023.

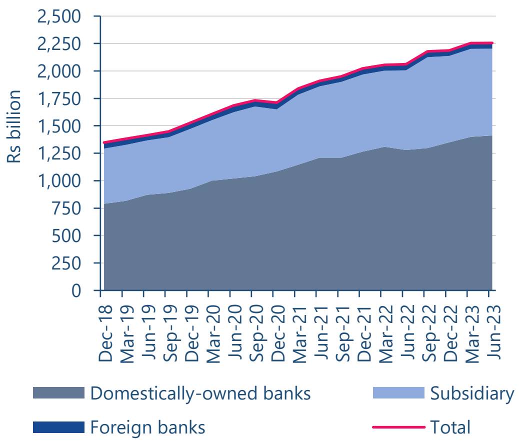
Resilient and expanding banking sector

The banking sector continued to thrive. The balance sheet position of banks expanded further in the first half of 2023, supported mainly by growing activity with the non-resident segment. High interest rates positively impacted profits, enabling banks to consolidate their capital base. Banks were able to sustain flow of credit to the domestic economy and the non-resident sector. They prudently managed liquidity risk, by maintaining adequate high-quality liquid assets (HQLA) for both the resident and non-resident segments, and the quality of assets.

Banking sector balance sheet rose further

Banks' balance sheet continued to grow, reflecting favourable prospects both domestically and globally. Total banking sector assets reached an all-time high of Rs2.3 trillion in June 2023, after growing at an annual rate of 9.4 per cent (Chart 3.1). Domestic-owned banks, leading the banking sector with around 63 per cent assets share, registered an annual expansion of 10.3 per cent of their aggregate assets in June 2023. Foreign-owned subsidiary banks, with a

Chart 3.1: Banking sector balance sheet



Source: Bank of Mauritius

[16] *Based on June 2022 data, the Bank assessed the same five banks as D-SIBs, namely: The Mauritius Commercial Bank Limited, SBM Bank (Mauritius) Ltd, Absa Bank (Mauritius) Limited, The Hongkong and Shanghai Banking Corporation Limited (Branch) and AfrAsia Bank Limited.*

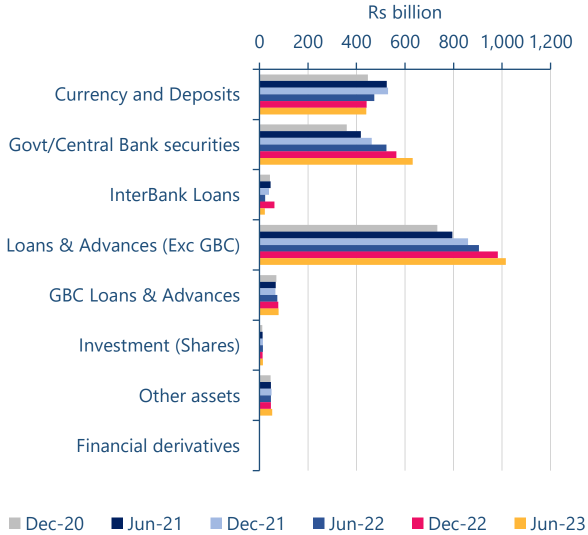
market share of around 35 per cent, recorded an annual increase of 9.3 per cent in their assets. In contrast, branches of foreign-banks – holding the remaining market share, recorded a decline of 8.1 per cent in their aggregate assets in June 2023.

The balance sheet composition of banks was broadly stable. Loans and advances remained the main components of the banking sector assets, growing at an annual rate of 11.8 per cent to reach Rs1.1 trillion as at end-June 2023 (Chart 3.2a). Banks continued to manage risk by investing in less-risky and more liquid assets, such as government and Bank of Mauritius securities.

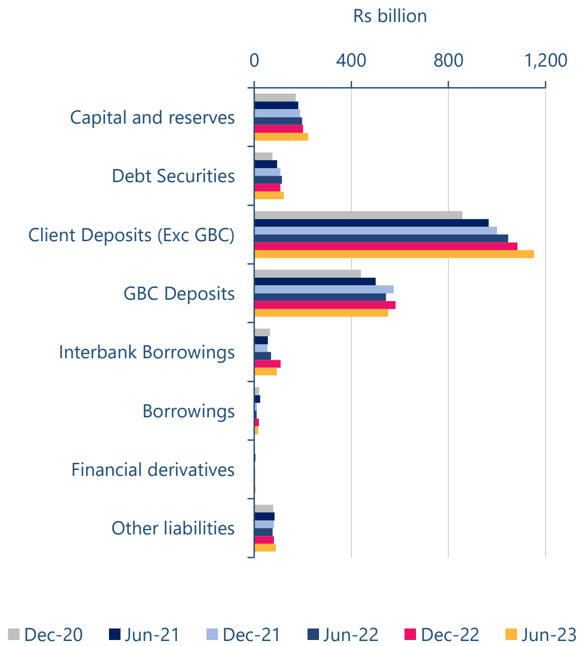
Banks' liabilities and capital structure remained mostly stable. Banking sector assets were funded primarily by deposits. Total deposits, in both domestic and foreign currencies, aggregated Rs1.7 trillion as at end-June 2023, after rising by 7.3 per cent annually in June 2023 (Chart 3.2b). Corporates were the highest contributor to banks' funding structure, representing around 57 per cent and 68 per cent of the sector's total liabilities and total deposits, respectively, as at end-June 2023.[17] Banks registered an annual growth of 6.7 per cent in deposits from corporates in June 2023. Similarly, deposits from households rose, on annual basis, by 6.0 per cent in June 2023. Capital and reserves of banks were also reinforced, with an annual growth of 12.9 per cent, supporting bank credit flows to the domestic economy and cross-border banking activities.

Chart 3.2: Banking sector balance sheet decomposition

a. Assets decomposition



b. Capital and liabilities decomposition

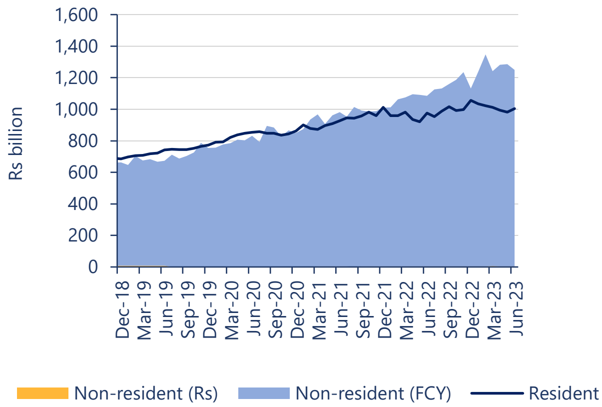


Source: Bank of Mauritius

[17] *Corporates comprise non-bank legal entities, both resident and non-resident, including: NBDTIs, Credit Unions, Trusts, Insurance companies, Pension funds, Investment funds, Holding companies, Financial auxiliaries and other financial intermediaries, GBCs, Public non-financial corporations, and other non-financial corporations.*

Growth of the banking sector balance sheet was primarily led by non-resident foreign currency (FCY) denominated assets. The value attained Rs1.2 trillion as at end-June 2023, up from Rs1.1 trillion from end-December 2022 (Chart 3.3). Banks maintained their investment strategy in foreign government securities and T-bills, whilst also on-boarding riskier assets – in the form of FCY debt securities and foreign bills. Banks focussed more on non-resident funding to sustain their FCY activities. FCY non-resident deposits, a major constituent of banks' funding, registered an annual growth of 15.0 per cent as at end-June 2023, demonstrating sustained confidence of non-residents in the banking sector.

Chart 3.3: Resident and non-resident bank assets



Source: Bank of Mauritius

Banks' balance sheet resilient to downside interest rate risk

Banks managed interest rate risk by adopting suitable mitigants. They deployed more funds into the banking book compared to the trading book to limit the effects of short-term interest rate volatility from interest-sensitive financial assets, particularly in the second quarter of 2023. Trading book assets represented 14.4 per cent of the banking sector Tier 1 capital as at June-2023, down from around 17.0 per cent as end-March 2023 and end-December 2022.

The balance sheet of banks was actively managed so as to lower exposure to downside interest rate risk. Banks maintained adequate capital to hedge their banking books against residual interest rate risk exposure. Most banks continued to register positive interest rate gap as at end-June 2023. A positive interest rate gap denotes higher interest rate-sensitive assets relative to interest rate-sensitive liabilities. There was an improvement in the positive interest rate gap in most time-band buckets.

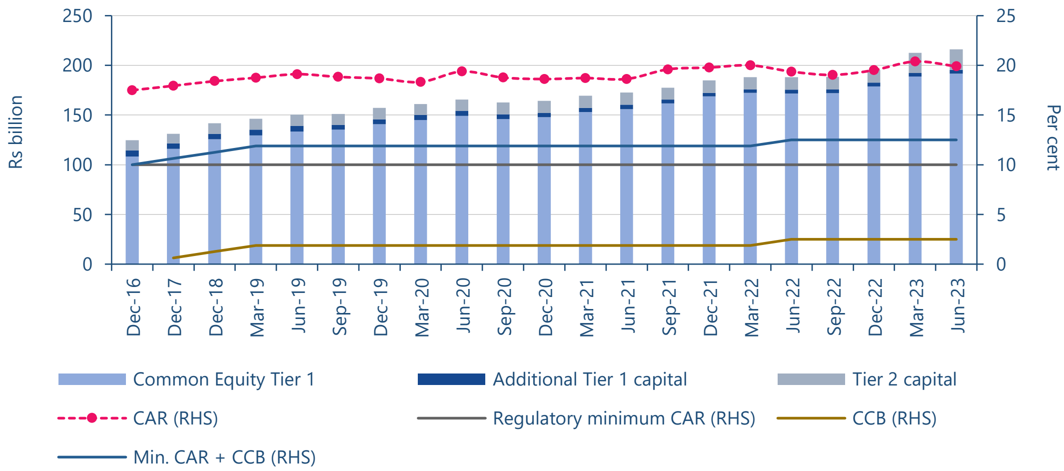
Capital charge for operational risk increased

Operational risk was recognised by banks as an important contributing factor to the overall risk landscape. In the Annual Financial Stability Survey conducted by the Bank in October/November 2023, cyber risk and IT failures were significant drivers of operational risk (Box 2). Banks were nevertheless well prepared to mitigate materialisation of operation risk. Capital charge for operational risk increased to Rs77 billion as at end-June 2023 compared to Rs72 billion as at end-December 2022.

Banks strengthened capital buffers

Banks held strong levels of capital, propelled by elevated earnings from high interest rates. The banking sector loss-absorbing capital ratios remained well above regulatory minimum, inclusive of capital conservation buffer (CCB) of 12.5 per cent (Chart 3.4). Banks' combined regulatory capital reached Rs216 billion in June 2023, up by 10.5 per cent from December 2022. The Common Equity Tier 1 CAR – representing around 90 per cent of total regulatory capital – was 17.7 per cent in June 2023. Banks also accumulated capital through Tier 2 instruments. Tier 2 capital went up by 58.3 per cent from December 2022. Consequently, the regulatory capital represented 19.9 per cent of RWAs as at end-June 2023, against 19.5 per cent as at end-December 2022.

Chart 3.4: Capital adequacy ratio of the banking sector



Source: Bank of Mauritius

The CAR of each D-SIBs was above the respective regulatory limits, providing adequate buffer against shocks. The aggregated CAR for the five large systemic banks was 18.3 per cent in June 2023, 0.6 percentage points higher than in December 2022. The D-SIBs accumulated Rs138 billion in regulatory capital as at end-June 2023.

Asset quality of banks broadly sound

The asset quality of banks remained broadly sound in the first half of 2023, maintaining credit risk at a manageable level, though a slight deterioration was noted relative to December 2022. The NPL ratio – measured by amount of NPL as a percentage of total gross outstanding credit facilities – rose to 4.6 per cent as at end-June 2023, up from 4.1 per cent as at end-December 2022 (Chart 3.5a).[18] The D-SIBs, on aggregate, demonstrated an enhanced asset quality, with their combined NPL ratio improving to 4.8 per cent in June 2023 from 5.1 in December 2022.

[18] Adjusting for one bank that has a very small share of banking sector assets, the rise hike in NPL ratio is dampened significantly. The adjusted NPL would be 4.2 per cent in June 2023, from 4.0 per cent in December 2022.

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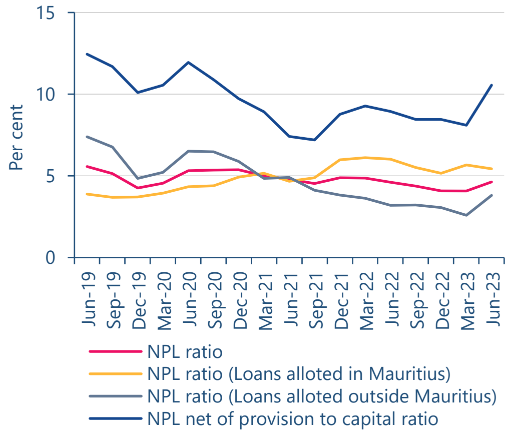
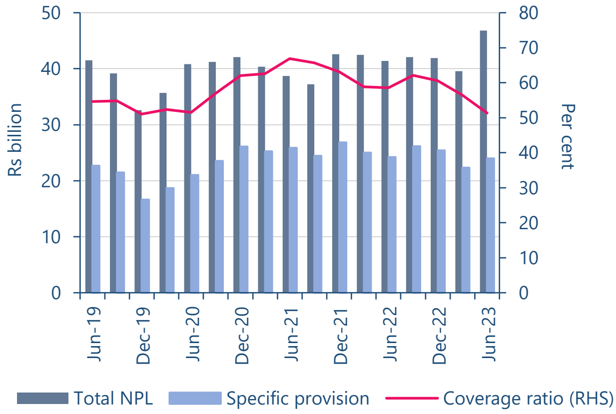
The domestic economy maintained its resilience, assisted by the panoply of financial support provided by the fiscal authority as well as flexibility offered by banks to borrowers. In contrast, foreign counterparties were more vulnerable, with some of them impacted by strains in their respective economies. As a result, non-resident borrowers exhibited elevated risk, with banks reporting significant increase in impairment in the segment which largely drove the rise in the overall banking sector NPL ratio.

Chart 3.5: Asset quality

a. Non-performing loans



b. Specific provisions



Source: Bank of Mauritius

In particular, the non-resident segment recorded an NPL ratio of 3.8 per cent in June 2023, up from 3.1 per cent in December 2022. The domestic sector, on the other hand, fared slightly better with a marginal increase to 5.4 per cent in June 2023 relative to 5.2 per cent in December 2022. In addition, the GB sector remained an important contributor to the impairment of the domestic credit portfolio. Exclusive of the GB sector, the NPL ratio for the domestic sector came down to 3.4 per cent in June 2023 and 3.2 per cent in December 2022, demonstrating sound asset quality for bank credit allotted to the economy.

Banks generally applied a prudent approach to cover for any materialisation of credit losses and made provisions proactively to cover impaired credit. These specific provisions came down due to write-offs of impaired credit. Specific provisions written off in the first semester of 2023 amounted to Rs6.7 billion. Altogether, the aggregate specific provisions in the banking sector dropped to Rs24 billion in June 2023, against Rs25 billion in December 2022 (Chart 3.5b). The coverage ratio, measured by specific provisions as a ratio to gross NPL, was at 51.3 per cent in June 2023.

The banking sector maintained a prudent approach to manage credit risk for their aggregate credit portfolio. As banks kept credit flowing to the domestic economy and to foreign counterparties, around 88 per cent credit was still classified as the Stage 1 in both quarters ended December 2022 and June 2023. A minor increase of 0.3 percentage point in the share of Stage 2 credit was noted over the same period, which was part of proactive risk management by banks to mitigate potential defaults by borrowers. Banks increased provisioning for Stage 1 and Stage 2 loans by around 1 percentage point.

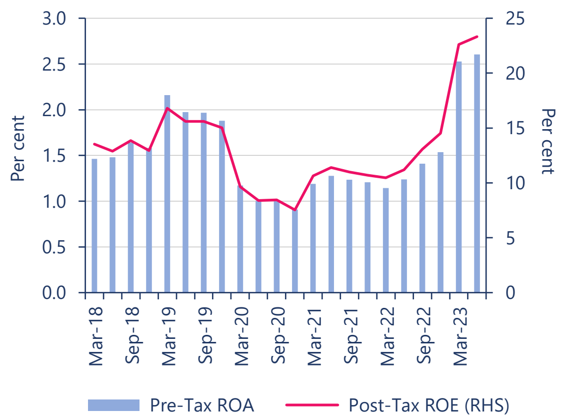
Profitability boosted by net interest income

Profitability of banks improved significantly in the first half of 2023, supported by high interest rates. Annualised net interest income of the banking sector surged to Rs64 billion during the period ended-June 2023, up by 45.2 per cent since December 2022. Interest income soared by 84.8 per cent, driven mostly by income from deposits placed with non-resident banks. Banks' investment strategy in debentures and corporate bond in the non-resident segment, and in government and Bank of Mauritius securities were highly lucrative. The growth of credit portfolios also contributed positively to net interest income.

Banks efficiently managed rising costs, sparked by high interest rate and inflation. Elevated interest expense on deposits was out-weighed by the rise in interest income. Operating expenses, of which personnel expenses represented around 50 per cent, went up by 11.2 per cent during the first half of 2023, but was amply covered by the improvement in gross income. The ratio of operating expenses to gross income came down to 32.9 per cent in June 2023, from 40.5 per cent in December 2022.

Profitability ratios reached new heights over a multi-year period, with strong profitability positively impacting the capital and solvency buffers of banks. (Chart 3.6). Pre-tax Return on Assets (ROA) rose to 2.6 per cent in June 2023, from 1.5 per cent in December 2022. Post-tax Return on Equity (ROE) also increased to 23.3 per cent in June 2023, an 8.8 percentage point increase since December 2022.[19]

Chart 3.6: Profitability ratios of the banking sector



Source: Bank of Mauritius

Ample liquidity buffers

The liquidity buffers maintained by banks, both in Rupees and other major foreign currencies, were assessed to be adequate to mitigate liquidity risk. The LCR of banks was 277.4 per cent

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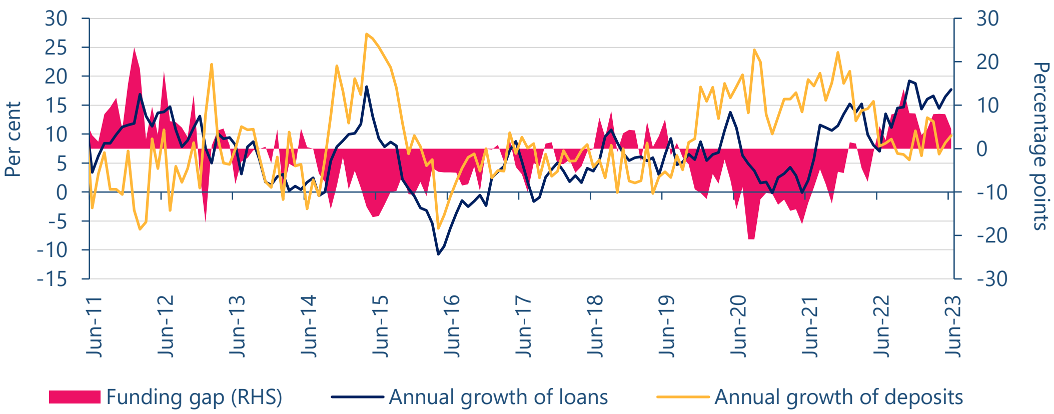
[19] *The profitability ratios have been computed based on the methodology advocated in the IMF Financial Soundness Guide (2019). The ROA is based on the annualized pre-tax profits and averaged total assets. The post-tax ROE is calculated as a ratio of annualized post-tax profits and average equity.*

in June 2023, up from 238.3 per cent as in December 2022, well above the regulatory minimum of 100 per cent. The aggregate LCR in FX was 191.9 per cent in June 2023, down from 207.2 per cent in December 2022. Still, the LCR in FX provided ample headroom to absorb potential materialisation of adverse liquidity shocks within a 30-day period. Banks held most of the FX HQLA in form of securities issued by sovereigns, the lowest risk-rated form of liquid assets.

