

Address by Mr Y. Googoolye, First Deputy Governor, Bank of Mauritius at the Financial Stability Institute, World Bank and International Monetary Fund Seminar on “Supervision and Regulation of State-Owned Banks”, hosted by the Reserve Bank of India, Mumbai, 5 November 2008.

Distinguished guests,
Ladies and Gentlemen,

I am very pleased to be in Mumbai today to share a few thoughts on supervision and regulation of government-owned banks. I must at the outset compliment the Financial Stability Institute, World Bank and International Monetary Fund for having chosen this issue as the theme for this seminar. No subject could be more topical in the current context given that we are seeing in the West a reverse process of private banks getting wholly or semi-nationalized. Therefore, the lessons of this seminar, which is targeted at the emerging economies, could be useful for the developed world as well, in a more meaningful way than perhaps they might have been a few weeks ago.

Before getting to the theme of regulation and supervision of government-owned banks, let us see the different ways in which Government can have stakes in banks. Firstly, government ownership can arise at the initial shareholding stage, i.e. an entity in which Government has majority shareholding applies for a banking licence. Secondly, Government may set up a bank or nationalize existing bank(s) through an Act of Parliament to further its social and developmental objectives, and thirdly Government could acquire shares in an existing bank to bailing out a failing bank, something quite fashionable these days!

Indeed there is an extensive literature and a lot of debate on the role of government ownership in banking. It would perhaps be useful to briefly touch upon some of the theories that have been put forward on government ownership in banking. The views that have been more frequently associated with state ownership of banks are the social view, the political view and the agency view. The social view suggests that government-owned banks contribute to economic development and improve general welfare (Atkinson and Stiglitz (1980)). The political view highlights the role of politicians in pursuing their personal goals, for example maximizing employment of their electorate or financing favoured enterprises (Shleifer (1998)). The agency view relates to the agency costs in government bureaucracy that may result in managerial inefficiency (Banerjee (1997), Hart, Shleifer and Vishny (1997)).

Various studies have also been conducted to assess the impact of government ownership on banks. Caprio and Martinez (2000) demonstrated that government ownership is significantly and positively associated with increases in bank fragility; Barth, Caprio and Levine (2004) found no conclusive evidence on the relationship between government ownership in banks and the likelihood of a banking crisis. Those inconsistent results seem to suggest that in spite of the implicit deposit protection arising out of government ownership of banks, such banks are not immune from insolvency risk.

Even if the depositors' interests are not jeopardized, it might be at the cost of general public interest.

These observations are meant to show the implications of government ownership of banks on the banking system and on economic growth, and put into perspective the critical importance of regulation and supervision of government-owned banks. In fact, it is rather easy to see that the best way to get the maximum benefit of the government ownership of banks is to subject them to proper regulation and supervision.

The whole issue of regulation and supervision of the public sector banks assumes a special significance only because there is a notion that the regulator may not have de facto independence because the Government, as the shareholder of the regulator, may influence the regulatory process as applied to the banks owned by it (Government). However, if government-owned banks have to function as commercially viable entities, the regulatory process should be able to shield them from being used in a manner detrimental to depositors'/public interest. This would also be necessary from the point of view of creating a level playing field for both government-owned banks and private banks.

The issue of differentiated regulation or regulatory process may take various forms. There could be differences in the way the directors are chosen by Government. If the board of directors of a government-controlled financial institution comprises only representatives of Government, there may be a tendency for the broader goals of Government to override the commercial objectives of the bank and thereby depositors' interest. The objectivity with which the regulator deals with nominations of persons who might not pass the fit and proper test in such cases will be an indicator of the independence of the regulator and the uniformity of supervisory practices.

Another issue, also emanating from the corporate governance perspective, arises from the fact that while in the case of most enterprises, the shareholder gets the prime place among various stakeholders, in the case of a bank, the protection of depositors' interest is the central area of focus. In the case of a public sector bank in which the shareholder/controller of the central bank or the regulator is the sole or majority shareholder, a question arises as to how the regulator (whether the central bank or any other authority) would focus on depositors' interest as opposed to shareholders' interest. One might wonder whether those interests are in conflict. It may not be so all the time but there do exist situations where conflicts might arise. For example, the various principles of prudence that the regulator requires financial institutions to adhere to might curtail the risk-taking ability and thus channel resources into safer, but not so remunerative activities.

