BANK OF MAURITIUS

FINANCIAL STABILITY REPORT

August 2010 | Issue No. 5

The Financial Stability Report was prepared by the Financial Stability Unit of the Bank

Editorial Team

Mrs V Soyjaudah	Chief - Financial Stability Unit
Mr K Pitteea	Analyst - Financial Stability Unit
Mr D Thakoor	Head - MCIB and Payment Systems
Mr B Kwok	Senior Bank Examiner - Off-Site Division, Supervision

Contributions were received from various Divisions of the Bank
Data support was received from the Off-Site Division, Supervision

Comments and Suggestions:

Mr H O Jankee	Chief Economist
Mr N S Vishwanathan	Director Supervision
Mr V M Punchoo	Head - Economic Analysis Division
Mr N Kowlessur	Chief - Statistics Division

The Report was reviewed by the Bank's Publication Review Committee

The Bank welcomes any comments and suggestions on this publication
You may send your emails to fsu@bom.intnet.mu

This Report refers to information as at 30 June 2010, unless otherwise stated.

Financial Stability Report August 2010 | Issue No. 5

Design, Layout and Printing by Lovells Printing and Artwork Ltd

ISBN: 978-99903-981-6-8

Contents

List of Charts

List of Tables

List of Boxes

List of Acronyms

BIA	Basic Indicator Approach
CAR	Capital Adequacy Ratio
CDS	Credit Default Swap
CMPHS	Continuous Multipurpose Household Survey
CNP	Contribution Network Project
CRR	Cash Reserve Ratio
CSO	Central Statistics Office
FSIs	Financial Soundness Indicators
GBLH	Global Business Licence Holders
GDFCF	Gross Domestic Fixed Capital Formation
GFSR	Global Financial Stability Report
HHI	Herfindahl-Hirschmann Index
IMF	International Monetary Fund
MACSS	Mauritius Automated Clearing and Settlement System
MCIB	Mauritius Credit Information Bureau
MERI	Mauritius Exchange Rate Index
MNS	Mauritius Network Services
MSCI	Morgan Stanley Capital Index
MTSP	Mechanism for Transitional Support for the Private Sector
NBDT	Non-Bank Deposit-Taking
NBDTIs	Non-Bank Deposit Taking Institutions
NPL	Non-performing Loans
PIGS	Portugal, Italy Greece and Spain
PLACH	Port-Louis Automated Clearing House
ROA	Return on Equity
ROE	Return on Assets
RTGS	Real Time Gross Settlement
SEM	Stock Exchange of Mauritius
WAI	Weighted Average Interbank
WEO	World Economic Outlook

OVERVIEW

Since the last Financial Stability Report, the global economic recovery proceeded further and risks emanating from the fallout of the global financial crisis to global financial stability have eased. World growth for 2010, as forecast by the International Monetary Fund (IMF), has been revised upwards to 4.6 per cent in its July 2010 World Economic Outlook (WEO) Update, reflecting stronger activity in the first half of the year. However, concerns about sustainability of the strength of the global economic recovery arose as new risks related to the sovereign debt in parts of Europe have materialised in late April and early May and have spread to the financial sector there. So far, there is little evidence of negative spillovers to real economic activity at a global level. Nevertheless, the economic outlook is clouded as there are increasing concerns on risks spilling over to other regions and to the real economy. The massive bailout fund initiated jointly by the European Union (EU) and the IMF helped to comfort markets to some extent. Further, results of the recent stress test confirmed the overall resilience of the EU banking and constituted an important step forward in restoring market confidence. Nevertheless, concerns still remain.

Against this backdrop, global stability gains are threatened and the Global Financial Stability Report Market (GFSR) Update of the IMF in July 2010 acknowledged that the progress towards financial stability has recently suffered a setback.

In Mauritius, the economy continued to remain stable notwithstanding below trend growth in main economic sectors. After registering contractions in 2009, key exports sectors, which are largely dependent on economic conditions in Europe, are forecast to record positive growth rates in 2010. Overall, the economy is expected to perform better this year compared to the 3.1 per cent growth registered in 2009. Unlike several countries which faced massive job losses, unemployment level in Mauritius did not give rise to any stability concern. The unemployment rate was 7.3 per cent in 2009 and is expected to reach 7.5 per cent in 2010. Growth of household indebtedness with banks maintained its upward trend and outpaced GDP growth as from late 2008, resulting in a widening of the gap between them. Monitoring of the evolution of these two variables as well as the ratio of household debt with banks to GDP would provide a better picture on whether there are potential increases in household vulnerabilities arising therefrom.

The current account deficit, which narrowed in 2009, started to widen again in the first quarter of 2010 as a result of a more pronounced deficit in the merchandise trade which outweighed the surpluses registered on the services, income and current transfers accounts. The level of net international reserves of the country represented above 10 months of imports, thus providing a comfortable cushion to absorb external shocks.

The Bank adopted the appropriate policy measures to maintain price stability and ensure the overall stability and soundness of the financial system. The key Repo Rate was thus kept unchanged at 5.75 per cent since March 2009. The foreign currency swap scheme, introduced in December 2009 to address volatility in the domestic spot foreign exchange market, achieved its objective and some orderliness in the functioning of the market was restored. The weakness of the euro in international markets was reflected in the domestic foreign exchange market and this led to some sectoral concerns. However, none of those concerns have so far jeopardised the overall performance of the economy.

The financial sector has remained relatively healthy and continued to support the domestic economic recovery. Banks in Mauritius are well capitalised with capital adequacy ratios well above the regulatory minimum of 10 per cent and profitability levels are considered reasonable. Risks in the banking sector were well managed and kept within the prudential limits prescribed by the Bank. Exposures of banks to the PIGS (Portugal, Italy, Greece and Spain) countries, and to the rest of euro area, were low and did not create any cause for concern.

Liquidity levels in the banking system remained high and were further amplified by subdued credit growth and lower risk appetite by banks due to the nebulous recovery. Yields at the shorter end of the spectrum of Government securities dwindled and fell outside the lower bound corridor of the key Repo Rate, leading to a disconnect with the signalling rate. As this is not conducive to effective monetary policy, the Bank of Mauritius raised the Cash Reserve Ratio (CRR) from 4.5 per cent to 5.0 per cent, in June 2010, with a view to bringing the liquidity overhang to reasonable levels.

The insurance sector, which witnessed a major merger operation between two large companies, continued to remain sound and profitable. Non-Bank Deposit-Taking sector also registered an overall sound performance.

The payment systems performed well without any major technical incidents and met the requirements of the expected target, in terms of volume and value of payment processed.

The Bank, which has regulatory and supervisory purview of only depository institutions, is required under the Bank of Mauritius Act (2004) to, *inter alia*, ensure the stability and soundness of the financial system. Financial Soundness Indicators (FSIs) for banks, computed over the last five quarters ended March 2010, did not indicate any vulnerability in the banking system that warranted remedial action by the Bank. However, the computation of the FSIs for the other segments of the financial sector would complement the Bank's effort to identify further sources of risks and vulnerabilities in the financial system and would enhance the overall macroprudential approach to financial sector surveillance in Mauritius.