The funding gap stayed in positive territory during the first semester of 2023 (Chart 3.7).[20] The gap, computed as the difference between annual growth of banks' loans and deposits, declined to 4.5 percentage points as at end-June 2023, from 8.1 percentage points as at end-December 2022 on account of a higher annual growth in deposits relative to loans. This drop suggests that banks were prudently managing the volume of new loans allotted with new deposit funding received.

Chart 3.7: Domestic banking system's funding gap



Source: Bank of Mauritius

[20] *The funding gap measures the difference between lending growth and deposit growth. It shows whether banks have enough new deposit funding relative to their lending growth. A positive funding gap means banks' loans (maturing assets) are growing faster than banks' deposits (liabilities).*

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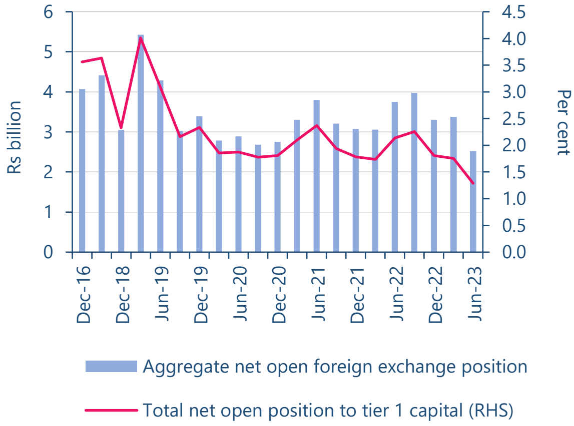
Credit concentration and FX exposures within prescribed limits

Banks met other prudential limits as set by the Bank. The level of large borrowers' credit concentration, measured as a ratio to Tier 1 capital, was well within the regulatory limits. The net open FX exposure to Tier 1 capital of banks was well below the prescribed limit as well (Chart 3.8).

Chart 3.8: FX exposure to tier 1 capital

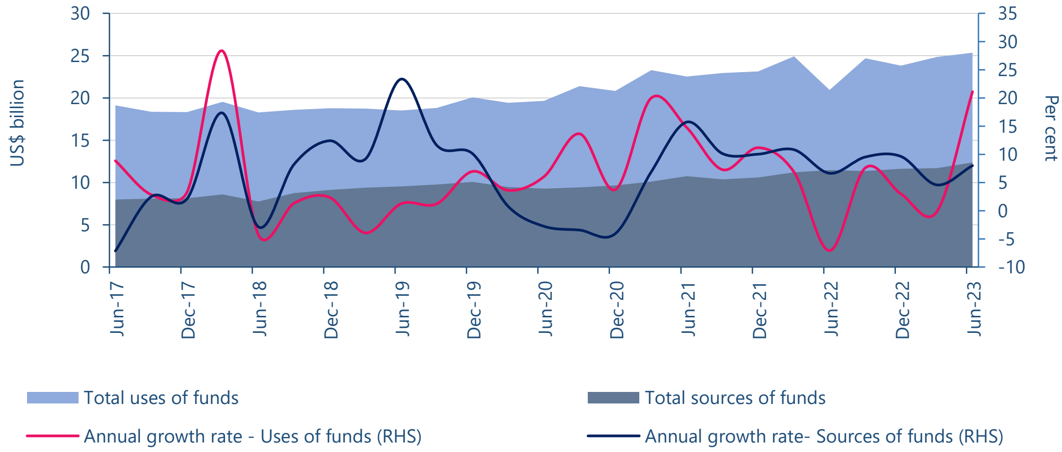


Source: Bank of Mauritius

Cross-border exposures continued to grow

The banking sector pursued the expansion of its cross-border activities, both through external sourcing and deployment of funds, as risks in the global economic and financial environment receded to some degree (Chart 3.9). Deployment of funds with cross-border counterparties continued to grow, rising at an annual rate of 21.1 per cent in June 2023. Funding raised from cross-border counterparties grew strongly as well, with an annual growth of 8.0 per cent in June 2023. On a net basis, the banking sector remained a provider of cross-border funds as most funds raised from the GB sector domestically were also deployed abroad.

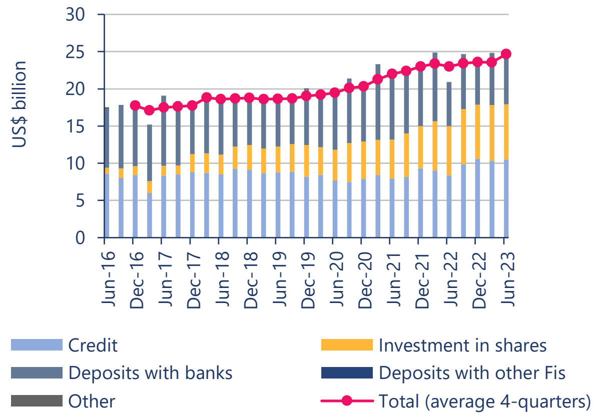
Chart 3.9: Cross-border funding activities and growth rates



Source: Bank of Mauritius

Funds were primarily deployed in the form of credit facilities, investment in shares and deposits with foreign financial institutions aggregating US$25.3 billion as at end-June 2023, up by US$1.5 billion from end-December 2022 (Chart 3.10). Credit facilities granted abroad fell to US$10.5 billion as at end-June 2023, a 0.6 per cent drop from end-December 2022, but represented the largest share of cross-border uses of funds. Deposits made with banks abroad went up by 24.5 per cent to US$7.4 billion as at end-June 2023, while investment in shares rose by 1.9 per cent to US$7.4 billion in June 2023.

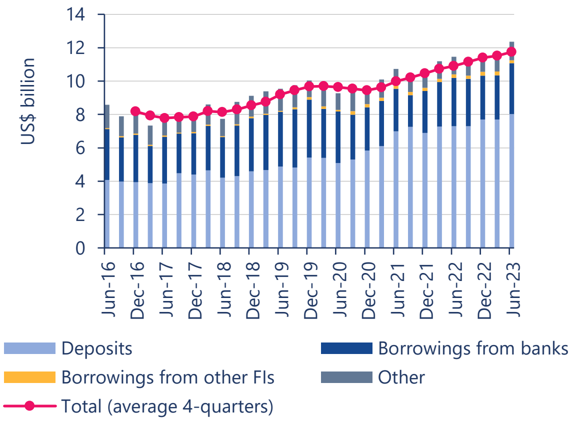
Chart 3.10: Cross-border uses of fund



Source: Bank of Mauritius

Cross-border sources of funds, comprising mainly deposits and borrowings, accounted for 25.2 per cent of the total funding structure of the banking sector in June 2023 compared to 23.5 per cent in December 2022. Funding from abroad was up by an annual rate of 8.0 per cent to stand at US$12.4 billion as at end-June 2023 (Chart 3.11). The increase was mostly driven by a 9.9 per cent annual increase in non-resident deposits. Borrowings from banks abroad followed a similar trend, growing by 5.2 per cent annually to reach US$3.1 billion in June 2023. Conversely, borrowings from financial institutions abroad declined by 18.4 per cent annually, to US$176 million in June 2023.

Chart 3.11: Cross-border sources of fund



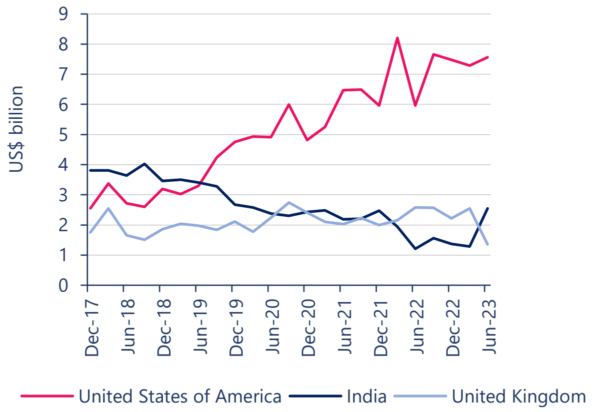
Source: Bank of Mauritius

In terms of geographical distribution, most of the funds were mainly deployed in United States of America (USA), India and United Kingdom (UK). These economies accounted for around 45 per cent of the total funds deployed abroad. Funds deployed into the USA remained at the top position, growing at an annual rate of 26.9 per cent to US$7.6 billion in June 2023 (Chart 3.12a). Funds to India registered an annual growth rate of 111.1 per cent, to US$2.6 billion as at end-June 2023. In contrast, funds to the UK declined by 47.4 per cent, to US$1.4 billion in June 2023.

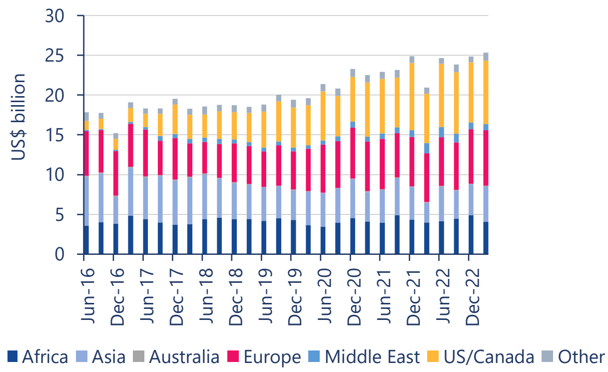
The USA and Canada received the highest share of funds, amounting to 31.4 per cent of the total cross-border uses of funds in June 2023 (Chart 3.12b). Europe and Asia followed, with a share of 27.6 per cent and 17.7 per cent, respectively.

Chart 3.12: Cross-border uses of fund

a. Top 3 countries



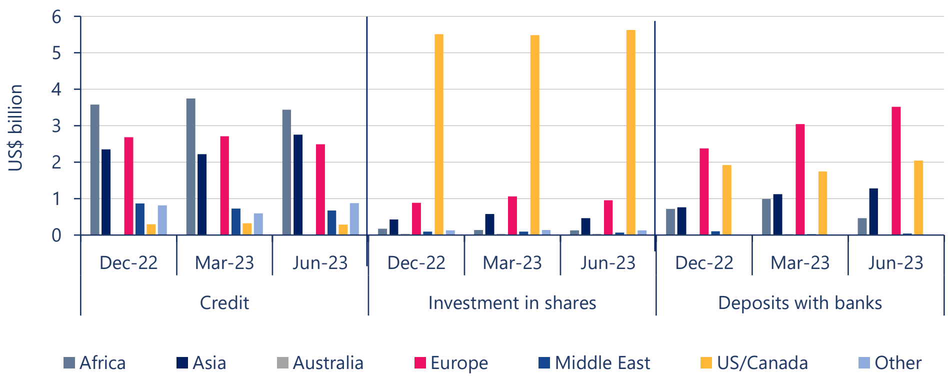
b. Continent-wise



Source: Bank of Mauritius

Most of the cross-border uses of fund were in the form of credit facilities. African counterparts were the largest recipient of credit facilities, amounting to US$3.4 billion in June 2023 (Chart 3.13). Investment in shares, another form of cross-border uses of funds, was channelled mostly to the US and Canada while deposit with banks abroad was mainly to Europe.

Chart 3.13: Main cross-border uses of fund



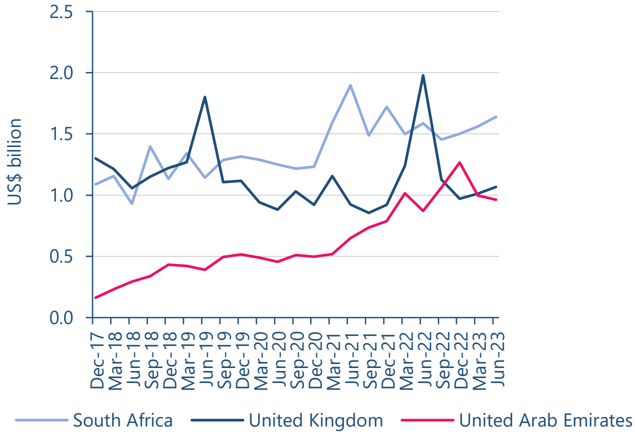
Source: Bank of Mauritius

There was no noticeable change in terms of geographical sources of funds. South Africa, UK and United Arab Emirates remained the top 3 jurisdictions from which the banking sector sourced of fund in June 2023, representing approximately 30 per cent of the total funds raised from abroad (Chart 3.14a). In terms of continents, most of the cross-border funding were from Africa, followed by Europe and Asia, which was around 75 per cent of the cross-border sources of funds (Chart 3.14b).

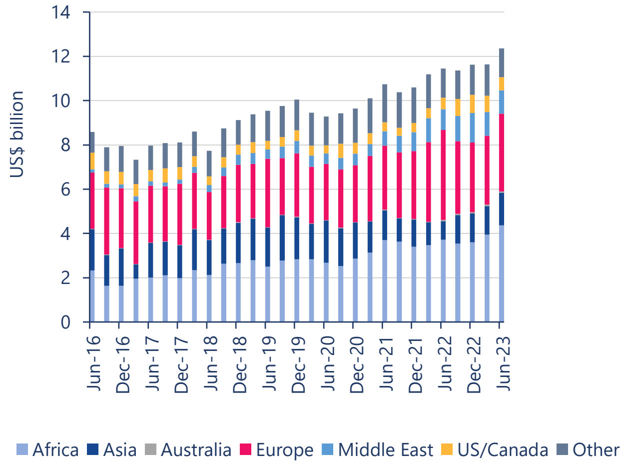
Non-resident deposits, one of the major sources of external funding, emanated mainly from Africa and Europe. Deposits from Africa remained on an uptrend in the first semester of 2023 (Chart 3.15). Borrowings from banks outside Mauritius, mainly from Asia, increased at an annual rate of 210.9 per cent to US$875.1 million as at end-June 2023. Borrowings from financial institutions in Europe fell by an annual rate of 6.2 per cent to US$163.3 million as at end-June 2023. Other sources of fund originated mostly from Africa.

Chart 3.14: Cross-border sources of fund

a. Top 3 countries

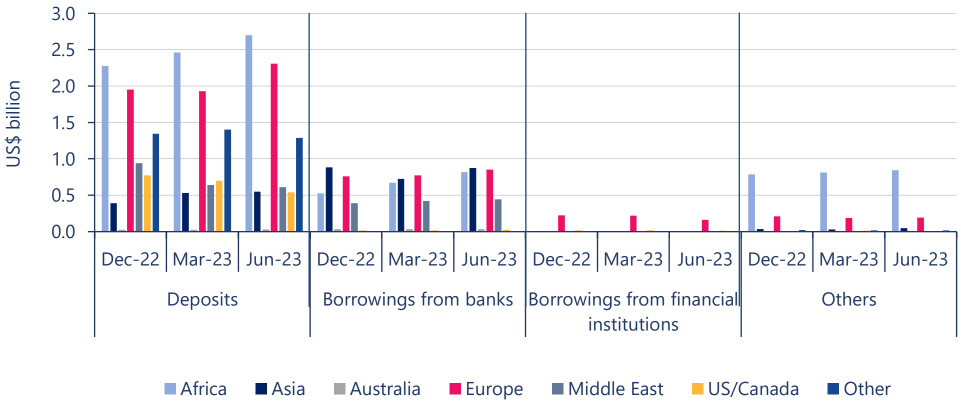


b. Continent-wise



Source: Bank of Mauritius

Chart 3.15: Main cross-border sources of fund



Source: Bank of Mauritius

The strong linkages of the banking system and the economy with the rest of the world necessitate close surveillance to ensure the resilience of the banking sector to external turbulences. Events in one part of the world can have worldwide ripple effects. Turbulence in certain large economies, in the likes of the real estate turmoil in China, worsening geo-economic fragmentations, and the onset of the Russia-Ukraine war, pose threats to global investment sentiments. To safeguard the banking sector, the Guideline on Cross-Border Exposure, issued by the Bank in August 2022, sets out the minimum prudential standards for banks to manage cross-border risks effectively. Strong capital and liquidity buffers maintained by banks also provided a shield against risk in addition to the internal risk management frameworks of banks.

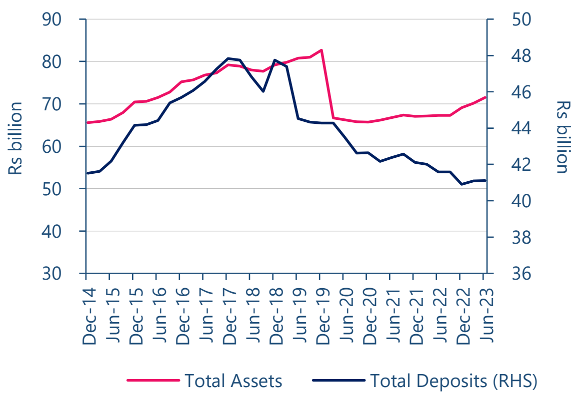
Cross-border banking activities have so far been resilient to global economic and financial tensions. Banks prudently managed risks including market, credit and liquidity risks. The quality of banks' credit portfolio allocated outside Mauritius remained broadly sound, with the NPL ratio standing at 3.8 per cent in June 2023. Those NPLs were adequately provided for, with coverage ratio at 44.0 per cent. Banks continued to pursue prudent liquidity risk management by holding high levels of HQLA to safeguard against potential outflows from the non-resident segment. In June 2023, non-resident and GBC FX deposits hovered around 84 per cent of total banking sector FX deposits. The LCR in FX of banks stood at 191.9 per cent in June 2023, implying that the banking sector maintained adequate buffers to absorb liquidity shocks emanating from cross-border activities.

Non-Bank Deposit-Taking sector performed well

The expansion of the NBDTIs was sustained in the first semester of 2023, complemented by sound financial performance and adequate risk buffers. The share of NBDTIs, in terms of asset value, in the deposit-taking sector has was maintained at 3.1 per cent in both quarters ended December 2022 and June 2023.