A third area of perception of different treatment arises in regard to lending policies. For instance, how would a regulatory authority view a public sector bank lending for socially justifiable objectives that may not be bankable in the strict sense of the term? Would the regulator treat such lending by all banks alike or would it condone the lending by the public sector bank as an extension of the social objectives of the Government?

A fourth aspect could be over regulation because of public accountability associated with government ownership. Thus the government may directly or through the regulator impose too many restrictions on the functioning of a bank owned by it and these could impede the fleet footedness one would expect a commercial entity to display. For example, decisions on write offs, restructuring involving financial sacrifice by the bank may go through the bureaucratic rigmarole leading to delays and failure to clinch critical settlements. Very often government ownership is associated with excessive emphasis on the process without regard to and often to the detriment of the expected outcome. The regulator too may view these passively, if not positively, as all such decisions or indecisions may be justified on the principles of propriety as also because of the comfort of the bail out of the depositor in the event of insolvency.

The Mauritian Experience

Let me now turn to the situation in Mauritius. Before I go into the details of the regulatory and supervisory process, I would like to outline the structure of the financial services industry in the country. The major financial institutions in Mauritius are banks, insurance companies- both general and life, non-bank deposit taking financial institutions, cash dealers comprising money changers and foreign exchange dealers. Banks account for 80% of the country's financial sector. The legal framework for the regulation and supervision of financial institutions is provided mainly by the Banking Act 2004, the Bank of Mauritius Act 2004 and the Financial Services Act 2007.

The Banking Act is administered by the Bank of Mauritius and applies to banks, non-bank deposit taking institutions and the cash dealers while the Financial Services Act is implemented by the Financial Services Commission which oversees all other segments of the financial sector including insurance and leasing. The non-bank deposit taking institutions engaged in leasing business are regulated and supervised by both the Bank of Mauritius and Financial Services Commission, such overlaps not being uncommon in other jurisdictions as well. There are conglomerates having business in segments coming within the purview of both regulators. We have a joint coordination committee to exchange notes and we are moving towards the concept of a lead regulator. The Bank of Mauritius Act basically sets out the responsibilities and functions of the Bank and thus its provisions have a bearing on the Bank's regulatory and supervisory role.

There are in all 19 banks and 13 non-bank deposit taking institutions. Out of these institutions, at present there are two banks and three non-bank deposit taking institutions in which Government has a majority stake - directly or indirectly. The shares in a bank in which the government-controlled development financial institution held a majority stake were divested to private entities recently.

The Government's interest in the five institutions is held in different ways. For instance, in one of the banks Government of Mauritius directly holds a part of the shares while the remaining is held through government-controlled organizations like the Pension Fund etc. In another case, Government stake is partly held by the government-controlled Post Office. One of those banks is listed on the Stock Exchange as well. Two of the non-

banks are subsidiaries of government undertakings. In the final analysis though, the manner in which the Government stake is held may not have any bearing on the control exercised by Government on the entities' management.

All these institutions are regulated and supervised by Bank of Mauritius like any other institution under its purview, as I would explain later on. However, a deposit-taking development financial institution in the public sector is not yet brought within the purview of the Bank.

A uniform regulatory approach

In certain jurisdictions, the legal framework for regulation and supervision makes a distinction on the applicability of certain provisions of the legislation to privately-owned and public sector financial institutions. In India, some of the provisions of the Banking Regulation Act (1949), particularly relating to the appointment of the Chief Executive and directors, are not applicable to the public sector banks. However, in Mauritius, all the provisions of the Banking Act apply in the same manner and to the same extent to both types of institutions. As such the regulatory authority of the Bank of Mauritius applies on all aspects of the functioning of a public sector financial institution as it does to those of similar institutions in the private sector.

Perhaps it would be worthwhile to outline some of the more important aspects to illustrate the uniformity of approach, namely in the areas of licensing, regulatory limits, audit, onsite examination, offsite surveillance and corporate governance.