1 Macroeconomic Environment

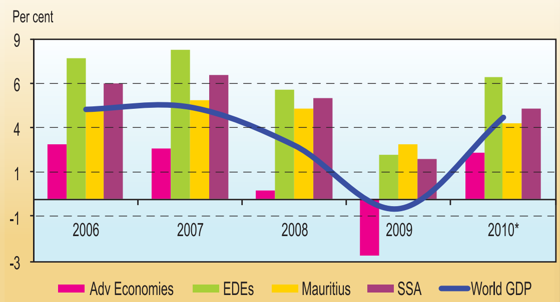
1.1 GLOBAL ENVIRONMENT

1.1.1 RISKS AND OUTLOOK FOR THE GLOBAL ENVIRONMENT

Risks emanating from the fallout of the global financial crisis to global financial stability have eased as global economic recovery continued to gain momentum since the turnaround in the second half of 2009. However, the eruption of risks related to sovereign debt, especially in the euro area, may threaten global stability gains. In its July 2010 WEO Update, the IMF forecast world growth at 4.6 per cent in 2010, following a 0.6 per cent contraction in 2009 (see Chart 1.1). Driven to a large extent by strong growth in emerging and developing economies, especially in emerging Asia, the recovery was fuelled by a turn in inventory cycle, ongoing fiscal stimulus, resumption of capital flows and recovery of global trade. Growth in emerging economies was further enhanced by buoyant domestic demand, rising confidence and positive wealth effects amid strong rallies in equity markets, until recently.

However, though the economic recovery has progressed, it still remained uneven and fragile. The path to a self-sustaining recovery is not yet clearly shaped, at least in advanced economies given that recovery in these countries was driven by policy stimulus. Many countries which resorted to large fiscal outlays to stabilise domestic demand and support the financial system now face increasing volumes of sovereign debt to be issued. Thus, there are increasing concerns on the sustainability of these debts apart from the crowding out effect. The increase in financing risks has led to a steady rise in credit default swap (CDS) spreads and yields on long-term government bonds issued by indebted countries. The timid rise of confidence in markets was dented by the European sovereign debt concerns, centered on Greece. A massive bailout fund of euro 750 billion (USD 1 trillion) that could rescue any member of Europe's currency union from default, set up jointly by the EU and the IMF helped to comfort markets to some extent, but stress remains.

Chart 1.1: GDP Growth – Mauritius and the World



Source: IMF and CSO, Government of Mauritius
**Estimate*

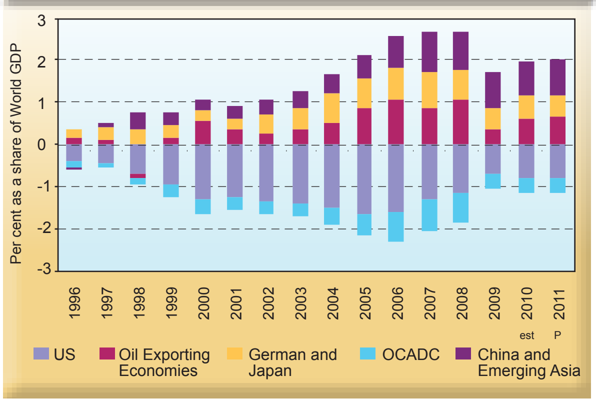
The outlook for global economic activity remains uncertain. Downside risks related to the growth of public debt have become more apparent although various other risks have receded. While the US economy has shown greater signs of improvement, recovery of the world economy will depend on how Europe manages its growth and public debt concerns. There are growing fears that implementation of announced austerity measures in Europe will impact adversely on the already weak growth in Europe. According to the July 2010 WEO Update of the IMF, downside risks to global growth have risen sharply amid renewed financial turbulence. Nonetheless, emerging and developing economies will continue to drive world growth and will be crucial to global financial and economic stability.

Global Imbalances

The global financial crisis and ensuing economic slowdown brought world trade to an unprecedented low level that in turn resulted in significant narrowing of global imbalances in 2009. China's current account surplus as a percentage of GDP fell from 9.5 per cent in 2008 to 5.7 per cent in 2009 while US current account deficit as a percentage of GDP decreased from 5.0 per cent in 2008 to 3.0 per cent in 2009. The decline in the US current account deficit was accompanied by a rise in US household savings reflecting weak private consumption in the US.

The current account deficit of the US, as a percentage of world GDP, fell from 1.2 per cent in 2008 to 0.7 per cent in 2009. Simultaneously, China and Emerging Asia's current account surplus as a percentage of world GDP fell by 0.05 percentage point. Oil exporting countries' current account surplus as a percentage of world GDP fell by a larger 0.74 percentage point not only as a result of reduced world trade but also due to significantly lower oil prices.

Chart 1.2: Current Account Balances for Selected Countries



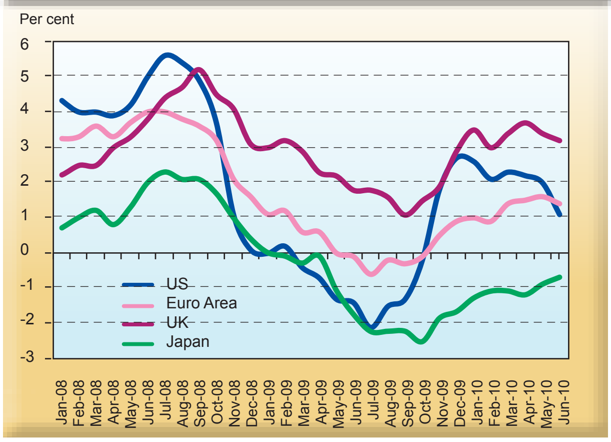
Source IMF
Note: OCADC includes Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Slovakia Republic, Slovenia, Spain, Turkey and United Kingdom.

However, when the global recovery began by mid-2009 and a rebound in oil prices followed, the imbalances started to widen again. According to the IMF, global imbalances will accentuate in 2010 as trade and international financial flows are forecast to pick up further and commodity prices to stabilise at higher levels.

Global Inflation Outlook

Global inflation remained subdued in the second half of 2009 and was even into negative territory in some advanced countries (see Chart 1.3). According to the IMF, the still low level of capacity utilisation and output gap coupled with well-anchored inflation expectations are likely to keep inflation low. However, with the rebound in commodity prices from their lows of late 2008 and early 2009, better prospects for the global economy and base effects given massive slump in prices in the second half of 2008, inflation in most economies has moved to positive territory. Nevertheless, overall inflation rates remain low and core inflation rates continue to recede in major industrial countries. Rising inflation is unlikely to be a concern in the near future for the United States, the euro zone and Japan. In the developing world, inflationary pressures are gaining momentum on the back of increased capital flows, surging asset prices and lower excess capacity.

Chart 1.3: Inflation in Advanced Economies



Against this backdrop, monetary policy in advanced economies remains accommodative. Furthermore, the exit strategies from emergency supports may be delayed in some advanced economies amid renewed uncertainties. In emerging economies, policymakers have begun, or are considering exiting the easing cycle.

Sovereign Debt

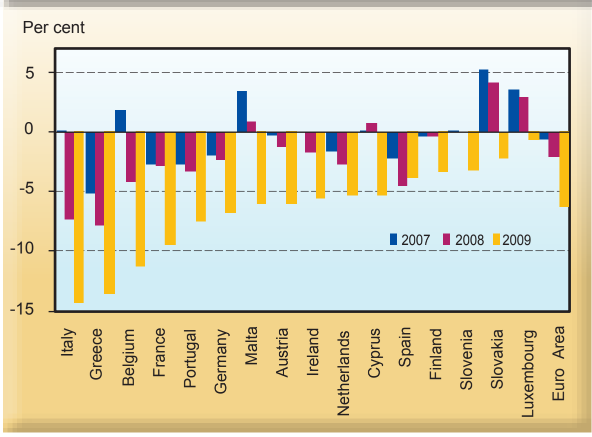
Governments around the world increased spending significantly to help combat the global crisis. Consequently, fiscal deficits and sovereign debt increased substantially. Overall fiscal balance for the world deteriorated from -0.3 per cent of GDP in 2007 to -6.7 per cent of GDP in 2009. Advanced economies registered a 7.7 percentage points increase in the fiscal deficit while emerging economies fared relatively better with only 4.9 percentage points increase in their fiscal deficit over the same period.