NBDTIs reported an improvement in their financials, supported by the high interest environment and sustained customer demand. The aggregate assets of NBDTIs expanded at an annual rate of 6.4 per cent to Rs72 billion as at end-June 2023 (Chart 3.16). The increase in the loan book (inclusive of finance leases), which represented around 80 per cent of total assets, drove most of this growth. Loans extended by NBDTIs to the domestic economy

Chart 3.16: Total assets and deposits of NBDTIs



Source: Bank of Mauritius

continued to grow during the first half of 2023 and accounted for 6.6 per cent of the total deposit-taking sector loans as at end-June 2023. Total loans allotted by NBDTIs grew by 5.1 per cent annually to attain Rs57 billion as at end-June 2023. As part of their risk management approach, the NBDTIs invested 6.7 per cent of total assets in government and Bank of Mauritius securities as at end-June 2023, which registered an annual increase of 5.5 per cent.

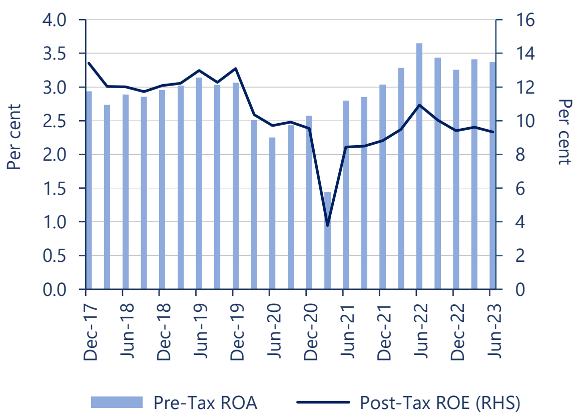
The asset growth of NBDTIs was funded largely through reserves and loan capital. Deposits remained the largest component of total liabilities, representing around 58 per cent, followed by reserves with a share of around 28 per cent. Deposits held with NBDTIs recorded an annual decline of 1.1 per cent as at end-June 2023. This was, however, more than offset by an increase in reserves of 7.9 per cent on an annual basis. In addition, NBDTIs continued to raise significant funds in the form of loan capital, which amounted to Rs2.6 billion as at end-June 2023, up from Rs1.7 billion as at end-December 2022.

The capital levels of NBDTIs were relatively high and provided ample loss-absorption capacity. The aggregate CAR of NBDTIs was at 50.3 per cent in June 2023, compared to 52.5 per cent in December 2022, well above the regulatory minimum requirement of 10 per cent. The regulatory capital was Rs18.5 billion as at end-June 2023, marginally down from Rs18.6 billion as at end-December 2022. The Risk-Weighted Assets (RWA) of NBDTIs expanded at an annual rate of 11.8 per cent as at end-June 2023, largely due to the growth of the credit portfolio.

The asset quality of NBDTIs remained sound. The NPL as a ratio of total outstanding credit was 4.9 per cent in June 2023, a slight improvement from 5.0 per cent in December 2022. The regulatory capital provided sufficient cushion against credit impairment, with the ratio of NPLs (net of provisions) to capital at 7.5 per cent in June 2023. The aggregate provision set aside by NBDTIs was 50.7 per cent of the NPL portfolio as at end-June 2023, compared to 53.6 per cent in December 2022.

Profitability of NBDTIs improved in the first semester of 2023, following higher gains from rising interest rates similar to the banking sector. The annualised profit after tax was Rs2.0 billion in June 2023, up by 4.9 per cent from December 2022. The pre-tax ROA and post-tax ROE were at 3.2 per cent and 9.3 per cent, respectively, in June 2023, from 3.3 per cent and 9.3 per cent, respectively in December 2022 (Chart 3.17)

Chart 3.17: Profitability ratios of NBDTIs



Source: Bank of Mauritius

The NBDTIs sector managed liquidity risk prudently. Liquid assets rose further in the first semester of 2023, on account of higher investment in government and Bank of Mauritius securities. Liquid assets amounted to Rs10 billion as at end-June 2023, up by 3.0 per cent from end-December 2022. The liquidity ratios remained quasi-constant over the period under review. Total liquid asset as a ratio to total assets was 13.8 per cent and accounting for 20.0 per cent of short-term liabilities as at end-June 2023.

Box 2: Survey on Financial Stability Perspective

The Bank conducted its annual survey on Financial Stability Risk Assessment for 2023/24 with banks in Mauritius. The responses affirmed banks' confidence in the stability of the financial sector and the resilience of the banking sector to plausible shocks during the next 12 months. The salient findings are summarised below.

Financial stability perspective

Banks were confident about the stability of the domestic financial sector over the coming year, despite risk to financial stability remaining somewhat elevated. The general consensus pointed towards cross-border activities by the financial industry and the economy as well as banks' exposure to riskier foreign counterparties, such as non-residents and GBCs, being the main sources of the elevated financial stability risks.

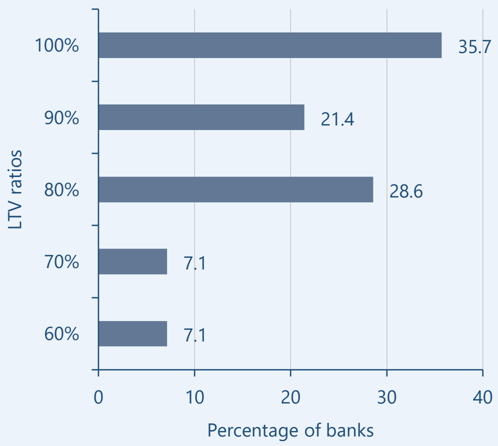
Risk to the banking system

Banks conceded that identified challenges, emanating from global and domestic sources, facing the domestic financial system would mostly have medium to medium-high level impact. A medium probability was ascribed for those challenges deemed to be of high-impact nature, with propensity of occurrence in a 6 to 12 months term. Domestic economic sectors were nevertheless deemed to be resilient as downside risks were mostly assumed to stabilise in the next 12 months.

i. Household sector

The continuous increase in wages has supported the financial resilience of households over the past twelve months. Most banks reported applying a maximum DSTI ratio of 50 per cent as per their internal policy, which was aligned with the Bank's directive on DSTI. Most banks reported that the DSTI ratio in their retail portfolio stayed, on average, below 40 per cent for the past year. Most banks reported LTV ratio of within the range of 80-100 per cent on housing credit (Chart I).

Chart I: Maximum LTV ratios on housing credit



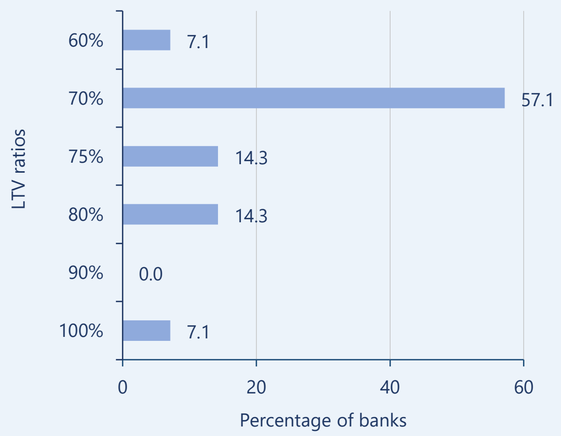
Source: Bank of Mauritius

ii. Corporate sector

Risk in the corporate sector is expected to remain subdued over the medium-term. Nevertheless, banks viewed the '*Construction*' and '*Manufacturing*' sectors as those segments that were vulnerable to a slight increase in risk in the forthcoming year. The majority of banks assumed risk from the commercial real estate market to remain stable over the next twelve months.

Around 57 per cent of banks have reported that their actual LTV ratios for their commercial real estate exposures were at 70 per cent (Chart II).

Chart II: Maximum LTV ratios on CRE

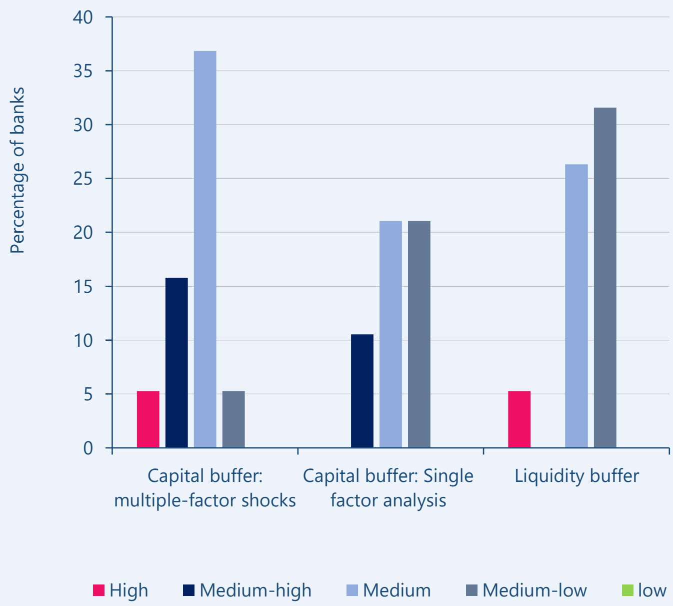


Source: Bank of Mauritius

Resilience and stress testing

Most banks conducted a bottom-up stress test to assess their resilience over the past year. Banks indicated having adequate capacity to absorb hypothetical shocks, with the impact on buffers mostly in the medium-low to medium range (Chart III). Banks generally ranked liquidity risks and operational risk – such as cybersecurity threats and cyber risks – to be most impactful and challenging to manage.

Chart III: Impact of stress test shocks



Source: Bank of Mauritius

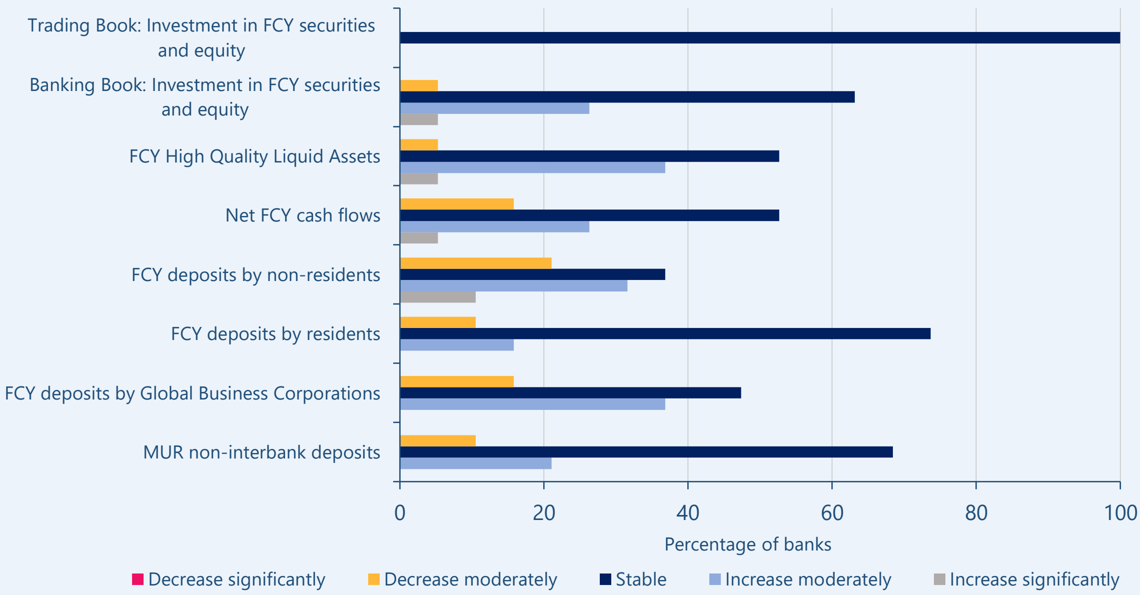
Profitability and strategy

Profitability level is estimated to continue rising for many banks over the next 12 months. Net interest income is expected to increase on account of additional lending volumes to both the resident and non-resident sectors, inclusive of GBCs. Fees and commissions would also to support income accumulation. Certain banks were also aiming to reduce operational cost by making more intensive use of technology and digitalisation.

Liquidity and funding

Banks managed liquidity risk adequately through robust risk management policies and procedures in place. The banking sector does not foresee any liquidity constraints in the upcoming 12 months. Almost all banks indicated that FCY denominated inflows and outflows would be stable over that period (Chart IV).

Chart IV: Funding outlook over the next year



Source: Bank of Mauritius

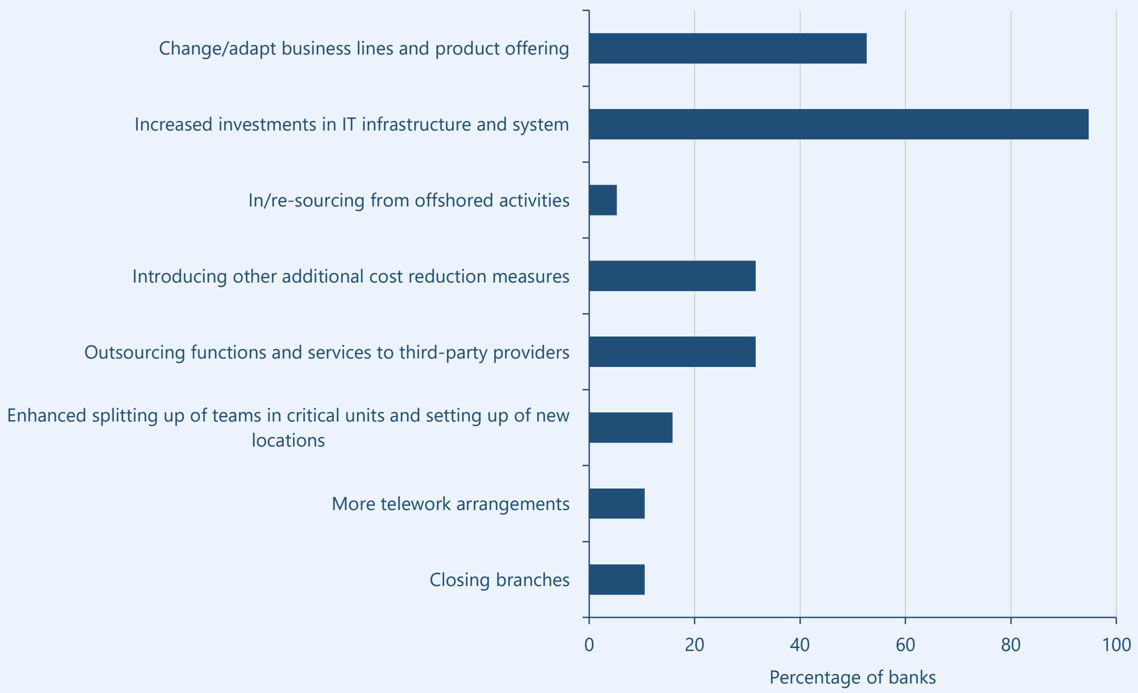
Asset quality and solvency

Many banks projected their asset quality to remain stable with some even indicating the possibility of an improvement over the upcoming year. Banks are, however, mostly prudent in their credit risk management by maintaining stable and/or increasing provisioning levels to cushion any unexpected shock. The majority of banks were also confident in the debt repayment capacity of their major borrowers. They also confirmed having appropriate instruments and channels to reinforce their capital buffers through strong parental and/or group support, retained earnings retention, wholesale market funding, RWA optimisation, and tier 2 capital instruments.

Operational risk and digitalisation

Operational risk was maintained under control following robust risk management practices of banks. Strategies to counteract operational risks were largely targeted through increased investment in IT infrastructure and system as well as to change and/or adapt business lines and product offering (Chart V). Cybersecurity, cyber risk and IT failures are also considered as important triggers of operational risk. A majority of respondents have highlighted several projects with regards to their digitalization transformation strategy for the year 2023/2024. Nevertheless, participants have cited the unavailability of skilled resources, complexity in the evolving digital technology and cyber-related risks as some of the hindrances in making digital banking transformation a success.

Chart V: Operational risk management strategies



Source: Bank of Mauritius

Climate-related risk

As the global climate crisis becomes more pressing, domestic banks indicated that only a small fraction of their credit portfolio is allocated to carbon-intensive sectors. Banks were fundamentally susceptible to climatic events such as floods, cyclones and rising sea levels which would affect borrowers in climate-sensitive economic sectors. These comprise principally the '*Agriculture*', '*Construction*', and '*Accommodation and food services*' sectors.

Concurrently, the imposition of a domestic carbon tax and an increase in carbon prices abroad will impact banks' credit portfolio allotted to sectors in the likes of the '*Wholesale and Retail Trade*' and '*Transportation*'. The mortgage credit portfolios of banks were predominantly allocated to the northern and western regions of the island. In the event of a sea level rise, over the next 30 years, the northern coastal region will account for a higher expected loss in banks' mortgage exposure value. Respondents also specified that an increasing proportion of their portfolios will be divested from carbon-intensive sectors towards greener sectors.

Contingency plan

Almost all banks have implemented contingency plans to assess their capacity to sustain potential credit and/or liquidity shocks. Many banks have evaluated these plans through stress testing and simulation to ensure adequate resilience. Banks also use early warning indicators to identify potential strains in order to deploy their contingency plans.

4. Non-bank financial services sector

The insurance activities and pension fund sectors, the main constituents of the non-bank financial sector, registered good performance in the first semester of 2023. The aggregate balance sheet of life insurers expanded further, with asset growth reflecting continuous investment mostly into debt securities. All life insurers which reported their Actuarial Valuation Report (AVR) for 2022 were solvent. For general insurers, gross premium continued to rise. As for pension funds, their aggregate assets expanded during the first half of 2023, after facing headwinds in 2022, driven by investment in equity shares and debt securities. The evolution of risks for the NBFIs sector is closely monitored as the sector continues to adapt to an evolving macroeconomic and financial environment.

The insurance and pension fund sectors, the main constituents of the domestic non-bank financial sector, registered strong financial performance in the first semester of 2023 as risk moderated and economic activity remained robust. Growing banking sector activity partly supported demand for insurance products as well. The outlook for the financial and insurance activities sector remained positive, with projected growth of 4.8 per cent for 2023.

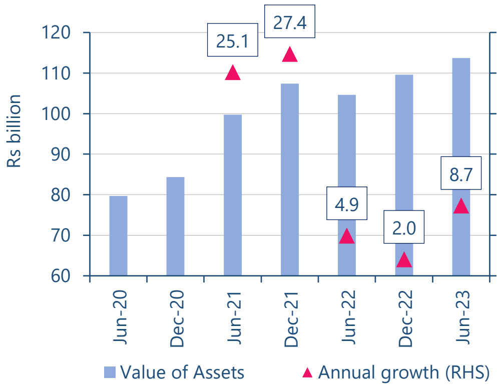
The number of insurance providers and pension funds entities remained unchanged relative to December 2022. The insurance industry consisted of 7 life insurers and 15 general insurers while the pension scheme industry counted 73 active schemes as at end-June 2023. The aggregated assets of the insurance industry attained Rs141.5 billion in June 2023, as compared to Rs137.4 billion in December 2022. The insurance industry remained mostly dominated by life insurers, with a market share of around 80 per cent of the insurance sector. Insurers' aggregate assets represented 21.9 per cent of GDP and pension funds' assets represented 11.0 per cent of GDP in June 2023, a decline from December 2022 primarily on account of high economic expansion.