The Chairman, Chief Executive officer, the directors and other senior officers of a government-owned entity are scrutinized for the fit and proper test in the same manner as a private sector entity, when examining an application for a banking licence. All guidelines apply equally to the public sector banks and the private sector banks. As an example of the extreme application of uniformity, I should cite the fact that lending by a government owned bank to a public sector entity is considered a related party exposure and subject to the discipline governing connected lending.

The Bank of Mauritius vets the credentials of the external auditors of both private sector banks and public sector banks before giving its approval for their appointment. The offsite surveillance and the onsite examination are conducted in the same manner for private sector banks and public sector banks.

Further, the various principles of corporate governance enunciated by the Bank are applied with the same rigour to a public and a private sector financial institution. As such the public sector institutions are required to even constitute Conduct Review Committees to examine related party transactions - which in their case would mainly mean credit facilities to or transactions with other public sector enterprises. Given the importance of corporate governance in banking institutions, the independent functioning of the Board of Directors cannot be overemphasized. Our Guideline on Corporate Governance requires the Board of a banking institution to have a healthy proportion of independent directors and encourages a minimum of 40 per cent. The Board should also

put in place an appropriate structure and procedures to achieve and project its independence. The directors of the Board should meet the 'fit and proper' criteria at the outset and on an ongoing basis. These requirements have contributed to ensure that political interests do not take precedence over the bank's commercial interests.

As such the uniformity, de jure enshrined in the legal framework, is de facto extended to the supervisory process as well.

Performance of Banks in Mauritius

Before moving over to my concluding remarks, I would briefly deal with the performance of the banking sector in Mauritius. It is a matter of great comfort that of late the sector has been witnessing robust growth in most parameters coupled with a decline in the ratio of non-performing loans to total advances. The deposits of banks increased from MUR435 billion to MUR537 billion between end June 2007 and end June 2008; while advances grew from MUR305 billion to MUR356 billion during the same period. The pre-tax profit increased from MUR9.9 billion for the year ended March 2007 to MUR11.1 billion for the year ended March 2008. Non performing loans represented 2.4 per cent of the gross advances at the end of June 2008. There are 186 branches and 382 ATMs in the country and on an average more than one electronic card is in use per adult population.

The public sector banks have also turned in good performance. In fact one of the two public sector banks is the second largest bank in the country. The return on assets for the year ended March 2008 of the two public sector banks was 2.84 per cent and 0.74 per cent as against the average of 1.7 per cent for the industry. Similarly the return on equity of one of them was 20.93 per cent as against the industry average of 23.26 per cent.

It is therefore evident that the banking sector, including the entities in which Government has controlling interest, has performed well. I must also assure you that they are resilient enough, thus vindicating our faith in applying a uniform legal, regulatory and supervisory framework.

Let me make one final comment on the performance of public sector banks. There is a general perception that public sector institutions are not as innovative as private sector entities. Well this may not always be true. In fact one of the public sector banks in Mauritius won the Euromoney and The Banker Award for the "Best Bank in Mauritius" on a number of occasions.

Concluding Remarks

It is undoubtedly a good practice not to let the ownership structure influence the regulatory and supervisory process. This has two positive effects. First, the public sector entity functions like any other commercial organization within the risk management guidelines issued by the regulator. Secondly, the privately owned entities in the sector would not feel discriminated. This is necessary to attract private capital in the sector.

Obviously, a regulatory process that favours one segment vis-à-vis the other within the same industry would not be conducive for fostering healthy competition.

Having said all this, there is an important issue, which we cannot lose sight of. One of the major comforts that a regulator seeks as part of its depositor interest centric function is the reputation and the financial strength of the promoter. From this perspective the nation's sovereign as the main shareholder gives a lot of comfort to the regulator. The recent events, even if one may consider them exceptional, demonstrated that those perceived as invincible also do not have the financial muscle of the sovereign. However, the regulator should not bask under the comfort of the sovereign being the promoter nor should it let any instruments of Government abuse this comfort.

The punch line, if one has to sum up the whole gamut of issues relating to regulation and supervision of public sector banks, could read - Feel comfortable, but don't relax!

Thank you all for your attention.