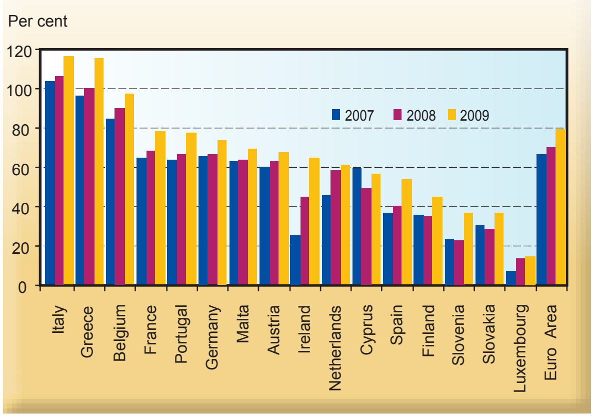
The IMF projects that public debt as a percentage of GDP in the advanced economies will rise by over 35 percentage points between end-2007 (pre-crisis) and end-2015, to reach 110 per cent. A large part of the increase reflects revenue losses arising from the crisis and only one-tenth would arise from anti-crisis stimulus measures. Compared to many countries in the world, Mauritius holds a relatively strong fiscal position with public debt remaining around the prudent reference level of 60 per cent of GDP and fiscal deficit for the six months ended December 2009 at 3.5 per cent of GDP.

Box I:
Euro Area Sovereign Debt Concerns

Expansionary fiscal policies in the wake of the global financial crisis and economic slowdown have been one of the major factors stabilising the global economy. However, the deterioration in fiscal balances and rapid increases in public debt of many advanced economies have raised sovereign debt sustainability concerns in the market, especially in Europe. In the wake of increased focus on Greece's fiscal woes, other countries in the euro area came under closer market scrutiny. Indeed, in 2009, budget deficits for most euro area member countries have more than doubled compared to 2008 (see Chart 1.4).

Chart 1.4: Budget Deficit as a Percentage of GDP and Public Debt in the Euro Area





Source: Eurostat

As a result of the rising fiscal deficit, the large volumes of sovereign debt to be issued at global level in the near term may stress wholesale debt markets and if it is not accompanied by a rise in global savings, borrowing cost of private borrowers would increase. This can further undermine systemic stability as some segments of banking systems in advanced economies are already under considerable strain. Additionally, rising yields and debt levels can mutually reinforce each other.

Concerns about the sustainability of fiscal deficits and the growing debt levels in advanced countries resulted in a significant increase in activity in the CDS market for developed countries' sovereign debts. While measures of sovereign risk have generally declined from their peak in 2009, CDS spread for Greek government debt and other highly indebted euro area countries increased drastically, especially since the start of 2010. These developments reflect increasing nervousness in markets and uncertainty about the sustainability of public debt given the current high levels in these countries and increased reliance on external borrowings.

Fiscal austerity measures have been initiated by several governments in an attempt to restore public debt to more sustainable levels. However, this may impact on consumer and business sentiments in the short-to-medium term and thus increase downside risk to growth. Policy priorities point to the need for fiscal consolidation to mitigate medium-term risks. Nonetheless policymakers are mindful that any new fiscal path may have overlapping generations structural implications. According to the IMF, most advanced economies should embark on fiscal consolidation in 2011 if macroeconomic developments proceed as expected. The European Stabilisation Mechanism and the successful implementation of well co-ordinated policies are projected to rebuild confidence and preserve financial stability in the euro area.

1.1.2 KEY DEVELOPMENTS IN THE INTERNATIONAL FINANCIAL ENVIRONMENT

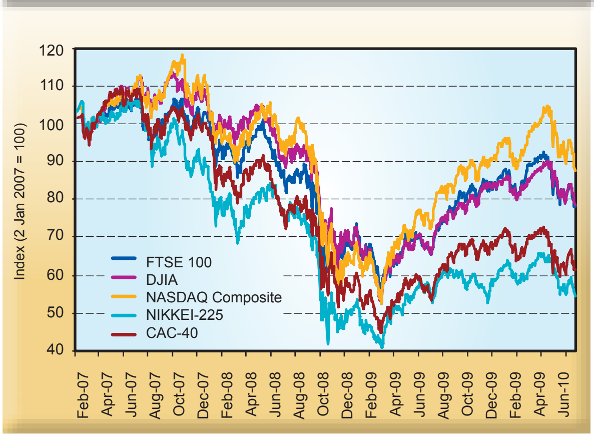
Confidence in the Global Financial System

The recent turbulence in financial markets, especially in Europe, reflected a drop in confidence casting a cloud over the global outlook. Market and liquidity risks, which were declining until then, increased and interbank funding strains caused the longer-term LIBOR-overnight index swap spreads to widen again.

Evolution of Major Stock Markets

The setback in investor confidence led to the emergence of volatility in global equity markets. Equity indices moved lower from mid-January to mid-February 2010 but recovered thereafter, on expectation that policymakers in Europe would act in concert to prevent spreading of sovereign debt woes (see Chart 1.5). However, the situation in Europe deteriorated further and fears that sovereign risks could spiral across borders and to the financial system and affect the real economy led to heightened risk aversion and increased volatility in the market.

Chart 1.5: Equity Indices in Major Economies

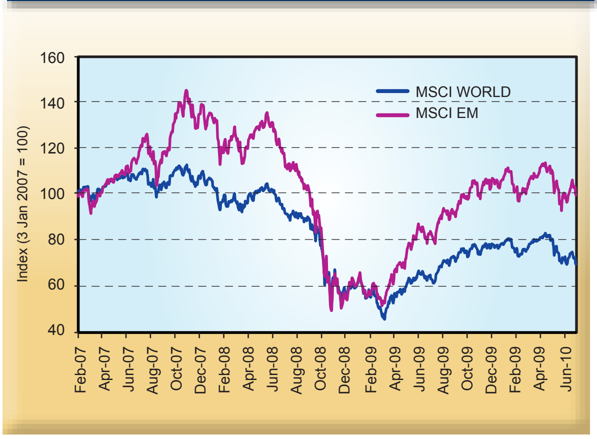


Source: Reuters

From their lows of March 2009, the NASDAQ Composite and DJIA moved up by 66.3 per cent and 49.3 per cent, respectively, by end-June 2010, compared to the FTSE 100 and the NIKKEI-225 which gained 40.0 per cent and 33.0 per cent, respectively. However, in the first six months of 2010, major equity indices, on average, fell by more than 10 per cent, following sharp declines in May 2010.

Equities in emerging markets were also affected by the broad-based sell-offs by investors but continued to outperform mature equity markets. China and India were among the two countries which recorded a rapid rise in asset prices. Over the period March 2009 to June 2010, the MSCI Emerging Markets index gained 89.2 per cent and this was 38.0 percentage points higher than the increase in the MSCI World index. In the first half of 2010, however, both indices fell by more than 10 per cent, on average. Movements of the MSCI World and the MSCI Emerging Markets indices are shown in Chart 1.6.