Uncertainties in the global economic outlook posed risks for the non-bank financial institutions (NBFIs), which are important financial intermediaries making their resilience a prerequisite to maintaining financial stability. In particular, insurance providers play a fundamental socio-economic role by covering personal and business risks. Insurers and pension funds relied heavily on their investment mix to maintain strong balance sheets, as they were not immune to long-term economic and financial imbalances. They may be transmission channels to intersectoral risks, even act as amplifiers of risks for the economy. Financial sector regulators closely monitor the evolution of risks for NBFIs.

Life insurance industry benefited from investment strategies

The performance of the life insurance industry was marked by an expansion of its balance sheet and a concurrent contraction in the number of life policies during the first semester of 2023. The aggregate balance sheet of the 7 life insurers expanded at an annual rate of 8.7 per cent to peak at Rs113.7 billion as at end-June 2023, amid bearish sentiment on the domestic financial market (Chart 4.1).

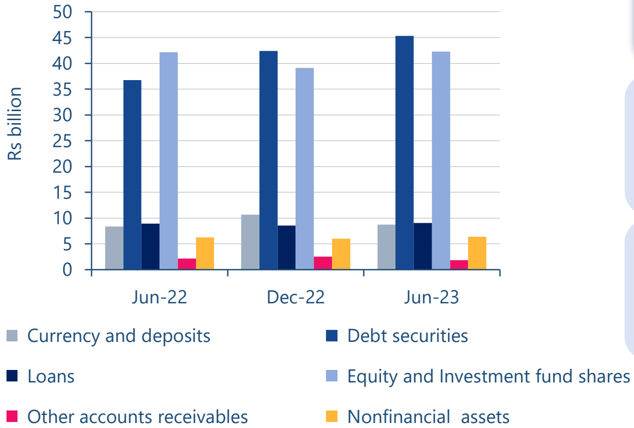
Chart 4.1: Long-term insurance assets and annual growth



Source: Financial Services Commission

The balance sheet composition was broadly unchanged as life insurers maintained their investment strategies. Asset growth reflected continuous investment of life insurers' funds mostly into debt securities, accounting for 39.9 per cent of their total assets (Chart 4.2). The sector also demonstrated confidence in the market outlook, with an increase in asset allocation into equity and investment fund shares, to 37.2 per cent as at end-June 2023 from 35.7 per cent as at end-December 2022. Loans granted by life insurers reached Rs9.0 billion as at end-June 2023, representing an annual growth of 1.3 per cent.

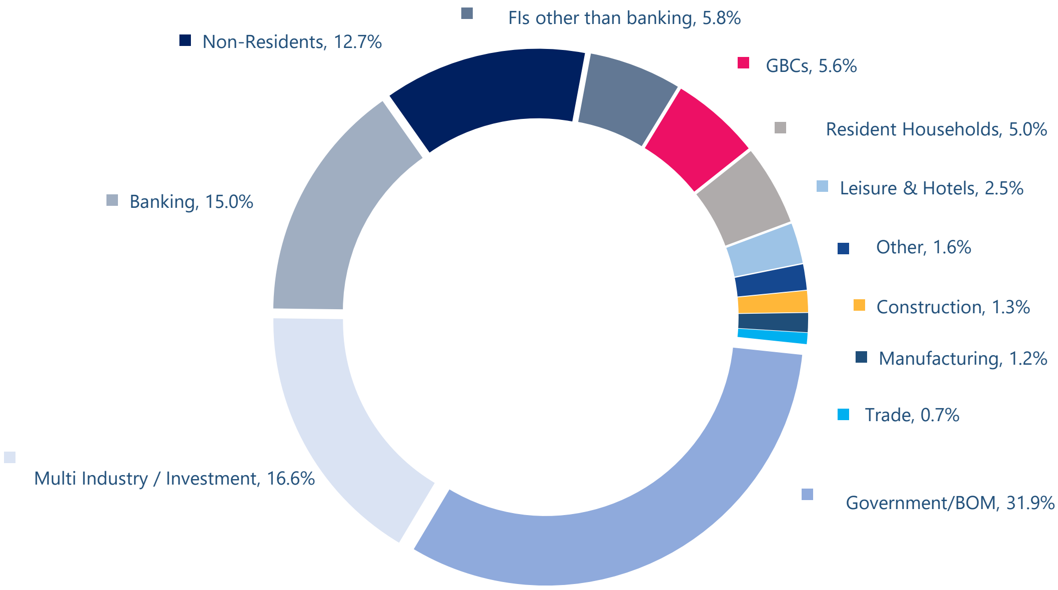
Chart 4.2: Asset distribution



Source: Financial Services Commission

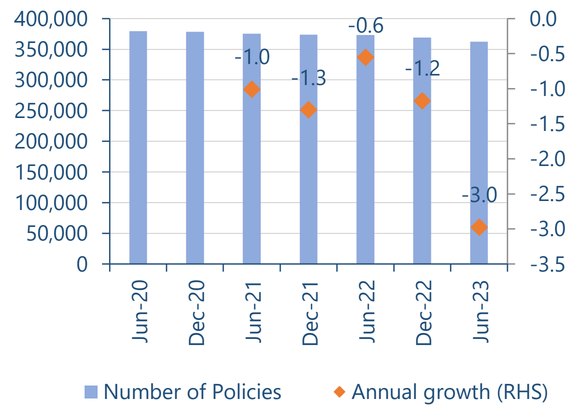
Life insurers increased investments in Government and Bank of Mauritius securities to benefit from the rise in interest rates and manage risks. The other sectoral exposures remained broadly unchanged (Chart 4.3). Government and Bank of Mauritius securities represented 31.9 per cent of total financial assets of life insurers. Investment in multi-industry, banking and non-resident sectors accounted on aggregate for 44.4 per cent of life insurer's financial assets.

Chart 4.3: Financial assets by industry as at end-June 2023



Source: Financial Services Commission

Chart 4.4: Number of life policies in force

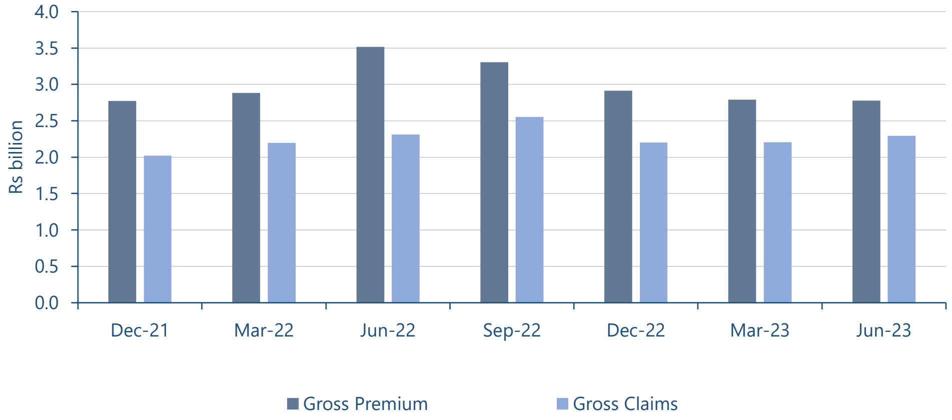


Source: Financial Services Commission

The life insurance sector registered a decline in policy underwritten in the first semester of 2023. New policy covers that were underwritten contracted at an annual rate of 3.0 per cent in June 2023, as compared to 1.2 per cent in December 2022. The number of policies stood at 362,266 as at end-June 2023 (Chart 4.4).

The contraction in the number of policies explained the downward trend in gross premium (Chart 4.5). In contrast, gross claims remained relatively unchanged and led to reduced margin in terms of net income generated on insurance activities. An average progression of around 9.1 per cent was observed in the ROE during the first semester of 2023 on account of the good performance in investment activities. The annualised ROE of insurance providers varied between 15.3 per cent and 193.6 per cent for the year ended June 2023, excluding two life insurers which recorded negative ROE of around 6 per cent.

Chart 4.5: Quarterly premium and claims



Source: Financial Services Commission

Insurance companies were not subject to an internationally agreed benchmark for capital adequacy, in contrast to banks. The required capital cushion for life insurers was calculated based on the Solvency Margin in most jurisdictions – measured as a ratio of the amount of capital determined for prudential purposes and a risk-based computation of the required amount of capital. As per the Insurance (Long-Term Insurance Business Solvency) Rules 2007, life insurers are required to maintain a solvency margin at least equal to their minimum capital requirement. All life insurers which reported their Actuarial Valuation Report (AVR) for year 2022 were solvent.[21] Of importance, the largest companies in terms of gross premiums tend to maintain higher capital cushion which improved on average by 10.0 per cent from 2021 to 2022 (Table 4.1).

Table 4.1: Solvency status of Long-Term Insurers

Capital available as a % of minimum capital required	Large Companies (Gross premium > Rs1 billion)	Medium Companies (Gross Premiums > Rs300 million and < Rs1 billion)	Small Companies (Gross Premiums < Rs300 million)
100 – 130%	0	1	1
130 – 250%	2	0	1
Above 250%	2	0	0

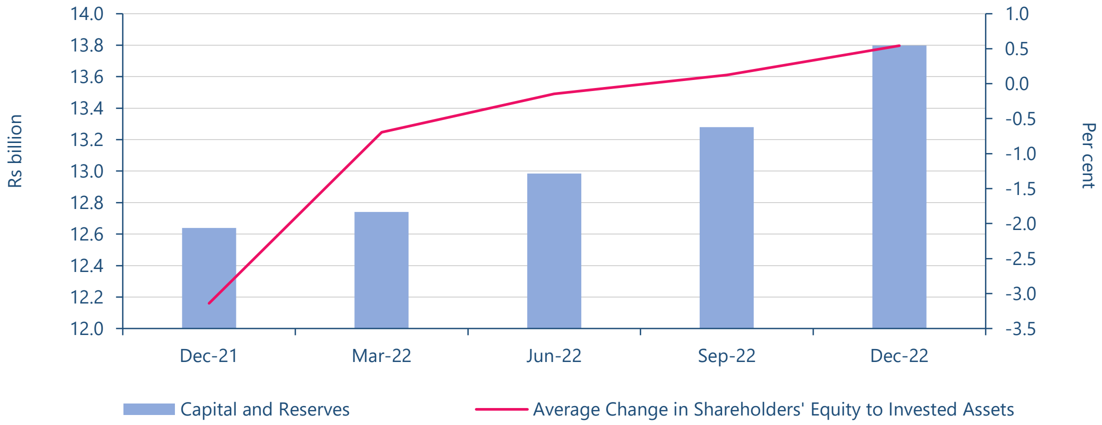
Source: Financial Services Commission

The complex calculation of solvency margin does not allow for a frequent and updated evaluation of life insurers' capital strength to sustain risks. A more basic but practical financial ratio is the Shareholders' Equity to Invested Assets ratio. This indicator uses capital and reserves as the numerator, and invested assets – inclusive of non-financial assets held for investment purposes – as the denominator. For the semester ended 30 June 2023, shareholders' equity to invested assets rose by 0.7 per cent on average compared to the

[21] *12-month period for which the accounts were audited and are different for different insurers.*

previous semester.[22] Capital and reserves of life insurers expanded by 4.2 per cent, denoting that the long-term insurance industry was adequately capitalised, while total invested assets went up by 1.4 per cent over the same period (Chart 4.6).

Chart 4.6: Capital and reserves

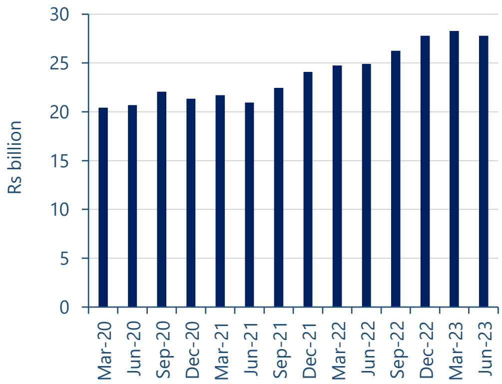


Source: Financial Services Commission

General insurance industry expanded steadily

The non-life insurance sector, also known as general insurance sector which covers motor and non-motor segments, continued to grow in the first semester of 2023, backed by rising number of policies and gross premiums. The aggregate asset of the 15 general insurance companies was, however, broadly unchanged during the first half of 2023 and stood at Rs27.8 billion as at end-June 2023 (Chart 4.7).

Chart 4.7: General insurance assets



Source: Financial Services Commission

The aggregate number of policies in the general insurance business increased in the first semester of 2023 (Chart 4.8). The number of motor segment policies recorded an annual growth of 5.0 per cent in June 2023 to stand at 448,007. As for non-motor policies, it reached 158,907 in June 2023, representing an annual growth of 6.1 per cent.

[20]*In the absence of benchmark range for this ratio, average progression is analysed rather than the absolute percentages calculated.*

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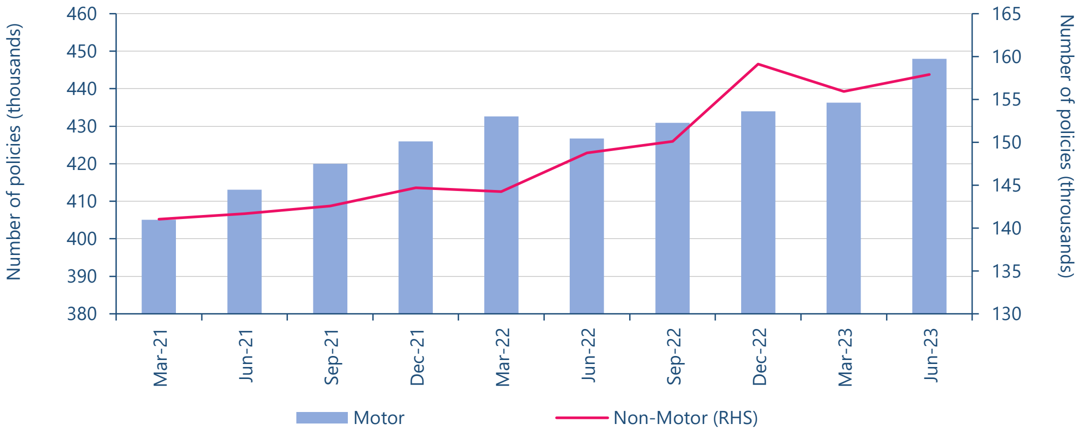
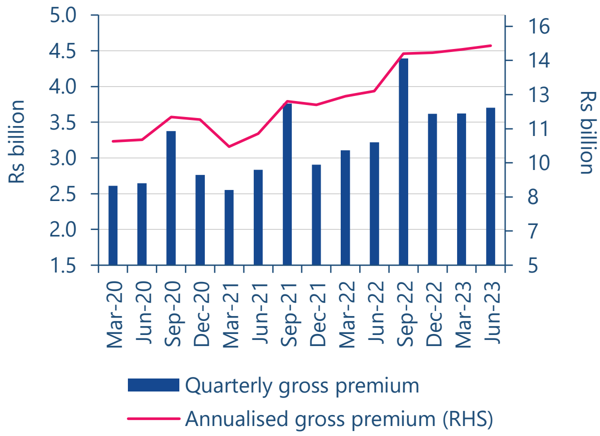
Chart 4.8: Number of policies



Source: Financial Services Commission

Gross premium continued to rise in the first half of 2023 partly due to higher prices of insurance covers on account of high inflation. Some insurers opted to pass on only a share of the extra costs to policyholders, possibly due to a highly competitive market, resulting in compressed profit margins. Annualised gross premium went up by 2.2 per cent to Rs14.7 billion in June 2023 (Chart 4.9). Unlike for life insurers, interest rate changes impacted general insurers only marginally as their liabilities were of shorter term and less dependent on interest rates.

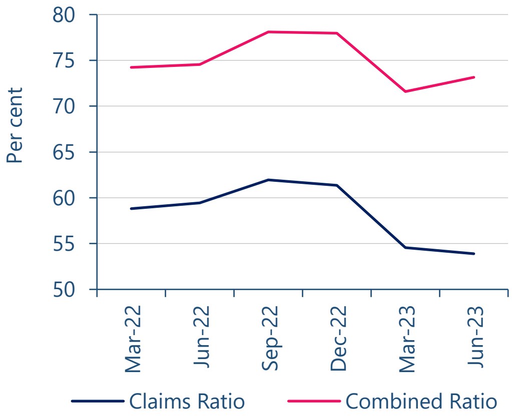
Chart 4.9: Gross premium



Source: Financial Services Commission

Most non-life insurers adjusted their pricing of insurance contracts and their technical reserves upward. This measure aimed to keep the claims ratio, measured as a percentage of claims costs incurred in relation to the premiums earned, within an acceptable range. Both the claims ratio and the combined ratio improved to 53.9 per cent and 73.1 per cent, respectively, in June 2023 (Chart 4.10).[23]

Chart 4.10: Claims and combined ratio



Source: Financial Services Commission

[23] *The combined ratio is a metric for evaluating the profitability and financial health of an insurance company. It is calculated by dividing the total sum of incurred losses and expenses by the earned premium. There is an inverse relationship between the ratio and profitability. The higher the ratio is, the lower the profitability of the insurance company and vice versa.*

With one exception, all remaining general insurers held solvency position above the minimum required level based on the respective individual AVR for the year 2022.[24] Small and medium sized companies maintained on average a larger solvency margin of around 318.4 per cent broadly unchanged compared to 2021 (Table 4.2). In contrast, large general insurers had an average solvency position of around 213.5 per cent for 2022, 7.5 per cent, lower compared to 2021. The insurer making the exception reached its target level after December 2022.

Table 4.2: Solvency status of General Insurers

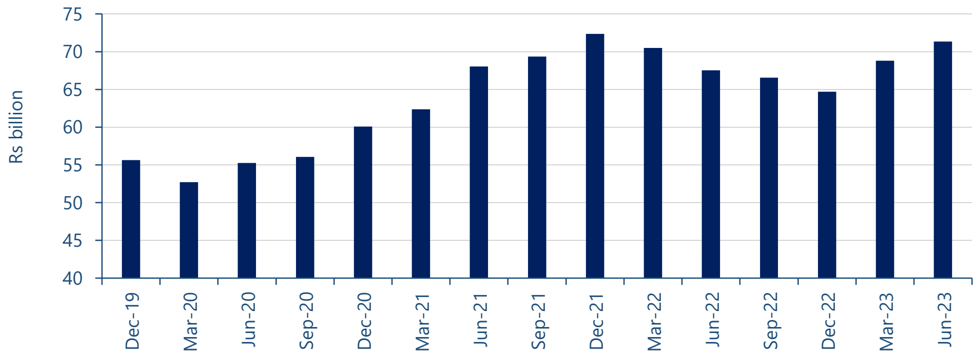
Capital available as a % of minimum capital required	Large Companies (Gross premium > Rs1 billion)	Medium Companies (Gross Premiums > Rs100 million and < Rs1 billion)	Small Companies (Gross Premiums < Rs100 million)
100 – 150%	0	1	0
150 – 250%	4	3	0
Above 250%	0	6	1

Source: Financial Services Commission

Pension scheme industry depicted improved performance

The performance of pension funds operating in Mauritius recovered in the first half of 2023, after facing headwinds during 2022 mainly caused by financial markets volatility. The aggregated assets of the pension funds expanded at an annual rate of 5.7 per cent to reach Rs71.3 billion in June 2023, following a contraction of 10.5 per cent in December 2022 (Chart 4.11).