Chart 1.6: MSCI World and Emerging Markets

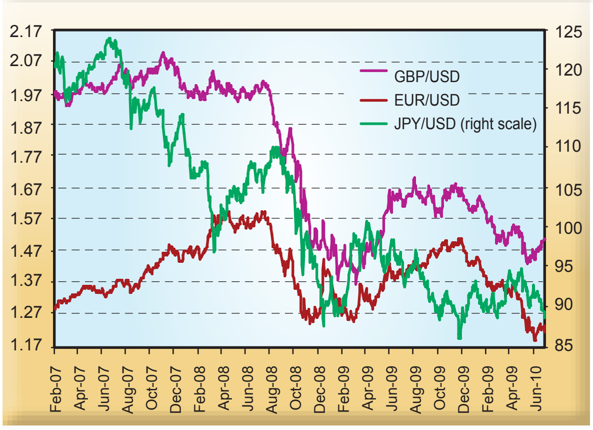


Source: Reuters

Evolution of Major Currencies

In the global currency markets, the euro fell significantly against other major currencies in the first six months of 2010 against the backdrop of increased financial risks related to the debt woes of euro zone countries. The downgrade of the credit rating of several European countries weighed heavily on the euro and pushed the US dollar pass through a four-year high of 1.19 in June 2010. The greenback was also supported by improvement in the US economy, in spite of the Federal Reserve's stance to keep rates exceptionally low for an extended period of time. Nonetheless, towards the end of June, the euro recouped some losses as solid demand at European debt auctions eased worries to some extent while soft US economic data led the US dollar to pare some gains.

Chart 1.7: Evolution of Major Currencies



Source: Reuters

The Pound sterling continued to be plagued by a fragile UK economy and political uncertainty, until recently.[1] Moreover, the record low interest rate, which is likely to stay for some time and the UK's mounting fiscal deficit, also weighed on the Pound. However, some tough fiscal measures announced lately by the new Government proved to be positive for the UK currency.

The Japanese Yen depreciated against the US dollar on reduced risk aversion as world economic recovery proceeded better than expected but turned to an appreciating trend as uncertainties engulfed markets in May-June 2010.

1.1.3 INTERNATIONAL INITIATIVES

A clearer framework for indentifying risks to financial stability is emerging at the international level. International standard setters are in the process of revising their existing standards and codes with a view to improving the resilience of the financial system.

With regard to financial regulation, reforms aimed at creating and fostering a strong regulatory framework which contributes towards stability of the financial system and supports steady and sustainable economic growth are on the way.

In the US, a Financial Services Oversight Council (FSOC) has been established to oversee systemic risk in the financial system while in the European Union, a European Systemic Risk Board (ESRB) has been set up to identify system-wide risks for the benefit of regulatory and supervisory policies.

The IMF has recently calibrated capital requirements to internalise the contribution of an institution (or group of institutions) to systemic risk.[2] Further, at its July 2010 meeting, the oversight body of the Basel Committee on Banking Supervision took the commitment to (i) increase the quality, quantity and international consistency of capital, (ii) strengthen liquidity standards, (iii) discourage excessive leverage and risk taking and (iv) reduce procyclicality.

1.1.4 RISKS TO GLOBAL FINANCIAL STABILITY

Global financial stability has recently experienced a setback, despite generally improved economic conditions. Sovereign risks which have materialised in parts of Europe spread to the financial sector there, causing financial risks to rise. There are increasing concerns that sovereign and banking risks in the euro area which threaten stability gains, may spill over to other regions without continued and concerted attention. Uncertainties are building up about policy responses as the potential downside economic risks and strains in the market have complicated exit strategies from the extraordinary fiscal and monetary policies.

Though the global economic recovery continued in the first half of 2010, downside risk to growth has increased substantially. The recent financial turbulence, in the euro area has, increased the possibility of adverse feedback loops to the economy. The IMF forecast that recovery will continue in the second half of 2010 and the year 2011 but in a recent Update, it stated that the sustainability of the strength of the recovery would depend on the successful implementation of policies to rebuild confidence and stability in the euro area.

1 *General elections were held in the UK on the 6th of May 2010 and a post-electoral coalition government was formed.*

2 *See IMF Global Financial Stability Report April 2010.*

The IMF pointed out that concerns surrounding the final set of regulatory reforms to render the global financial system safer, makes it difficult for banks to take business decisions about various activities and may limit their willingness to lend. Thus, despite low interest rates, credit conditions, especially in the advanced economies, could pose a threat to the growth outlook, as lending standards would remain tight. In addition, the cleansing of banks' balance sheets over the past three years is still unfinished and this highlights remaining pockets of vulnerability.

On a positive note, results of the recent stress test carried on European banks confirmed the overall resilience of the EU banking system to negative macroeconomic and financial shocks and constituted an important step forward in restoring market confidence.

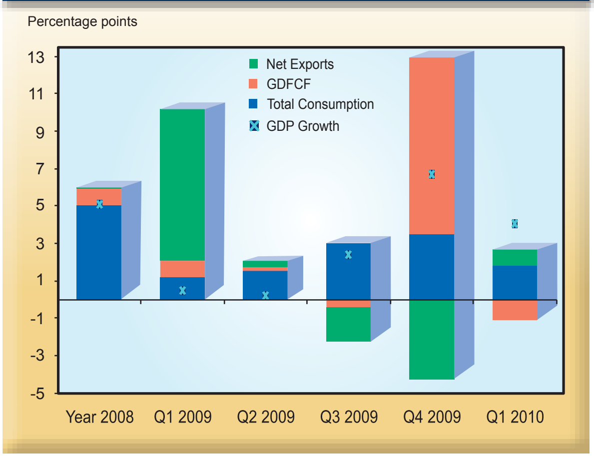
1.2 THE DOMESTIC ENVIRONMENT

1.2.1 GROWTH OUTLOOK AND RISKS

Despite that lower year-on-year growth rates were recorded in the first and second quarters of 2009, the domestic economy remained stable during that year and in the first quarter of 2010. Activity in the domestic economy continued to improve as from the second semester of 2009 and was driven mostly by domestic demand and GDFCF with the front-loading of major infrastructural projects, and the fiscal stimulus being maintained. In the first quarter of 2010, growth was sustained mainly by the consumption component (see Chart 1.8).

Recovery in our main exports markets as from the second half of 2009 impacted positively on the domestic economy, particularly the export-led sectors. However, with the recent financial turbulence in Europe, one of our main export destinations, some concerns remain. Overall, the economy is estimated to have grown by 3.1 per cent in 2009, lower than the 5.1 per cent growth registered in 2008, largely driven by the weak performance of the external-led sectors. Quarter-on-quarter, seasonally adjusted GDP growth showed continued improvement in three successive quarters to December 2009, following a contraction in the first quarter of 2009. According to the Central Statistics Office (CSO), growth rate in first quarter of 2010 is estimated at 3.6 per cent compared to 1.1 per cent in the corresponding period of 2009. However, on a seasonally-adjusted basis a contraction of 4.0 per cent is estimated in the first quarter of 2010.