Chart 4.11: Pension funds asset value



Source: Financial Services Commission

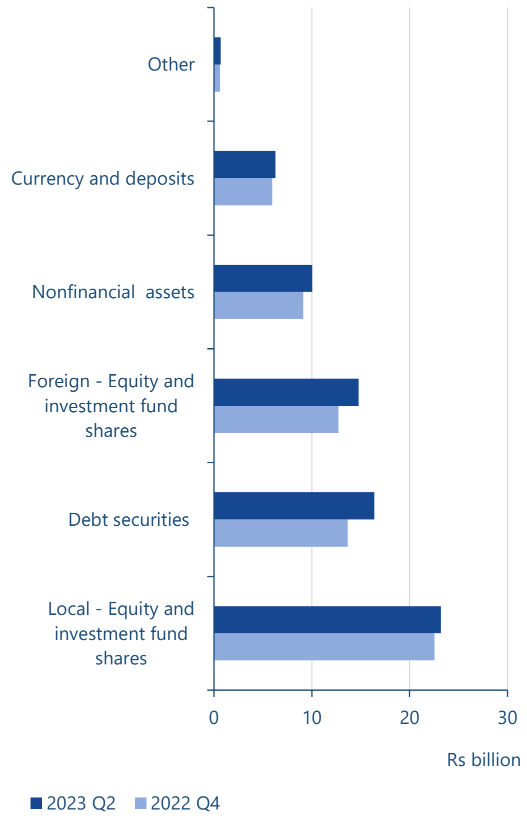
The asset allocation of pension funds was broadly unchanged in June 2023 relative to December 2022, with the pension industry maintaining significant exposure to equity and debt securities making their asset portfolio sensitive to market volatility (Chart 4.12a). Equity investment accounted for slightly more than 50 per cent of total assets, followed by debt securities with a share of 23.0 per cent. Investment in equity shares was valued at Rs38.0 billion

[24] *12-month period for which the accounts were audited and are different for different insurers.*

in June 2023, compared to Rs35.3 billion in December 2022. Investment in debt securities rose to Rs16.4 billion as at end-June 2023 from Rs13.7 billion in December 2022. The increase in equity investments and debt securities drove the expansion of pension funds' assets.

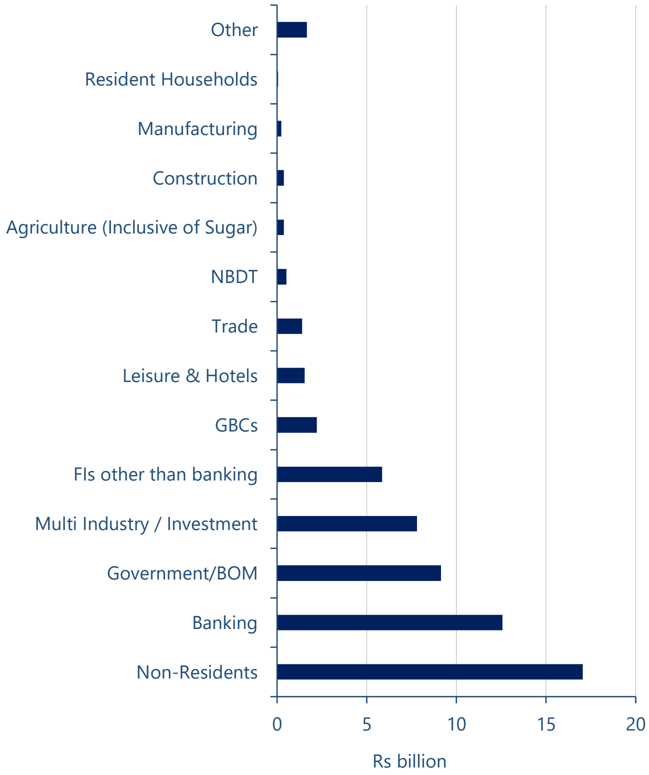
In terms of counterparty exposure, pension funds invested mostly into foreign assets with a 28.0 per cent share as at end-June 2023 (Chart 4.12b). Investments in foreign assets were primarily in the form of equity and investments fund shares, representing 87.0 per cent of non-resident assets. Exposure to the domestic banking industry was 20.7 per cent, followed by investments in the government/Bank of Mauritius securities at 15.0 per cent, multi-industry/investment at 12.8 per cent, and non-banking financial institutions at 9.6 per cent.

Chart 4.12a: Distribution of assets by class



Source: Financial Services Commission

Chart 4.12b: Distribution of financial assets by sector



Source: Financial Services Commission

5. Global business sector

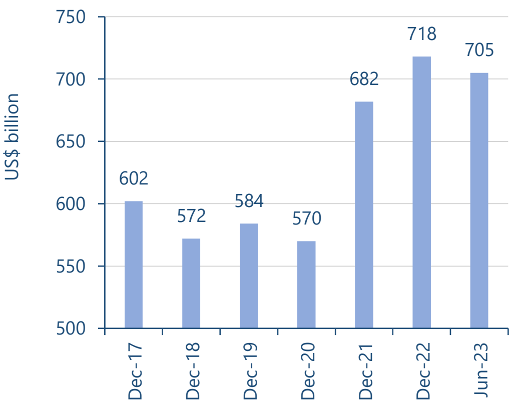
Risk to the stability of the financial system from Global Business (GB) sector activities eased in the first half of 2023. GB sector activities gathered momentum, despite lingering uncertainties in the global economic and financial environment. Aggregate assets of GBCs remained at historical highs. The number of live GBCs reached a six-year high whilst new GBC licences maintained an upward trend. Movements in GBC deposits did not exert any liquidity strain on the banking system. Banks pursued the diversification of their sources of FX funding, reducing their reliance on GBC deposits. Credit risk in the GB sector portfolio eased, though the ratio of non-performing to total loans remained elevated. However, the impaired credit was adequately covered by specific provision set aside by banks. The momentum in the GB sector coupled with stabilising global economic and financial conditions are expected to contain risks from the sector.

Risk to financial stability from GB sector activities moderated in the first half of 2023. Renewed investor confidence, boosted by fading fears of a global economic recession, improved conditions in the GB sector relative to the preceding semester. Capital flows channelled through the MIFC were strong, in particular portfolio investments as global equity markets fared better relative to the last semester of 2022. Nevertheless, investment flows remained vulnerable to external shocks, including from the risk of global financial fragmentation which stayed elevated with enduring geo-political tensions.

The GB sector remained a key pillar of the domestic economy, contributing to economic and financial activities as well as job creation. The sector was projected to contribute 8.3 per cent to the country's GDP in 2023, with an estimated annual growth of 4.3 per cent in real terms. The GB sector generated around 5,300 direct employment through Management Companies (MCs) and stimulated job creation indirectly in other sectors such as banking, professional services (e.g., legal and audit services) and the insurance sector. It is also a source of revenue to the government, notably through tax receipts and regulatory costs.

The number of active GBCs in the MIFC reached a multi-year high in June 2023, characterising the trust of GB sector operators and attractiveness of the jurisdiction. The aggregate assets held by GBCs dropped slightly to US$705 billion as at end-June 2023 but remained at a historically high level (Chart 5.1). The majority of these assets were invested abroad and were largely financed by non-residents, underscoring the strong linkage of GBCs with the external environment.

Chart 5.1: Total assets of GBC



Source: Financial Services Commission

The GB sector remained intricately connected to the domestic financial system. Investment flows through GBCs were partly routed through banks operating in the MIFC, with deposits amounting to US$12.0 billion as at end-June 2023 representing 32.4 per cent of total deposits of the banking sector. These flows and net income generated favourably supported the balance of payments of the country. The susceptibility of the GB sector to global and regional developments can transmit external disturbances to the banking and financial system, making close surveillance of the GB sector a key element in safeguarding financial stability.

Global Business activities gained traction as risk moderated

GB sector activities were buoyant in the first semester of 2023. Investor confidence picked-up as concerns of a global recession waned towards the end of the first half of 2023, boosting optimism among operators. Licensing trend equally maintained an upward trajectory. The number of live GBCs attained 13,065 as at end-June 2023, representing a 3.5 per cent increase over December 2022. However, the figures on newly licensed GBCs remained below pre-pandemic levels.

The MIFC provides a wide array of services and incentives to global investors, complemented by a sound and stable financial sector as well as competitive tax regime conducive for outbound investment. The jurisdiction remains equally committed to adhere to international initiatives to combat abusive tax planning practices. Some advanced countries are increasingly concerned by large multinational companies (MNEs) transferring a greater portion of their income generated worldwide into low-tax jurisdictions and which reduces tax revenue in many of the economies where these companies operate.

The above developments prompted the Organisation for Economic Co-operation and Development (OECD) and the Group of 20 (G20) to create the Inclusive Framework on Base

Erosion and Profit Sharing followed by the Global Minimum Income Tax. The latter was introduced to ensure that global companies pay a minimum level of income taxes based on where income and profits were generated. To achieve this, the proposal is divided into two independent plans: notably, Pillar 1 and Pillar 2.

The Income Tax Act for Mauritius was amended in 2022 to empower the Mauritius Revenue Authority to impose a Qualified Domestic Minimum Top-up Tax on a company which forms part of a large MNE group under Pillar 2. The implications of these rules on the GB sector and the financial system as a whole are closely monitored.

The authorities are consistently aiming to enhance the MIFC's competitiveness by providing a conducive ecosystem for investors. Concurrently, continuous improvements are brought to strengthen the regulatory framework. In the same stride, a series of amendments to the Financial Services Act were announced in the 2023-2024 Budget Speech and came into effect following the promulgation of The Finance (Miscellaneous Provisions) Act 2023, namely:

i. Revisions to the Financial Services Act were made to empower the Financial Services Commission (FSC) to conduct enforcement actions in case of breach of AML/CFT legislation and to take sanctions for other non-compliances;

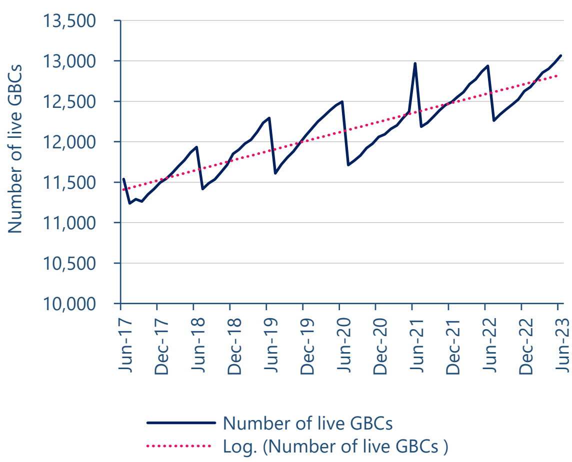
ii. The scope of Variable Capital Company (VCC) was extended to allow use for family offices and wealth management; and

iii. The Income Tax Act was amended to cater for an increase from 80 per cent to 95 per cent in partial exemption on interest earned by a Collective Investment Scheme and Closed End Fund.

Live GBCs rose further

The number of active GBCs progressed steadily in the first semester of 2023, reflective of improving conditions in the GB sector. The number of live GBCs increased to 13,065 as at end-June 2023, from 12,938 as at end-June 2022 representing an annual growth of 1.0 per cent. The above dynamics depicted the resilience of the GB sector despite uncertainties in the global economic environment (Chart 5.2). More importantly, it underscored the trust of GB sector operators in the MIFC.

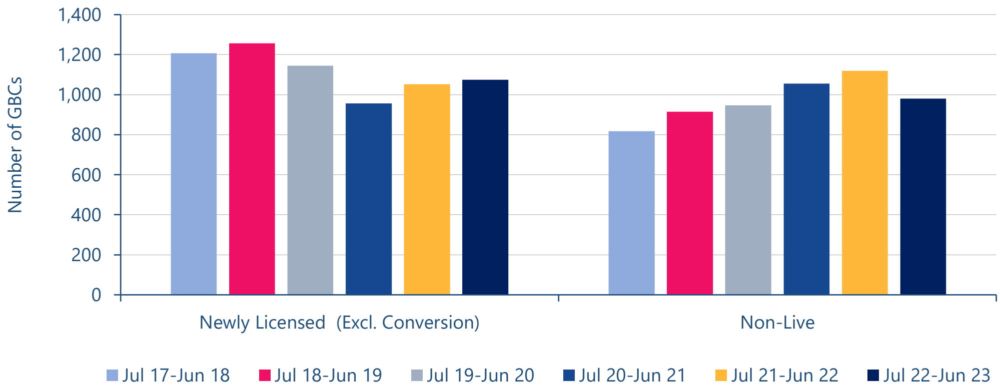
Chart 5.2 - Evolution of live GBCs



Source: Financial Services Commission

The operating environment in the GB sector improved gradually as reflected in the decline in the number of non-live GBCs. The number of exits, denoted by non-live GBCs, displayed a notable decline of 12.5 per cent for the financial year ended June 2023, following a continual upward trend for the past five years. Accordingly, the number of GBCs turning non-live stood at 980 for the year ended June 2023 from 1,120 a year before. Moreover, the number of new GBC licences (exclusive of conversion cases) issued maintained an upward trajectory during the financial year ended June 2023 to reach 1,074 as compared to 1,052 recorded during the preceding financial year (Chart 5.3).[25]

Chart 5.3 - Evolution of newly-licensed and non-live GBCs



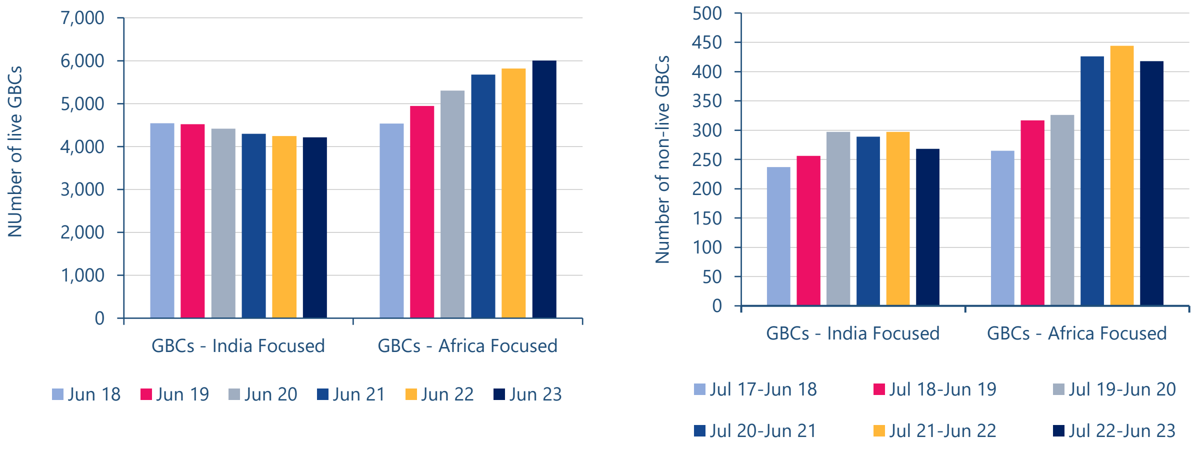
Source: Financial Services Commission

The African continent preserved its position as the leading investment target region for GBCs. The number of Africa-focused GBCs represented 46.0 per cent of total live GBCs, while the Indian market attracted 32.2 per cent of total live GBCs as at end-June 2023. The number of live GBCs focussed on the African continent was on an upward trend in the first half of 2023, reaching 6,008 as at end-June 2023 representing an annual growth of 3.3 per cent. In contrast, the number of live GBCs directed to India declined slightly to reach 4,211 as at end-June 2023, denoting a 0.8 per cent annual contraction (Chart 5.4).

The number of inactive GBCs focussed towards both the African continent and India slumped in the first semester of 2023. Non-live GBCs contracted at an annual rate of 9.8 per cent and 5.9 per cent towards India and Africa, respectively (Chart 5.4).

[25] *Around 600 GBC2s converted to GBCs following the phasing out of Category 2 Global Business regime in June 2019.*

Chart 5.4: Live and non-live GBCs targeting India vs Africa



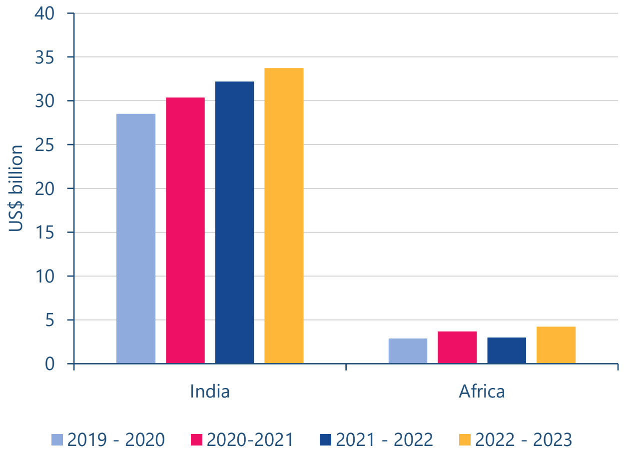
Source: Financial Services Commission

Investment flows picked up supported by renewed investor confidence

Renewed investor optimism bolstered investment flows through the GB sector. Foreign Portfolio Investment (FPI) remained the predominant form of investment flows through GBCs in the first half of 2023, representing 81.9 per cent of total investment flows. A share of 88.9 per cent of FPIs went to the Indian market compared to 11.1 per cent to the African market. FPI towards India maintained an expansionary trend over the past four years – despite a decline in the number of India-focused GBCs, recording an annual growth of 4.8 per cent for the year ended June 2023. Likewise, FPI to the African market recovered considerably to register a 41.1 per cent annual growth (Chart 5.5).

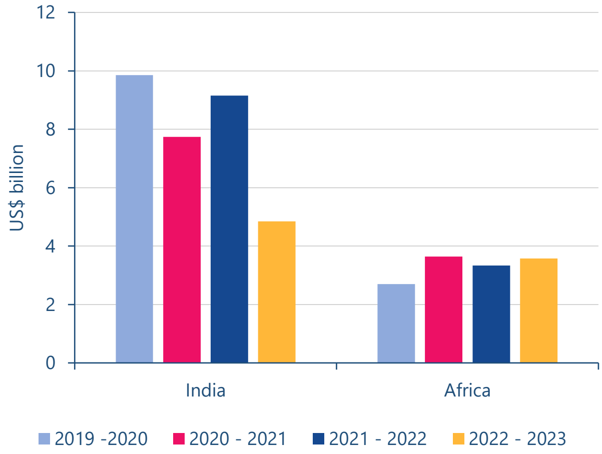
Foreign Direct Investment (FDI) flows tended to be volatile as they were largely influenced by prospects for private equity investments. Gross FDI flows towards the Indian economy displayed a contrasting picture as compared to FPI flows, shrinking by 47.1 per cent during the year ended June 2023. On the positive side, FDI to the African region registered an expansion of 7.3 per cent for the year ended June 2023 compared to the previous year (Chart 5.6).