Chart 1.8: Contribution to GDP Growth by Main Expenditure Components



Source: CSO, Government of Mauritius

The non-sugarcane agricultural and the construction sectors are estimated to have recorded negative growth rates in the first quarter of 2010. Estimates for the external-led sectors, namely tourism and textiles, showed their second consecutive positive growth after several quarters of contraction. While the growth estimates for the textile sector remained weak at 1.0 per cent, the tourism sector experienced a robust growth of 7.2 per cent. Growth in the 'financial intermediation' and 'real estate, renting and business activities' sectors remained firm.

Risks to Growth

In 2010, the economy is forecast to grow by 4.2 per cent but downside risks remain due to the economic conditions in Europe. The construction, tourism, transport and communication and financial intermediation sectors are expected to be the main drivers of growth in 2010, with projected growth rates for these sectors ranging between 5.0 per cent and 5.9 per cent. These projections nonetheless depend on the assumption that domestic activity remains well-supported with several public sector investment projects being implemented this year. Bottlenecks in project implementation may unfavourably impact on growth.

Several risks emanating from the external front may spill over to the domestic economy. As economic conditions in Europe remain fragile, consumer spending there may remain subdued leading to lower demand for our exports of both goods and services. However, the Economic Restructuring and Competiveness Programme (ERCP), introduced recently, may ease those concerns to some extent.

To complement Government's efforts, operators, especially in the export-dependent sectors, may envisage diversification of their exports destinations. In addition, they may also consider a higher retention of profits to better cope in times of stress.

1.2.2 INFLATION RISKS AND MONETARY POLICY

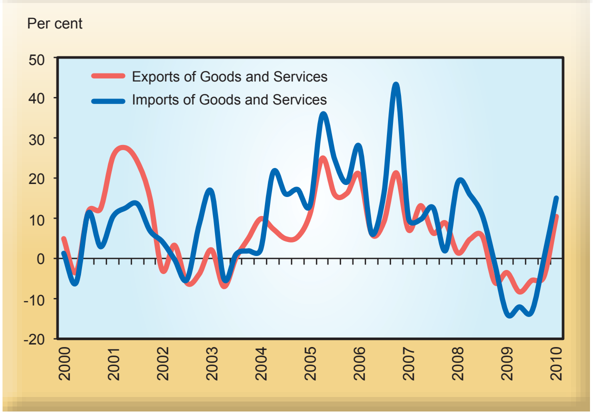
The key Repo Rate has been kept unchanged at 5.75 per cent since March 2009, and this policy stance contributed to maintain the overall stability of the economy. Although inflation outlook is favourable in the short term, potential inflationary risks over the medium to long-term remain.

1.2.3 RISKS FROM THE EXTERNAL SECTOR

The current account deficit narrowed to 7.9 per cent of GDP in 2009 from 10.4 per cent in 2008 on account of declining merchandise trade deficit. In fact, lower domestic economic activity led to a slowdown in import demand which outpaced the setback in exports. However, provisional estimates for the first quarter of 2010 pointed to a widening current account deficit in comparison with the first quarter of 2009. This was largely driven by a more pronounced deficit in the merchandise trade account, which outweighed the surpluses registered on the services, income and current transfers accounts.

Compared with the first three months of 2009, net inflows in the capital and financial account fell by more than 65 per cent and net foreign direct investment inflows slowed by 15.5 per cent in the first quarter of 2010. Net outflows on portfolio investment increased during that same period. The overall balance of payments for the first quarter of 2010 recorded a deficit of Rs 315 million against a surplus of Rs 154 million in the corresponding quarter of 2009.

Chart 1.9: Growth of Exports and Imports (Year-on-Year)



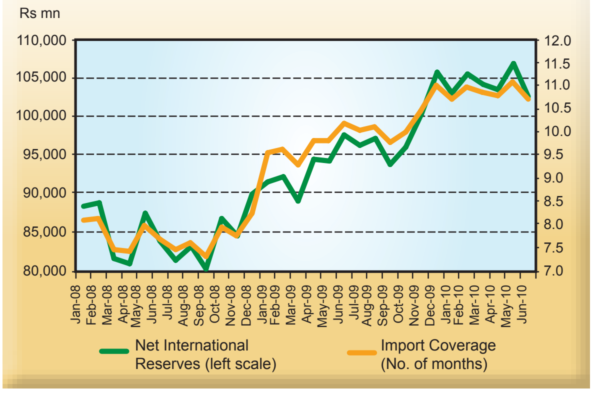
Source: CSO, Government of Mauritius

The current account deficit as a percentage of GDP is expected to widen further to 8.9 percent in 2010 from 7.9 per cent in 2009, mostly on account of deteriorating merchandise trade deficit with import growth expected to stay above exports growth. The capital and financial account, inclusive of reserve assets, is projected to record higher net inflows in 2010.

Reserves Adequacy

Adequacy of reserves is an important parameter in gauging the country's ability to absorb external shocks since it provides confidence in the authorities' commitment to the timely discharge of external obligations and to support the value of the domestic currency. The level of net international reserves of the country at end-June 2010 stood at Rs 102,773 million, which represented above 10 months of imports thus providing a comfortable cushion to absorb external shocks.

Chart 1.10: Net International Reserves and Import Coverage



1.2.4 RISKS FROM THE FISCAL SECTOR

The budget deficit for the budgetary central government sector has been projected at 4.5 per cent of GDP for fiscal year 2010 but it is expected to come down to 3.9 per cent in 2011 and to 3.0 per cent in 2012 on the back of further fiscal consolidation. Tax reforms in recent years have focused on improving tax buoyancy and revenue collection while the abolition of a range of tax deductions has reduced distortions in the economy. Should such types of fiscal reforms be sustained, government finances would improve further with a positive impact on financial stability.

The government has so far benefited from the low interest rate environment, both local and international, but with the expected rise in interest rates in the years ahead in the wake of economic recovery, higher debt servicing could become an added burden, given that projected interest payments currently accounts for around 15 per cent of Government expenditure. In the short-to-medium term, the persistence of growth below trend levels could exacerbate fiscal imbalances and may raise stability concerns.

Public sector debt, comprising debt of Government and public enterprises, as a percentage of GDP at market prices went up to 61.7 per cent as at end-December 2009, breaching for the first time the ceiling of 60 per cent prescribed in the Public Debt Management Act 2008. As at end-June 2010, however, the ratio was within the threshold of 60 per cent and stood at 59.1 per cent.

From the trough of 43.3 per cent at end-September 2009, the share of short-term domestic debt in total budgetary central Government debt followed a general upward trend, peaking at 48.3 per cent at end-May 2010 and going down to 45.8 per cent at end-June 2010. The concentration of domestic debt of Government at the shorter end is a cause for concern, especially in relation to interest rate and roll-over risks. It is, however, expected that with the issuance of longer term Government securities, which started in July 2010, and further disbursements of foreign loans, the above ratio would be coming down gradually. The share of external public sector debt in total public sector debt, which stood at 16.0 per cent as at end-June 2010, could be considered as reasonable, especially in light of the external debt service ratio[3] being estimated at 3.7 per cent in 2010. The level of external public sector debt therefore does not presently pose any risk to financial stability.

1.2.5 HOUSEHOLD SECTOR

The recent financial crisis has shown that household financial fragility may have important financial stability implications as, despite the existence of collaterals and lenders legal protection, personal bankruptcy is costly for lenders. In Mauritius, household assets are dominated by non-financial assets in the form of property such as houses, buildings and land, followed by financial assets in the form of bank deposits and placements with non-bank financial institutions. Government has implemented various policies to promote home ownership and according to the CSO, more than 80 per cent of households are presently homeowners. Preliminary results of the CMPHS conducted by the CSO for the first quarter of 2010 indicated that 40.0 per cent of households borrow for housing purposes.

Household indebtedness, as estimated from credit by depository corporations, insurance and leasing companies, accounted for 25.3 per cent of GDP at end-December 2009, up from 24.4 per cent a year earlier.

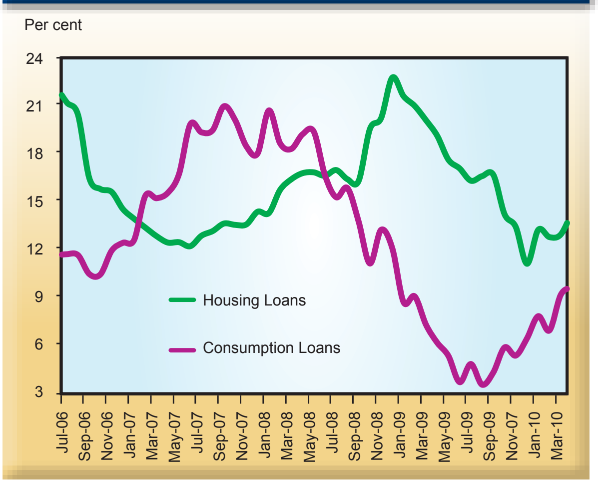
3 The debt service ratio is defined as capital and interest payments on external obligations of Government, public corporations and the private sector as a percentage of exports of goods and non-factor services.

Due to data constraints the analysis that follows is based on household indebtedness to banks only. The banking sector, with its extensive branch network, is the largest provider of household credit. Unlike the tendency in developed and emerging economies where there have been important shifts towards household financing, in Mauritius, loans granted by banks to households remained around 20 per cent of total loans.

In terms of composition, household debt changed only slightly over the last five years with the largest share represented by housing loans. At end-March 2010, housing finance accounted for 56.9 per cent of total household loans extended by banks while the remaining share was for consumption purposes, which also include loans for the purchase of assets. Within consumption loans, credit card advances amounted to 8.5 per cent. This is indicative that indebtedness of households is towards building of assets rather than consumption.

As economic activity slowed down and uncertainty increased about future incomes, growth of housing and consumption loans decelerated. Mirroring improved economic activity as from the second half of 2009, growth of consumption loans picked up as from August 2009 while growth of housing loans improved only as from December 2009. In the first three months of 2010, growth of housing and consumption loans averaged 12.9 per cent and 7.9 per cent, respectively, compared to 20.9 per cent and 8.3 per cent, respectively, in the corresponding period, a year earlier.

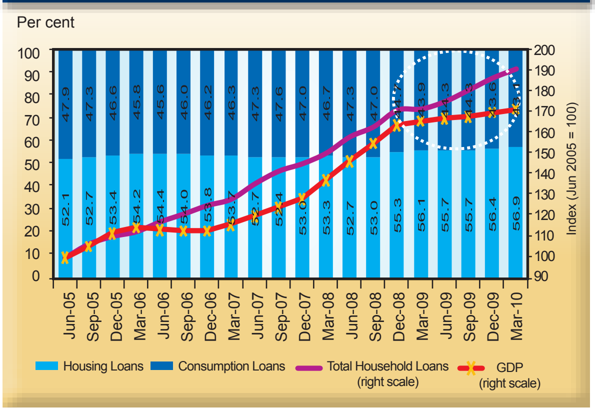
Chart 1.11: Year-on-Year Growth of Housing and Consumption Loans



Exposure of households to foreign currency borrowings may pose risks to financial stability due to exchange rate volatilities, thus affecting the servicing abilities of households. In Mauritius, loans in foreign currencies to households are granted for housing and consumption purposes. At end-March 2010, the share of these loans in total household loans was 2.0 per cent. Foreign exchange risk arising therefrom is however low as banks ensure that such borrowers have foreign source revenues.

Household debt can create vulnerabilities if such debts reach an unsustainable level. Over the past years, household indebtedness with banks has grown almost in tandem with GDP. However, as depicted in Chart 1.12, as from late 2008, GDP grew at a slower rate compared to growth of household indebtedness with banks and this resulted in a widening of the gap between them. As a share of GDP, household debt with banks stood at 15.9 per cent at end-March 2010 compared to 14.8 per cent in the corresponding period of 2009.

Chart 1.12: Evolution of Household Debt with Banks and GDP



Monitoring of the evolution of these two variables as well as the ratio of household debt to GDP would provide a better picture on whether there are potential increases in household vulnerabilities arising therefrom. Closer attention may be required on early warning indicators of asset quality of these exposures in the coming quarters. In addition, further studies may be carried out to determine whether a growing ratio of household debt to GDP will impact on national savings and raise stability concerns.

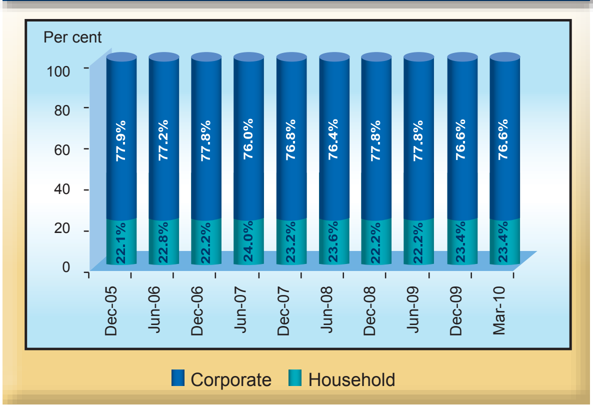
1.2.6 CORPORATE SECTOR

The global financial crisis has highlighted the importance of a financially strong corporate sector in the stability of the financial system, especially with increased connectedness. In the wake of the global crisis, the Government of Mauritius initiated fiscal measures with a view to protecting employment and support companies in distress. Funds granted under the Mechanism for Transitional Support to the Private Sector were availed by 15 companies operating mainly in the export-led sectors. Corporates in Mauritius generally remained resilient to the economic slowdown despite a decline in activities and did not face any major funding hardships.

Due to data limitations, the analysis is based on corporate sector indebtedness with banks only.

The corporate sector is the largest borrower in the banking industry. Over the last five years credit to the corporate sector represented more than 75 per cent share of total credit, on average. The composition of corporate credit reflected a large exposure to the services and manufacturing sectors. At end-March 2010, tourism, traders, and financial and business services accounted 50.4 per cent of corporate credit by banks while the construction[4] and manufacturing sectors aggregated 23.7 per cent.

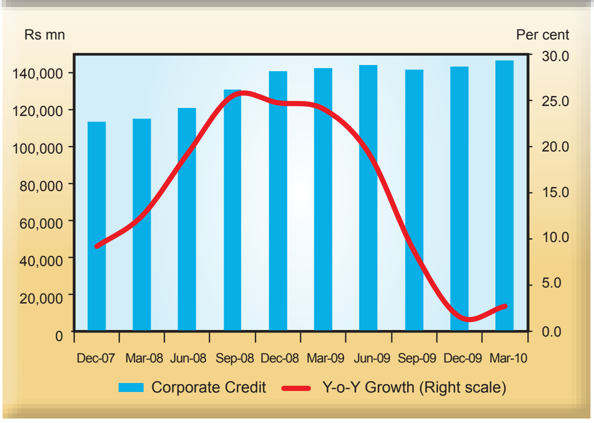
Chart 1.13: Breakdown of Banking Sector Loans



Year-on-year growth of credit to corporates by the banking sector decelerated as from September 2008 through December 2009. In early 2010, indications of a reversal in this trend were noted though the growth rates were still lower than what was observed prior to September 2008.