Chart 5.5: Gross flows of FPI



Source: Financial Services Commission

Chart 5.6: Gross flows of FDI

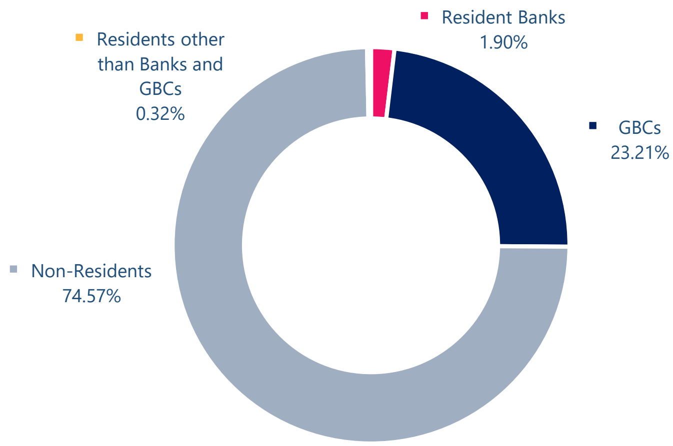


Source: Financial Services Commission

Intricate linkages between the GB and banking sectors

GBCs are the favoured gateway for penetrating the Asian and African regions, with the use of banking services being of prime importance. The most significant exposures for GBCs were with non-resident entities, accounting for 74.6 per cent of total monetary and financial assets or a nominal value of US$674.8 billion as at end-June 2023. The remaining share constituted primarily of cross-holding of assets between GBCs, indicating the presence of GBC group structures operating within the sector. Exposures with residents other than GBCs represents only 1.9 per cent and were fundamentally in the form of deposits held with domestic banking institutions (Chart 5.7).

Chart 5.7: Exposures of GBCs by institutional sectors as at end-June 2023



Source: Financial Services Commission

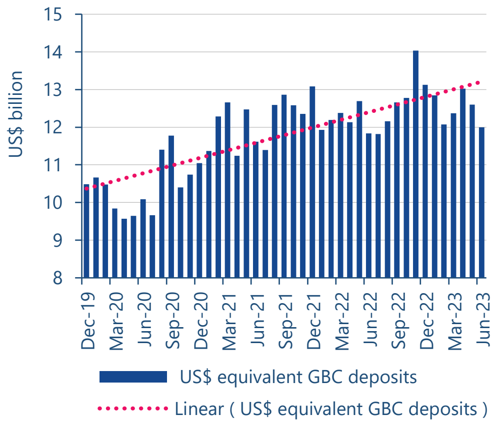
The close linkages of the GB sector with the banking sector and the economy calls for careful monitoring of risks associated with the sector. The close collaboration between the Bank and the FSC has enabled the design of a comprehensive risk assessment and surveillance framework. The framework will enable regular evaluation of risks and act as an early warning mechanism. It will support the formulation of suitable policy responses with the aim of mitigating the build-up of risks in the GB sector, with the broader objective of upholding the stability of the financial system (see Box 3).

Movements in GBC deposits cushioned by liquidity buffers

The linkage between the GB sector and the banking system stems primarily from dependencies on deposits. These deposits are generally of short-term nature and are, therefore, carefully managed by banks. The banking system has so far been able to satisfy all deposit withdrawals due to robust liquidity risk management practices and buffers.

GBC deposits remained a non-negligible source of FX funding to the banking system, representing 32.4 per cent of aggregate deposits and 48.8 per cent of total FX deposits as at end-June 2023. The evolution of these deposits reflected their volatile nature, but liquidity risks were cautiously managed by banks through careful maturity transformation and maintenance of high FX liquid buffers (Chart 5.8). GBC deposits stood at US$12.0 billion as at end-June 2023, after hovering around an average of US$12.5 billion in the first half of 2023.

Chart 5.8: Evolution of GBC deposits in US$ equivalent



Source: Bank of Mauritius

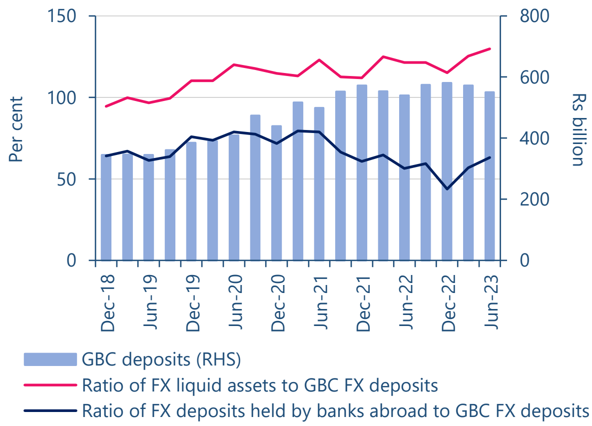
Funding vulnerabilities from GBC deposits have moderated from a historical perspective, as banks tapped more FX resources from non-residents. The share of FX GBC deposits to total FX deposits fell to 48.8 per cent in June 2023, from an average of 58.3 per cent for the period June 2013 to December 2022. Comparatively, the share of non-resident FX deposits to total FX deposits has been rising, indicating a shift in the funding strategy of banks and also in their business model favouring expansion beyond the domestic economy inclusive of the GB sector.[26]

[26] *The share of non-resident FX deposits to total FX deposits averaged 31.2 per cent between June 2020 to June 2023 as compared to an average of 26.1 per cent recorded from June 2013 to May 2020.*

A range of prudential requirements on liquidity risk have been in place for more than two decades in the MIFC and are regularly reviewed to address micro-level as well as systemic liquidity vulnerabilities.[27] This has contributed to improving the resilience of banks against liquidity risks, including those coming from GBC deposits. The introduction of the LCR in 2017 has improved the capacity of the banking system to respond to liquidity shocks. Moreover, the inherent characteristics of deposits from GBCs constrain banks to deploy these funds into short-term liquid assets to prevent maturity mismatch and mitigate liquidity risk. The funds are usually deployed in the form of deposits held with foreign banks and investment in low-risk sovereign securities.

The banking system held high level of FX liquid assets. The ratio of FX liquid assets held by banks to FX GBC deposits expanded to 129.8 per cent as at end-June 2023 (Chart 5.9). Concurrently, the ratio of FX deposits held abroad by banks to FX GBC deposits increased to 63.2 per cent as at end-June 2023. In addition, an analysis of the stickiness of GBC deposits, using data for recent years, revealed that around 82 per cent of total GBC deposits tend to be stable.

Chart 5.9: Deployment of GBC deposits



Source: Bank of Mauritius

The FSC applied a risk map to monitor and assess risk stemming from the linkage between the banking and GB sectors. Risk ratings were established by evaluating the likelihood of GBCs leaving the MIFC and the potential implications on the banking system.

The share of GBCs assigned with a high-risk score of leaving the jurisdiction rose to 15.7 per cent in June 2023, from 13.4 per cent in December 2022. The impact of these exits could trigger GBC deposit withdrawals of 26.1 per cent from the banking system, as per the risk matrix. These risks are suitably factored in by banks in their liquidity risk management framework, with the maintenance of high liquidity buffers.

[27] *The Guideline on Liquidity Risk Management, which include a set of minimum standards which banks should adhere to when managing liquidity risk, has been consistently upgraded with improvements brought in 2009, 2010, 2017, 2019, 2020, 2021 and 2023 since its introduction in January 2000.*

Table 1: Risk map – per cent of total GBC deposits

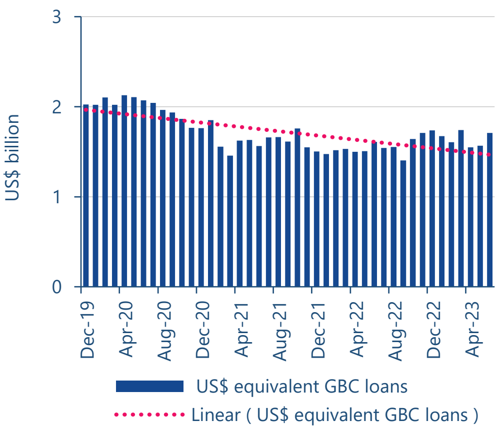
Risk Score – GBCs leaving the Mauritian jurisdiction	Sub-Total Risk scores	Low Impact	Medium-Low Impact	Medium Impact	Medium-High Impact	High Impact
High Risk	15.7	0.0	2.3	4.0	2.5	6.9
Medium-High Risk	14.9	0.1	4.9	3.5	1.4	5.0
Medium-Low Risk	15.0	0.1	4.4	4.8	2.4	3.3
Low Risk	54.4	0.3	22.0	15.5	5.7	10.9
Sub-Total Impact Score		0.5	33.6	27.8	12.0	26.1
		Impact Score – Deposit withdrawals				

Source: Financial Services Commission

Asset quality of the GB sector improved

Banks have credit exposures to the GB sector, though to a much lower extent relative to their funding base. The share of loans extended to the GB sector relative to total loans granted by the banking sector remained low at 7.2 per cent as at end-June 2023. Bank loans to the GB sector stood at US$1.7 billion as at end-June 2023, barely unchanged from the last quarter of 2022 (Chart 5.10). Banks' credit exposures to the GB sector were much lower relative to GBC deposits.

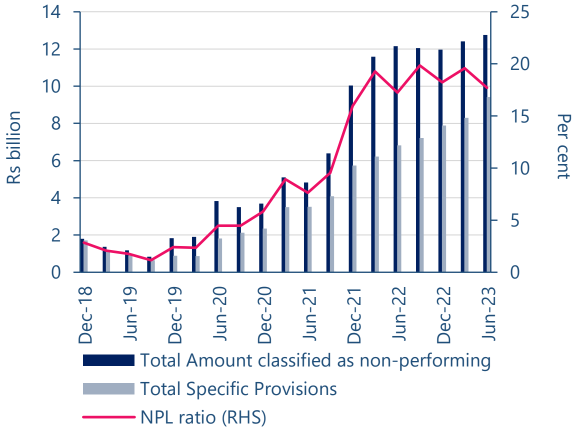
Chart 5.10: Evolution of GBC loans



Source: Bank of Mauritius

The asset quality of the GB sector in banks' credit portfolio improved in the first half of 2023. Headwinds in the global economic environment in the past few years have largely influenced the asset quality of GBCs. The NPL ratio of the GB sector dropped to 17.7 per cent as at end-June 2023, from 18.2 per cent as at end-December 2022. Banks have revised up their coverage ratio for the GB sector, keeping additional provisions against potential losses. Consequently, the coverage ratio – that is, specific provisions as a proportion of NPLs – improved to 73.9 per cent from 66.0 per cent over the same period (Chart 5.11).

Chart 5.11: Asset quality of GBC loans



Source: Bank of Mauritius

Overall, risks from the GB sector to the financial sector and the economy were well contained. The flow of investments through the MIFC to traditional markets remained sustained, supporting the resilience of GBCs deposit flows in the banking system. Moreover, funding vulnerabilities from reliance on GBC deposits declined further as banks pursued diversification of funding sources. As banks maintained a prudent approach in managing risks from the sector, the robust liquidity buffer and high coverage ratio were expected to keep risks from the GB sector in check.

Box 3 – Global Business sector: Assessment of risks to the financial system

The GB sector is one of the pillars of the economy, with direct contribution of 8.3 per cent to Gross Value Added in 2023. Its strong intricate linkages with the financial sector make close surveillance of risks to and from the sector compelling in order to safeguard the stability of the financial system of Mauritius.

The GB sector comprises resident corporations operating in the MIFC that conduct most of their business outside Mauritius. The sheer size of the portfolio managed in the GB sector, valued at around US$705 billion in June 2023 together with bank deposits aggregating around US$12.0 billion as at end-June 2023 – depicts its importance in the financial landscape of Mauritius. Moreover, the intricate interconnections with various other segments of the economy, including the labour market, amplifies the systemic importance of the GB sector.

The sector is obviously exposed to exogenous and endogenous hazards – such as changes to the Double Taxation Avoidance Agreements (DTAAs), Global Minimum Tax, competition from other IFCs, global financial market turbulence, regional and global economic outlook, etc. As it is closely intertwined with the banking system and the economy, adverse external and domestic developments can trigger stresses that impact banks and the economy, which can give rise to vulnerabilities and trigger systemic risk.

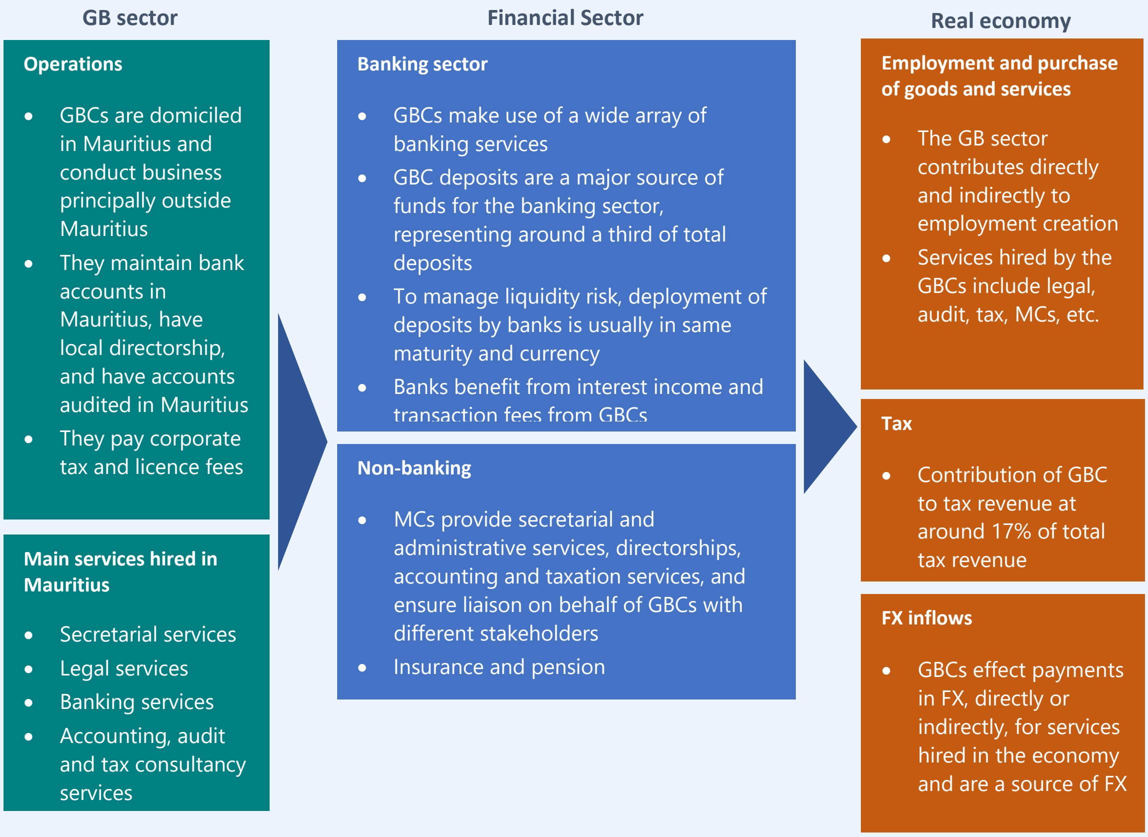
Close monitoring and assessment of risks posed by the GB sector is therefore critical for timely policy response to safeguard financial stability. The Bank and the FSC have jointly devised a framework comprising key sources and types of risk specific to the GB sector that can be transmitted to and undermine the financial system and, ultimately, the economy. The framework would facilitate regular assessment of the degree of vulnerabilities and risks. The two financial sector regulators are collaborating closely to deploy the framework for the prompt identification of risks that will assist the design of suitable policy responses.

Interconnectedness with the banking sector and the economy

GBCs avail of the services of, *inter alia*, MCs, banks and auditing firms based in the MIFC to conduct business outside Mauritius. The banking sector benefits significantly from GBC deposits, a major source of funds representing around one-third of total deposits mobilised. An assessment of the balance sheet structure of banks in Mauritius revealed that 15 banks' strategy are heavily oriented towards the external sector, notably in terms of funding sources and deployment. Other sectors also benefit from services purchased by GBCs, such as legal and administrative services.

The GB sector benefits the real economy with its direct and indirect contribution to employment, purchase of goods and services, tax revenue and FX inflows, amongst others, as illustrated in Figure 1.

Figure 1 – Cross-cutting dependencies with the financial sector and the economy

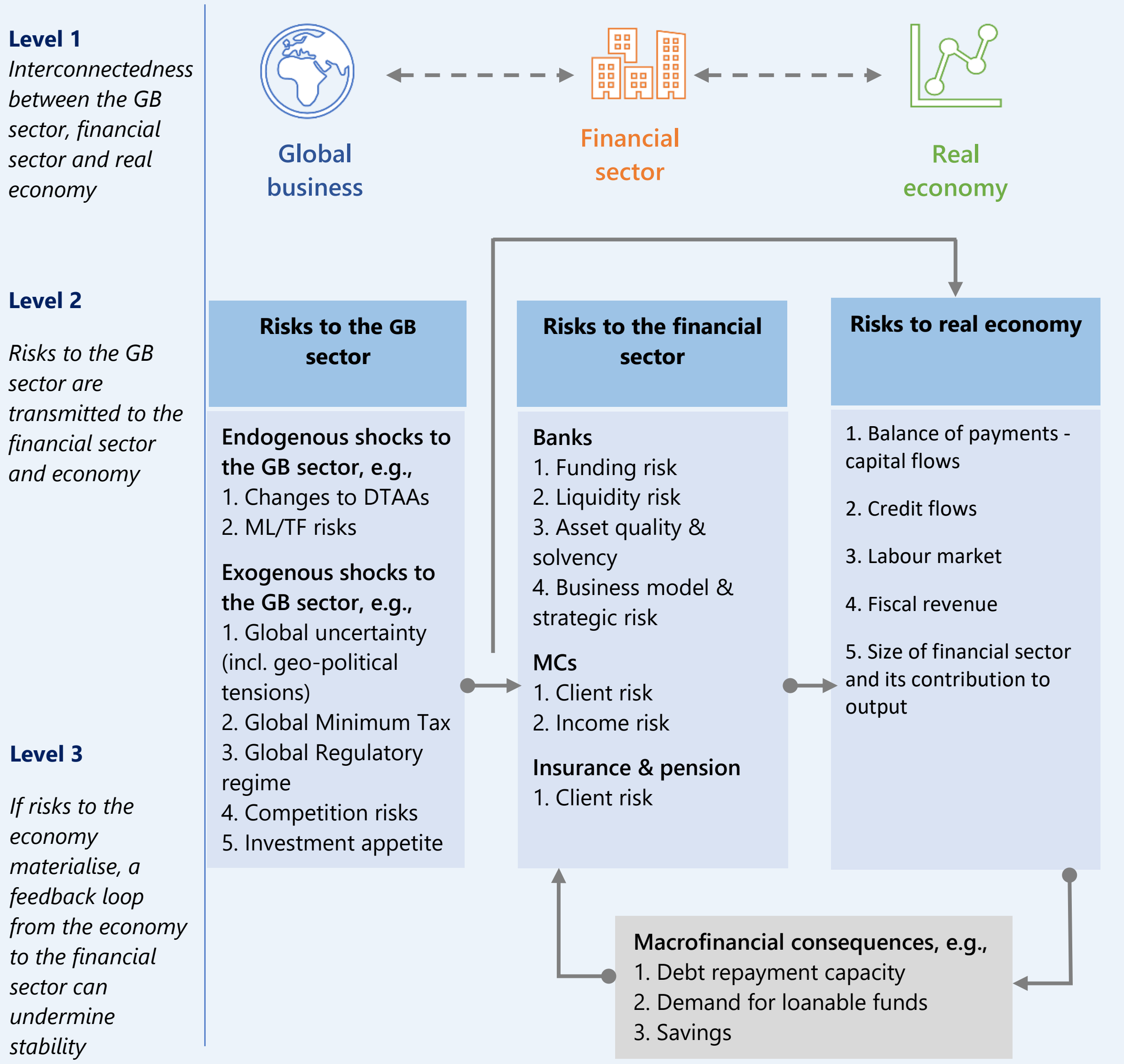


Source: Bank of Mauritius and FSC

Risks transmission mechanism

Events impacting the GB sector can be channelled to the banking sector and the economy. The potential risks for the banking and financial sector are numerous, such as funding risk, liquidity risk, credit risk, business model and strategy risk as well as reputation risk. The effects on the economy can be through various channels, including the balance of payment, credit flows to the economy, labour market, fiscal revenue and size of the financial sector. Figure 2 provides an overview of the risk transmission mechanism between the GB sector, the banking sector and the real economy.