4 *Excluding housing loans*

Chart 1.14: Evolution of Banks' Exposures to Corporates



The interim reports of some corporates listed on the SEM indicate that most of these corporates registered higher revenue in the first quarter of 2010 compared to the corresponding period of 2009.

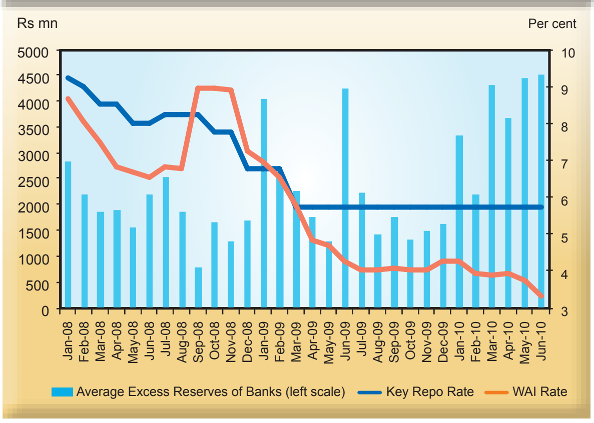
1.2.7 DEVELOPMENTS IN THE DOMESTIC FINANCIAL MARKETS

Domestic Money Market

Notwithstanding renewed concerns for liquidity in international markets, the domestic banking system continued to remain liquid with banks holding an average excess reserves of Rs 3.8 billion in the first semester of 2010 up from Rs 2.7 billion in the corresponding period of 2009. The excess liquidity in the system in the first semester of 2010 is mainly attributable to net redemption of Government of Mauritius Securities. Further, the foreign currency swaps which were introduced in December 2009 to address volatility in the domestic spot foreign exchange market, further contributed to the excess liquidity in the system.

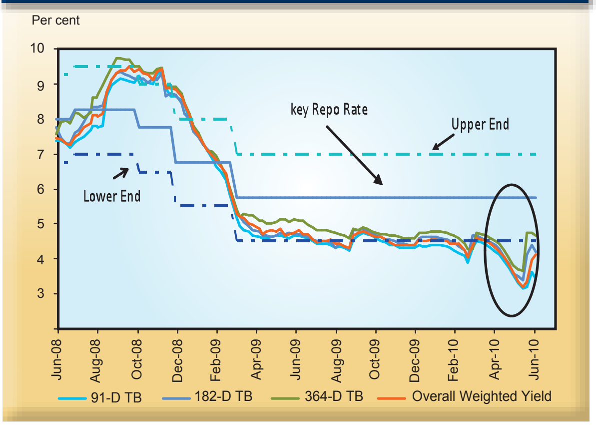
The excess liquidity also resulted in lower activity in the interbank money market in the first six months of 2010 compared to the corresponding period of 2009. The Weighted Average Interbank Rate ranged between 3.34 per cent and 4.26 per cent in the first half of 2010 compared to a range of 4.28-6.96 per cent in the corresponding period of 2009.

Chart 1.15: Banks' Excess Reserves, Key Repo Rate and WAI Rate



Although liquidity shields banks from funding and solvency risks, the building up of excess liquidity in the first six months of 2010 was one of the major factors which created a disconnect in the yields' correlation with the interest signalling rate of the Bank. As this is not conducive to effective monetary policy, the Bank adopted a series of measures aimed at addressing the disconnect and bringing down the excess liquidity to reasonable levels. These open market operations measures included special deposits, reverse repos and issue of Bank of Mauritius Bills which mopped a total of Rs 8.4 billion from the system in the first semester of 2010. The Cash Reserve Ratio was also raised from 4.5 per cent to 5.0 per cent, effective for the maintenance period starting 18 June 2010, which helped to absorb Rs 1.4 billion from the system. Though yields are slowly returning to normalcy, only the 364-D Treasury Bills yields were within the corridor at end-June 2010.

Chart 1.16: Evolution of Weighted Average Yields on Treasury Bills and Key Repo Rate

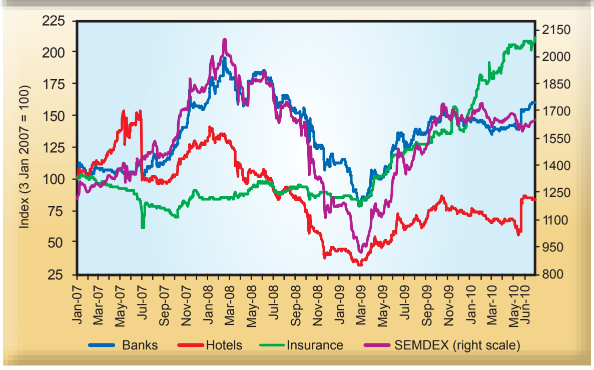


Given current economic cycle, risks to financial stability emanating from the excess liquidity position of banks are considered as low in the short-to-medium term.

Domestic Stock Market

In the first six months of 2010, the SEMDEX fell by 0.2 per cent but the decline was rather subdued compared to the 8.6 per cent decline in the MSCI Emerging Markets index over the corresponding period. The local stock market derived support from gains in some non-blue chip companies in the 'Commerce' and 'Industry' sectors as well as some insurance companies which picked up around that period. The SEM-7 companies, consisting mainly of banks and hotels, continued to lose steam led by the latter. In the first six months of 2010, reflecting conditions in the tourism sector, share prices of hotels, on average, fell by 20.1 per cent while those of banks and insurance companies registered an increase of 0.1 per cent and 16.6 per cent, respectively.

Chart 1.17: SEMDEX and the Performance of Banks, Hotels and Insurance

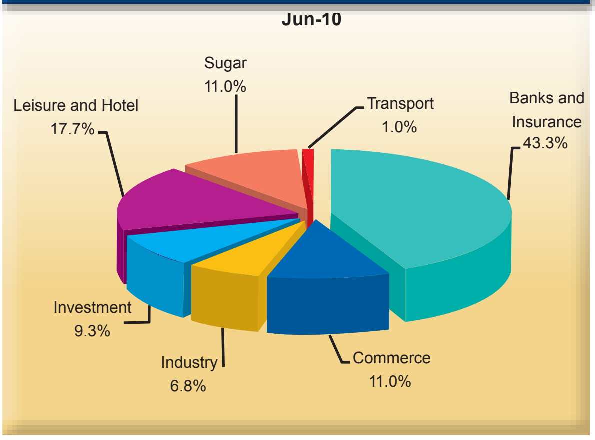


Source: Stock Exchange of Mauritius

The recent rupee evolution and its potential negative impact on export-oriented companies led to some concerns in the market and this undermined investors' confidence to some extent. However, it is perceived that these developments might be a concern to a few highly leveraged companies while most companies are expected to remain resilient.

Market capitalisation which went above Rs158 billion in January 2010 fell marginally by 0.3 per cent in the first six months of 2010. In terms of composition of market capitalisation, the share of 'Leisure and Hotels' fell by 5.6 percentage points in June 2010 compared to June 2009, while 'Banks and Insurance' maintained their share of more than 40 per cent (see Chart 1.18). Over the period January to June 2010, net purchases by foreign investors amounted to Rs765.7 million and were mainly concentrated towards banks. This reflected continued interest of foreign investors in banking stocks.