Figure 2 – Risks transmission mechanism



Source: Bank of Mauritius and FSC

The comprehensive framework, designed to enable the systematic identification and assessment of risks to and from the GB sector, will act as an early warning mechanism as well. This process will support suitable policy responses with the aim of mitigating the build-up of risks from the GB sector, with the broader objective of upholding the stability of the financial system.

6. Stress testing the Mauritian banking sector

The Bank's stress testing exercise, based on June 2023 data, confirmed that the banking sector was resilient to estimated shocks, given robust capital and liquidity buffers. The capacity of the banking sector to absorb shocks was evaluated through two sets of macroeconomic shocks as well as a series of hypothetical but plausible sensitivity scenarios, which altogether included shocks to the credit portfolios, interest rate, exchange rate and liquidity positions of banks. The banking sector was able to amply absorb the hypothesised stressed scenarios. In addition, most banks showed resilience, as they had consolidated their buffers mainly from high global and domestic interest rates. However, a few institutions displayed vulnerabilities, particularly in the harshest scenarios. As the domestic economy paves its way further on solid ground, banks were expected to strengthen their buffers further, providing additional headroom to absorb any materialisation of shocks.

Risk to financial stability moderated in the first half of 2023. Concurrently, the soundness of the banking sector improved as banks consolidated their capital and liquidity buffers. These major developments strengthened the position of the sector to withstand any deterioration in the macrofinancial environment.

The Bank conducted its regular stress test exercise to measure the capacity of the sector as well as individual banks to absorb plausible macroeconomic and idiosyncratic shocks. The stress test framework considers several scenarios and sensitivity shocks to the credit portfolios, interest rate, exchange rate and liquidity position of banks. The goal of the exercise is to evaluate the capacity of the banking sector to continue serving the economy under stressed economic and financial conditions.

The results of the stress test showed sustained resilience of the banking sector under adverse economic and financial settings. This buoyancy emanates from stronger capital and liquidity buffers that banks consolidated in the first half of 2023, including from higher net interest income. Most banks proved to be resilient in the stressed scenarios. A few banks demonstrated signs of vulnerability, mostly in the severe scenarios. The Bank has been tackling the vulnerabilities through appropriate measures.

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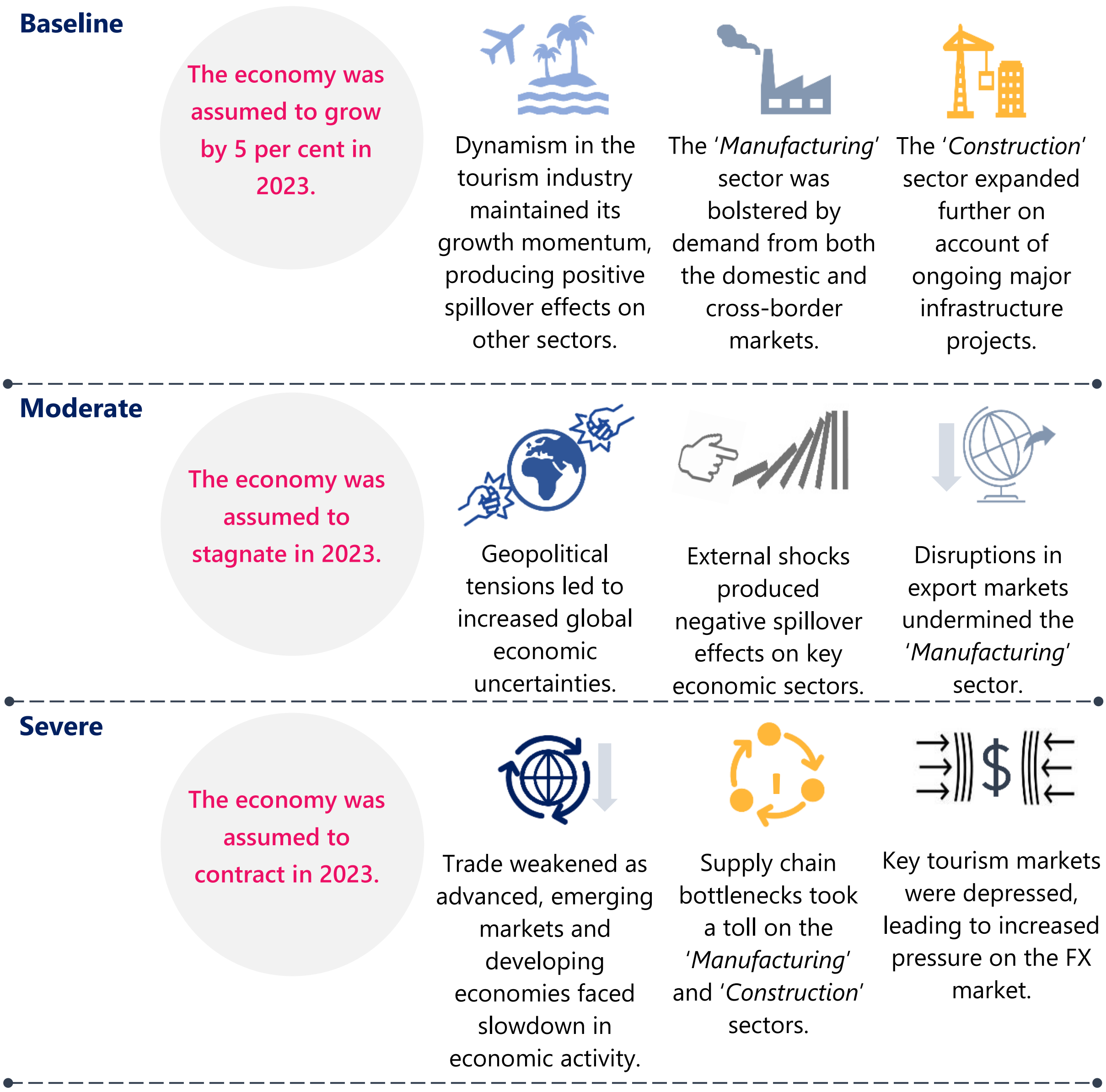
Macroeconomic scenario analysis

Three hypothetical scenarios – baseline, moderate and severe – were designed to assess the strength of the banking sector (Figure 6.1). The scenarios considered macroeconomic and idiosyncratic shocks, each with increasing degree of severity. The baseline, moderate and severe scenarios assumed a 5 per cent economic growth, economic stagnation and an economic contraction of 3 per cent, respectively. These scenarios should not be considered as macroeconomic forecasts.

Figure 6.1: Macroeconomic scenarios

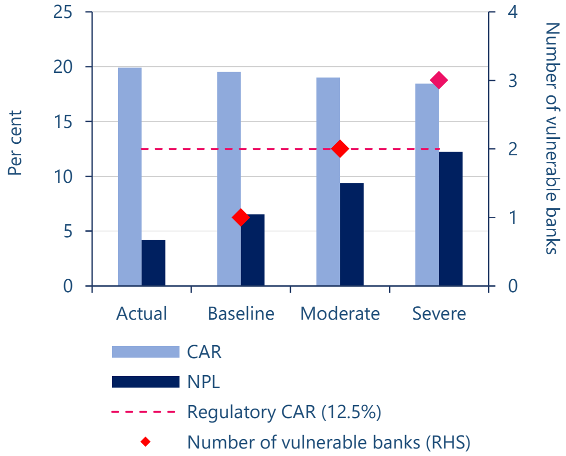


Source: Bank of Mauritius

The macroeconomic shocks are transmitted to the banking sector mainly through credit losses, ultimately getting channelled to bank capital ratios and solvency. A satellite model was used to estimate the correlation between economic growth and credit portfolio. For each scenario, the NPL ratio is projected based on the feedback of a GDP shock on the credit portfolio. Assumptions are made on the additional amount of provision that banks would have to set aside to cater for the higher impairment of the credit portfolio. Supplementary provision charges would lower profits of banks and, therefore, impact capital ratios and solvency.

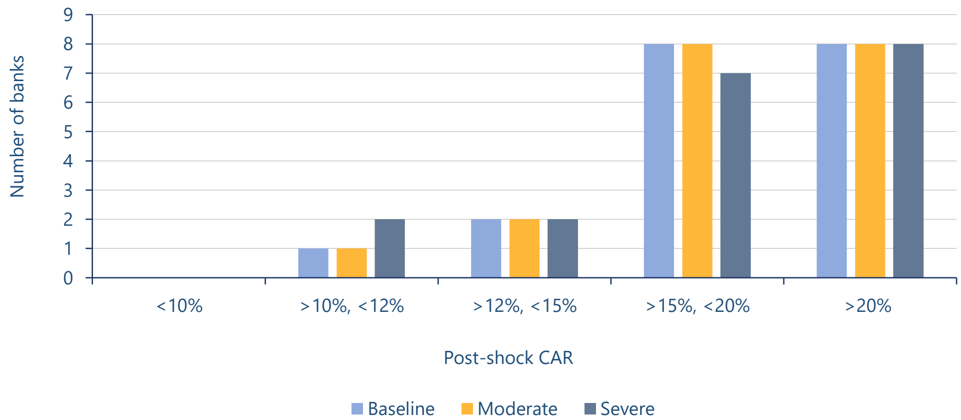
The banking sector demonstrated sound resistance to economic challenges. The stress test results, based on June 2023 data, displayed a well-capitalised banking system in the baseline scenario, with the exception of one bank which recorded a post-shock CAR below 12.5 per cent (Chart 6.1a).[28] As for the moderate and severe scenarios, two banks and three banks would, respectively, breach the adjusted CAR limit. These three banks represented a small share of the banking sector. Most banks registered post-shock CAR above 15 per cent in all three scenarios (Chart 6.1b).

Chart 6.1a: Macroeconomic shock results – sector level results



Source: Bank of Mauritius

Chart 6.1b: Macroeconomic shock – bank-wise distribution of post-shock CAR



Source: Bank of Mauritius

[28] *The regulatory minimum CAR, inclusive of the Capital Conservation Buffer of 2.5 per cent, to be maintained by all banks is 12.5 per cent. This is exclusive of D-SIBs capital charges ranging from 1.0 per cent to 2.5 per cent.*

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Interest rate and exchange rate shocks

The macroeconomic scenarios were complemented with two additional hypothetical shocks, interest rate and exchange rate, which have key macroeconomic implications on the banking sector (Table 6.1). The augmented macroeconomic scenario was tested at two severity levels, namely, baseline and moderate. Based on conjectural economic shocks, it is assumed that a 200-basis point increase in market interest rates would not be enough to normalise conditions on the FX market, thereby failing to relieve pressure on exchange rates. The severe scenario is not simulated since policy rate is not likely to be raised during economic contraction.

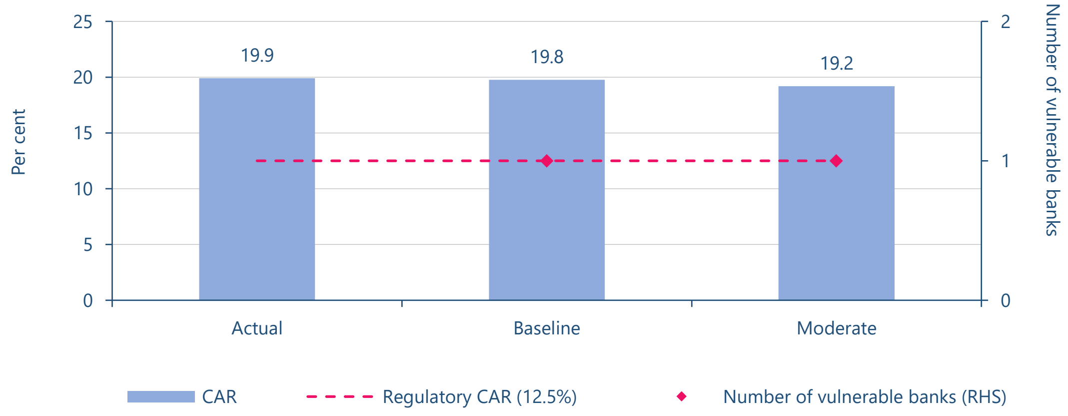
Table 6.1: Interest rate and exchange rate scenarios

	Baseline scenario	Moderate scenario
GDP growth	5 per cent	Zero growth
Interest rate hike	200 basis points	200 basis points
Exchange rate depreciation	4 per cent	8 per cent

Source: Bank of Mauritius

The stress test results confirmed the resilience of the banking sector against the augmented macroeconomic shock scenarios based on June 2023 data. The robustness of the sector to these simulated shocks was largely due to banks' strong capital buffers. Most banks registered a positive net interest rate gap as at end-June 2023, implying that rising interest rates would lead to higher net interest income translating into higher profits. Nearly all banks were able to meet their regulatory CAR limit in the baseline and moderate scenarios, with the exception of one bank which displayed signs of vulnerability in both scenarios (Chart 6.2).

Chart 6.2: Macroeconomic interest rate and exchange rate shocks results – sector level results



Source: Bank of Mauritius

Sensitivity analysis

A series of sensitivity stress tests, using a top-down approach, was performed to evaluate the banking sector's capacity to withstand idiosyncratic shocks. The sensitivity analysis tested for sectoral credit, credit concentration and liquidity risks. A reverse stress test was carried out to assess the adequacy of banks' capital buffers.

Sectoral credit risk

The sectoral credit sensitivity analysis assumed a specific percentage of the performing loan portfolio becoming impaired. The loan portfolio of six key sectors – namely, "*Agriculture*," "*Manufacturing*," "*Construction*," "*Wholesale and retail trade*," "*Accommodation and food services*," and "*Housing*" – were subjected to the test. These sectors accounted for the largest proportion of credit in the banking sector's portfolio.

The shock in the sectoral credit sensitivity analysis measured the sufficiency of the capital buffer of the banking sector through three scenarios – baseline, moderate and severe – each with incremental degree of severity (Table 6.2).

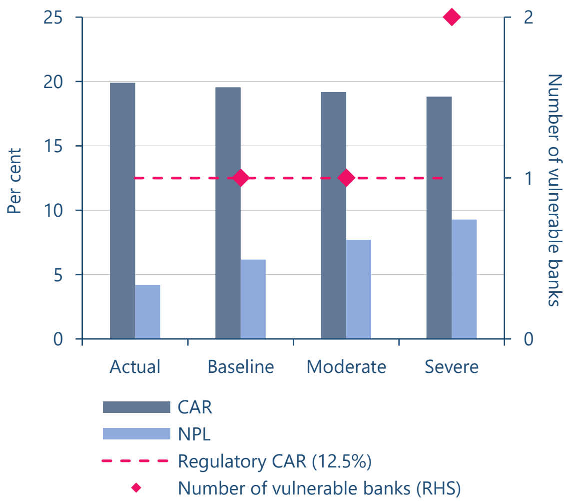
Table 6.2: Sectoral credit risk scenarios

	Baseline scenario	Moderate scenario	Severe scenario
Percentage of performing credit turning impaired	4 per cent	8 per cent	12 per cent

Source: Bank of Mauritius

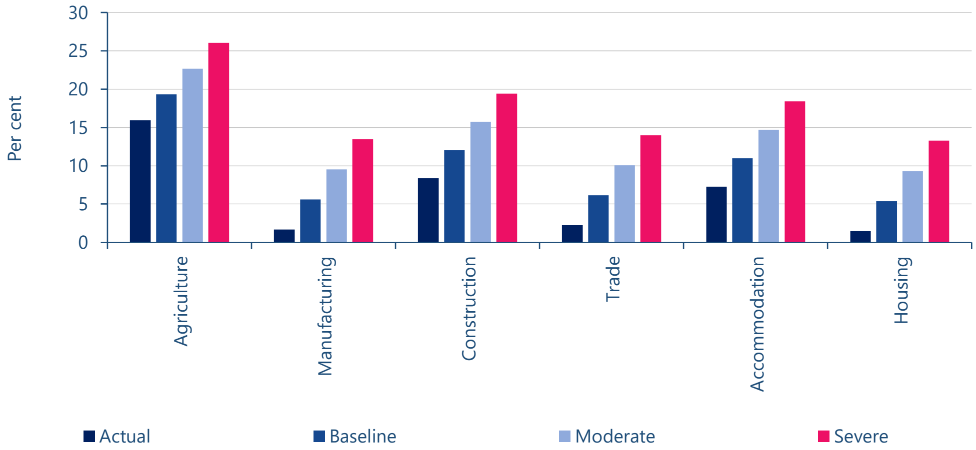
The results demonstrated that most banks held adequate capital buffers to withstand sectoral credit shocks, except one bank falling in the vulnerable zone under both the baseline and moderate scenarios, while two banks would breach the CAR limit of 12.5 per cent in the severe scenario (Chart 6.3a). The 'Agriculture' sector held the highest post-shock NPL ratio, building on its already high actual NPL ratio. The '*Manufacturing*' '*Wholesale and retail trade*' and '*Housing*' sectors would see the largest increase in post-shock NPL ratio (Chart 6.3b).

Chart 6.3a: Sectoral credit sensitivity analysis - Sectoral level results



Source: Bank of Mauritius

Chart 6.3b: Sectoral credit sensitivity analysis - Sector-wise NPL ratio sensitivity analysis



Source: Bank of Mauritius

Credit concentration risk

Credit concentration risk was measured by stress testing the cumulative default of up to the top ten single borrowers in the performing credit portfolios of each bank. The selected borrowers comprise unlisted and non-governmental organisations only. The banking sector was shocked at three different severity namely baseline, moderate and severe (Table 6.3).

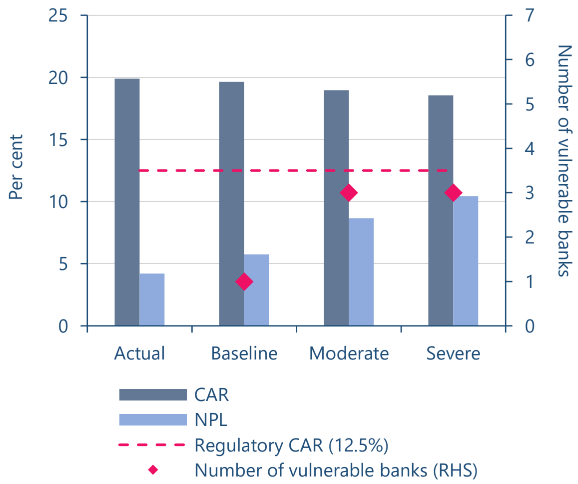
Table 6.3: Credit concentration risk scenarios

	Baseline scenario	Moderate scenario	Severe scenario
Default of top single borrower(s)	1	5	10

Source: Bank of Mauritius

The results revealed that banks were well capitalised to absorb shocks associated with credit concentration. Under the baseline scenario, the aggregated CAR of the banking sector would decline from 19.9 (actual) to 19.6 per cent. It would go further down to 19.0 per cent in the moderate scenario and to 18.6 per cent in the severe scenario which remained well above the minimum requirement (Chart 6.4a).

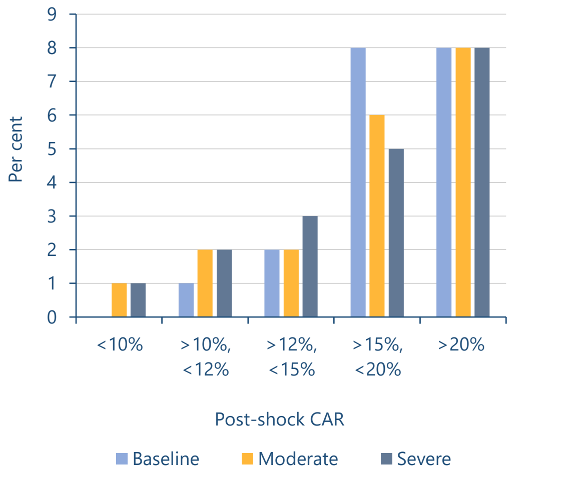
Chart 6.4a: Credit concentration risk – sector level results



Source: Bank of Mauritius

In the credit concentration sensitivity exercise, most banks' capital buffers displayed robustness, although a few banks showed signs of vulnerability. In the baseline scenario, all banks would meet their respective regulatory CAR limit, except one bank breaching the regulatory CAR limit of 12.5 per cent. In both the moderate and severe scenarios, three banks would register post-shock CAR below 12.5 per cent. These three banks represented a small share of the banking sector. In all three scenarios, the majority of banks recorded post-shock CAR above 15 per cent (Chart 6.4b).

Chart 6.4b: Credit concentration risk – Bank-wise distribution of post-shock CAR



Source: Bank of Mauritius

Liquidity risk

The liquidity stress test was conducted to evaluate the ability of banks to sustain FX liquidity outflows. Five shock scenarios were applied for this exercise, involving mostly deposits outflows from the GB sector (Table 6.4). A significant proportion of banks' overall deposits was from the GB sector, representing around 32 per cent of total banking sector deposits. Under one scenario, the resilience of banks to outflows from the aggregate FX deposits was also stress tested.

The capacity of banks to sustain FX deposit withdrawals was tested against their adjusted FX HQLA in the five scenarios. The adjusted HQLA combines FX HQLA (as defined in Basel III LCR) and FX interbank deposits.[29] A bank that records a negative post-shock adjusted HQLA is considered vulnerable to liquidity shocks.

Table 6.4: Liquidity risk – FX deposit withdrawals by GBCs

Shocks	Description
1	Assume 35 per cent one-off FX deposit withdrawal
2	Assume largest GBC depositor withdrawal
3	Assume riskiest GBC depositor withdrawal
4	Aggregate of Shocks 2 and 3 (provided largest GBC depositor is not the riskiest one as well)
5	Aggregate of Shocks 1, 2 and 3

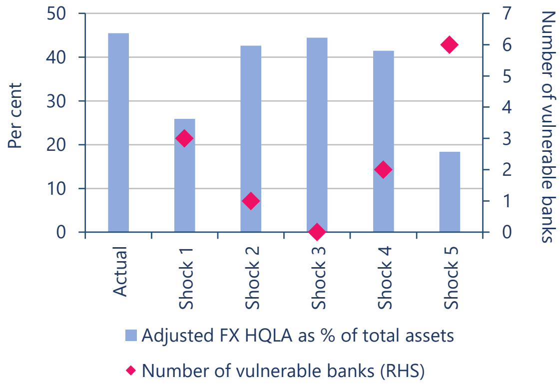
Source: Bank of Mauritius

[29] *FX interbank deposits refer to FX denominated cash balances placed by banks with other banks, mostly overseas.*

The findings showed that the banking sector as a whole was resilient to the five liquidity shocks with post-shock adjusted FX HQLA in the positive range. The post-shock adjusted FX HQLA was scattered above the median for all five shocks whilst still in the positive zone. In shock 1, two upper outliers were noted while one and four upper outliers were recorded for shock 4 and shock 5, respectively. This demonstrated that the banking sector's liquidity buffers were adequate and robust enough to withstand FX liquidity shocks.

At bank level, the majority of banks held adequate adjusted FX HQLA to withstand the shocks. Three banks would show signs of vulnerability at shock 1 while one bank would see its adjusted FX HQLA turn negative under shock 2. All banks were robust when shock 3 was applied. For shocks 4 and 5, two banks and six banks respectively would record a negative post-shock adjusted FX HQLA (Chart 6.5).

Chart 6.5: Liquidity risk – adjusted FX HQLA



Source: Bank of Mauritius

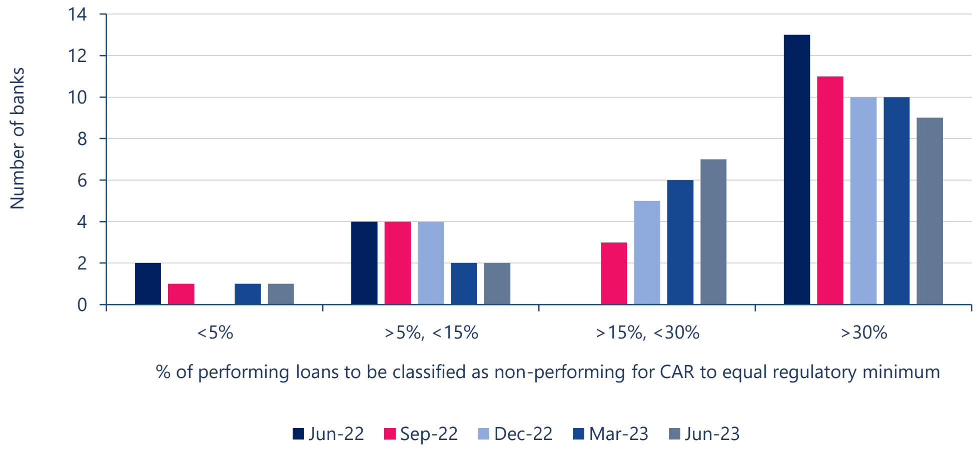
The number of banks falling in the negative zone for post-shock adjusted FX HQLA was similar to the December 2022 exercise. The banks that showed signs of vulnerability in the liquidity stress test exercise accounted for a small portion of banking sector's assets. Liquidity risk remained at manageable level, due to the degree of stickiness of GBC deposits and lines of credit to foreign-owned banks by their parent banks.

Reverse stress test

The reverse stress test provided further evidence of the resilience of the capital buffers of banks. This test examined the maximum amount of additional NPLs that banks would be able to absorb, through increased provisions, for their CAR to fall to the minimum regulatory CAR of 12.5 per cent or augmented minimum regulatory CAR adjusted for D-SIB capital charges, ranging from 13.5 per cent to 15.0 per cent.

The results of the reverse stress test confirmed the resilience of the banking sector to absorb additional impairment of the credit portfolio. Banks' capital buffers as at end-June 2023 would be able to absorb from 4.9 per cent to 205.3 per cent impairment of their performing loans portfolio (Chart 6.6). It is noteworthy that 16 out of 19 banks would be able to sustain more than 15 per cent of their performing loans turning impaired. Therefore, most banks' capital buffers could absorb additional impairment well above the sector average.

Chart 6.6: Implied percentage of performing loans to be classified as non-performing



Source: Bank of Mauritius

Box 4: Upgrades to the stress testing framework

Stress testing is a highly-utilised tool among financial sector regulators to assess the soundness and resilience of the financial system. The Bank has been using a 'top-down' stress testing framework since 2018 focussing on both the banking system and individual banks to evaluate the resilience of the banking system and design suitable policy responses. The framework enables the Bank to perform scenario as well as sensitivity analyses. These analyses assess how the sector and individual banks fare when shocks are applied to *inter alia* credit portfolios, interest rate, exchange rate and liquidity. The framework provided a simple and transparent mechanism to measure the adequacy of capital and liquidity buffers to sustain the stability of the banking system. However, the shocks to the global economy and the banking world in the recent times coupled with the evolving risk landscape have necessitated more in-depth assessment and monitoring of the banking system.

The Bank initiated an upgrade of its stress testing framework in 2022 for better surveillance and to ensure the resilience of the banking sector against more complex and unconventional stressed situations. The existing modules in the framework have been upgraded and new modules have been introduced taking into consideration macrofinancial developments and cross-border exposures of the banks. The main features of the upgraded framework are outlined hereunder.

a. Solvency

i. Macroeconomic shock

An upgraded macroeconomic model has been rolled out to estimate the correlation between credit to the private sector and macroeconomic indicators such as GDP, prime lending rate and unemployment. The model will be run periodically to investigate any shift in the parameters. The model assumes a shock to these macroeconomic indicators which would eventually explain movement to bank credit. After having undertaken various tests, the best fitted model was selected to assess the transmission of macroeconomic shock on banking sector credit.

ii. Forward-looking solvency test

A forward-looking stress testing framework is paramount for effective surveillance, even more so in the current dynamic economic context. One of the new modules consists of a forward-looking solvency stress test. All relevant parameters are forecasted for the purpose of running this module, including GDP, credit portfolios, performing loans, NPLs, and CARs. For instance, the CAR of the banking sector and for each bank are estimated using historical data on capital and RWA. The projected CARs and parameters are stress tested based on scenario and sensitivity analyses.

iii. Cross-border sensitivity analysis

The cross-border scenario is a new module added to the stress testing framework to cater for the significant exposure of the banking sector to non-resident entities and GBCs which conduct business mostly with the rest of the world from the Mauritius IFC. The cross-border stress test assesses the potential impact of adverse events on banks' balance sheets arising from activities conducted across different jurisdictions, with specific focus on credit risk. It is noteworthy that, as at end-June 2023, total cross-border deployment of funds was mostly in the form of credit facilities granted to non-resident segment (around 42 per cent) followed by investment in shares (around 29 per cent) and deposits with banks abroad (around 29 per cent). A sample of countries was selected constituting roughly 80 per cent of cross-border credit exposures. The solvency stress test is performed based on shocks to banks' credit portfolios for the selected countries under three degrees of severity. The shocks are designed based on specific parameters for each of the selected countries such as historical NPL ratios.

b. Liquidity

The liquidity module has been overhauled to accommodate all potential sources of liquidity risk, including the funding structure of banks. Banks have been classified into distinct categories, depending on their reliance on domestic (exclusive of GBC) and non-resident (inclusive of GBC) funding, to benchmark the degree of liquidity stresses from historical episodes for each category. Historical liquidity outflows were analysed for each category to determine hypothetically plausible deposit outflows for three distinct sectors: namely, domestic households, domestic corporates, and GBCs combined with non-residents. The net cash outflows were determined for these segments for the baseline, moderate and severe liquidity stress scenarios. The scale of run-offs applied for the moderate and severe were stricter compared to the Basel III LCR given the share of wholesale funding.

The Bank will pursue the upgrading of its stress testing toolkit in a phased manner to better capture potential sources of vulnerabilities and assess the resilience of the banking sector. A number of new modules will be added to complement the assessment of the soundness of the banking system, including from a macroprudential perspective.

The upgraded stress testing framework was applied to June 2023 data and confirmed the resilience of the banking sector. The results demonstrated continued adequacy of solvency and liquidity buffers, including over the next two quarters covered by the forward-looking module. The liquidity stress test results displayed the soundness of the liquidity position of most banks in Mauritius. The new framework will be applied by the Bank going forward.

Annex A: Financial Soundness Indicators

FSIs of other depository corporations [a, b]

Per cent

Core set of FSI	Dec-21	Jun-22	Dec-22	Jun-23
Capital-based				
Regulatory capital to risk-weighted assets	20.7	20.3	20.6	20.9
Regulatory Tier 1 capital to risk-weighted assets	19.4	19.0	19.3	19.0
Non-performing loans net of provisions to capital	8.9	8.8	8.3	10.3
Common Equity Tier 1 capital to risk-weighted assets[1]	19.0	18.6	19.0	18.7
Tier 1 capital to assets[1]	9.1	9.1	9.0	9.3
Asset quality				
Non-performing loans to total loans[2]	5.8	5.6	4.9	5.6
Loan concentration by economic activity[1]	49.6	44.8	43.8	43.7
Provisions to nonperforming loans[1]	61.3	60.0	60.2	51.3
Earnings and profitability				
Return on assets	1.3	1.3	1.6	2.6
Return on equity[3]	10.5	11.2	14.0	22.1
Interest margin to gross income[3]	65.9	68.6	70.1	74.2
Non-interest expenses to gross income[3]	44.6	45.1	40.6	33.0
Liquidity				
Liquid assets to total assets[3]	48.6	47.8	45.5	47.0
Liquid assets to short-term liabilities[3]	54.3	53.6	50.8	52.8
Liquidity Coverage Ratio[1]	236.3	235.5	238.3	277.4
Sensitivity to market risk				
Net open position in foreign exchange to capital	1.5	1.3	1.5	1.1

Per cent

Encouraged set of FSI	Dec-21	Jun-22	Dec-22	Jun-23
Credit growth to private sector[1]	2.2	4.4	8.3	6.3
Value of large exposures to capital	284.0	308.1	278.5	280.2
Customer deposits to total (non-interbank) loans	234.3	228.1	226.3	222.0
Trading income to total income[3]	12.4	10.0	10.7	10.1
Personnel expenses to non-interest expenses[3]	47.6	49.1	50.1	49.9
Residential real estate loans to total loans[2]	11.6	12.5	11.9	12.8
Commercial real estate loans to total loans[2]	5.4	4.9	4.3	4.5

[a] *Effective December 2021, FSIs are computed based on the Financial Soundness Indicators Compilation Guide (2019) of the IMF. Some FSIs may, therefore, not be strictly comparable with those prior to December 2021.*

[b] *Other Depository Corporations refer to banks and NBDTIs that are all licensed by the Bank.*

[1] *New indicators introduced following the adoption of the Financial Soundness Indicators Compilation Guide (2019) of the IMF as from December 2021.*

[2] *Total loans include commercial loans, instalment loans, hire-purchase credit, loans to finance trade credit and advances, finance leases, repurchase agreements not classified as a deposit, and overdrafts.*

[3] *Indicators amended following adoption of the new Financial Soundness Indicators Compilation Guide (2019) of the IMF as from December 2021. Hence, data may not be strictly comparable to quarters prior to December 2021.*

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List of acronyms

ARA	Assessing Reserve Adequacy
Bank	Bank of Mauritius
CAR	Capital Adequacy Ratio
D-SIBs	Domestic Systemically Important Banks
DSTI	Debt-service-to-income
ECB	European Central Bank
EU	European Union
FCY	Foreign Currency
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investment
FSC	Financial Services Commission
FSIs	Financial Soundness Indicators
FX	Foreign Exchange
GB	Global Business
GBCs	Global business corporations
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
GOIR	Gross Official International Reserves
HHI	Herfindahl-Hirschman Index
HQLA	High-Quality Liquid Assets
IMF	International Monetary Fund
KRR	Key Repo Rate
LCR	Liquidity Coverage Ratio
LTV	Loan-to-value
MCs	Management companies
MIC	Mauritius Investment Corporation Limited
MIFC	Mauritius International Financial Centre
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital International
NBDTIs	Non-Bank Deposit-Taking institutions
NPLs	Non-performing Loan(s)
ROA	Return on Assets
ROE	Return on Equity
RPPI	Residential Property Price Index
Rs	Mauritian Rupee
RWAs	Risk-Weighted Assets
SRI	Systemic Risk Indicator
UK	United Kingdom
US	United States
US$	US dollar
WRI	Wage Rate Index

Glossary

Annual change or growth *compares the value of a variable at one period in time with the same period of the previous year.*

Credit to private sector *has been aligned with the IMF FSI Compilation Guide (2019). Credit comprises loans and debt securities issued by private nonfinancial corporations and private sector encompasses private non-financial corporation, households and non-profit institutions serving households.*

Credit extended to households for other purposes *include purchase of other consumer durable goods, purchase of land, purchase of motor vehicles, education purposes, medical purposes, investment purposes, and other unspecified purposes.*

Credit-to-GDP gap *is the percentage deviation between the credit-to-GDP ratio and an estimate of its trend. The trend in the credit-to-GDP ratio is estimated by using the HP filter.*

Corporate sector *comprises only Other Nonfinancial Corporations in Mauritius.*

Household indebtedness *considers a broader measure that adds up household credit from banks, NBDTIs, insurance and leasing companies.*

Non-performing loans ratio *is measured by the share of non-performing loans to gross loans.*

Percentage point *is the arithmetic difference of two percentages.*

Return on Assets *is the annualised pre-tax return on assets and is measured by the ratio of pre-tax profit to average assets.*

Return on Equity *is the annualised pre-tax return on equity and is measured by the ratio of pre-tax profit to average equity.*

Residential Property Price Index (RPPI), *is an indicator of how the prices of transacted residential properties (houses and apartments) have evolved over time.*

SEMDEX *is an index of prices of all listed shares on the Stock Exchange of Mauritius wherein each stock is weighted according to its share in the total market capitalisation.*

SEMTRI *is an index, which tracks the price performances of the constituents of the SEMDEX and ensures that the dividends paid by these constituents are reinvested.*

Tier 1 capital *is a term used to qualify eligible capital of a bank and is constituted of the components having the highest loss absorbing capacity.*