Chart 1.18: Sectoral Composition of the SEM



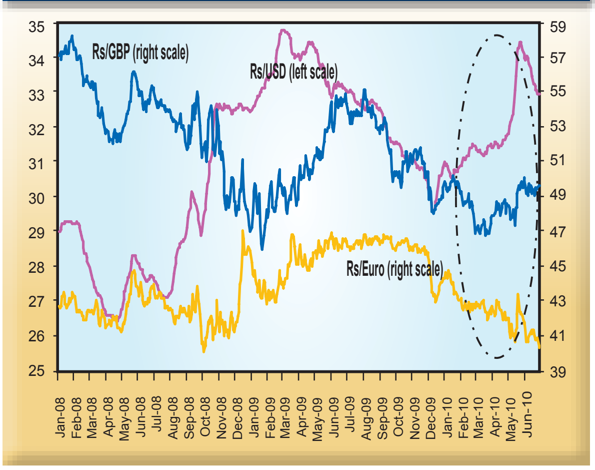
Source: Stock Exchange of Mauritius

Looking ahead, the pace of recovery in our export markets and growth in the local banking and hotel sectors as well as the rupee evolution are factors that may potentially influence the domestic stock market.

Domestic Foreign Exchange Market

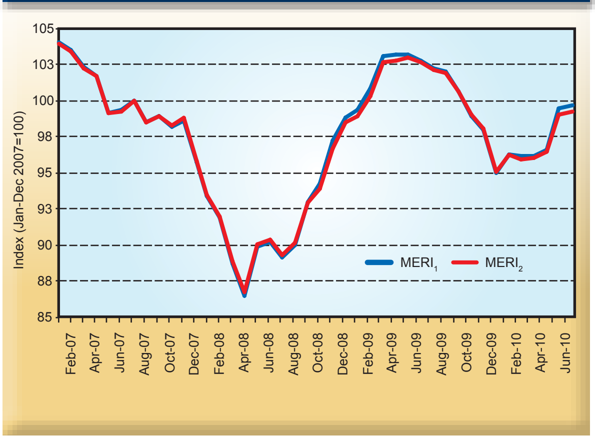
The evolution of the rupee in the domestic foreign exchange market, as usual, continued to be driven by the interplay of domestic and international factors. For the period January to June 2010, on a weighted average dealt selling rates basis, the rupee depreciated against the US dollar by 4.38 per cent but appreciated *vis-à-vis* the euro and Pound sterling by 10.87 per cent and 2.58 per cent, respectively. The rupee gained against the euro and pound sterling, given the fragility of the European economies.

Chart 1.19: Exchange Rate of the Rupee



In effective terms, $MERI_1$ and $MERI_2$ kept a depreciating trend during the period January to June 2010. $MERI_1$, which has currency distribution of trade as weights depreciated by 3.43 per cent while $MERI_2$, which accounts for tourism receipts as well, depreciated by 3.0 per cent over the said period.

Chart 1.20: Movements of $MERI_1$ and $MERI_2$



Intervention by the Bank to either buy or sell US dollar during January to June 2010 was not required, reflecting that conditions in the domestic foreign exchange market were normal. Banks maintained an overbought foreign exchange position which averaged USD 60.3 million during the period January to June 2010 compared to USD 77.9 million in the corresponding period of 2009. Activity on the interbank foreign exchange market increased markedly to a total of USD 226.2 million in the period January to June 2010 compared to a total of USD 68.5 million in the first half of 2009.

The swap scheme, introduced in December 2009 to address volatility in the domestic spot market achieved its objective and some orderliness in the functioning of the market was restored. Exporters took advantage of the scheme as they were able to obtain rupee funds at lower rates and at end-June 2010, the total value of swap transactions amounted to an equivalent of USD 89.2 million.

2 The Financial Sector

2.1 OVERVIEW

The financial sector in Mauritius, which is dominated by banks and insurance companies accounting for more than 70 per cent of the sector's total assets, remained stable and sound throughout 2009 and in the first six months of 2010. Financial corporations, nevertheless, faced a slowdown in their activities as a result of the challenging economic conditions, but there were no instances of institutions in the sector facing financial hardships.

The banking sector is characterised by a large presence of subsidiaries and branches of foreign banks. At end-March 2010, these banks accounted for 67.5 per cent of total banking sector assets while the remaining share was held by domestic banks. The downturn in economic activity in 2009 has influenced risks on banks' balance sheets but not so adversely as to impact their performance severely. As per quarterly reports, domestic banks and, subsidiaries and branches of foreign banks recorded sound profits which averaged Rs 1.5 billion and Rs 2.0 billion, respectively, over the four quarters ended March 2010.

Growth of credit to the private sector by banks slowed down markedly in 2009 and this contributed to the build-up of additional liquidity in the system. However, in the first three months of 2010, slight improvements in credit growth were noted. The Bank has raised the CRR from 4.5 per cent to 5.0 per cent in June 2010 with a view to bringing liquidity to a reasonable level.

The level of non-performing assets recently moderated and fed through an improved non-performing loans ratio both on credit extended in and outside Mauritius. The exposure of banks to the construction sector may be a significant risk as that sector is more vulnerable to cyclical behaviour as real estate assets are susceptible to price volatility. Further, the high exposures of banks to the external demand-led sectors, such as tourism and manufacturing remain areas where some vigilance would be required.

The insurance sector, governed by the Insurance Act 2005, is mainly controlled by three large companies which hold more than 80 per cent of total assets in that sector. While most insurers conduct both general and long term businesses, the sector is characterised by high heterogeneity by size and by types of products insurance companies offer. The Act introduced new solvency and capital rules and includes the segregation of the long term and general businesses. This requirement, which aims at protecting the interests of policy holders has to be complied with, by 1 January 2011, at latest. Recent developments in the sector include the taking over of the life segment of a small insurer by one major operator and, a major merger operation of two large insurance companies which is in the process of being finalised. The insurance industry posted a reasonable performance in 2009.

On an overall basis, risks to financial stability arising from the activities of banking institutions are considered as low. Nevertheless, some downside risks to the revenues of most financial institutions remain due to stagnating activities.

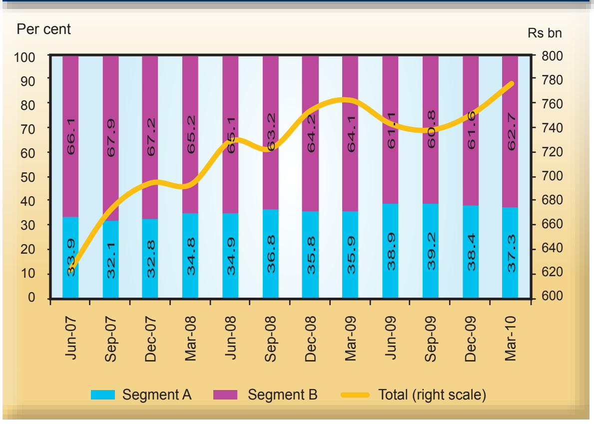
2.2 BANKING SECTOR

2.2.1 BALANCE SHEET STRUCTURE AND RISK PROFILE

Evolution of Banking Sector Assets

The banking sector in Mauritius consists of both domestic banks and subsidiaries and branches of foreign banks and the effects of the crisis were asymmetric across these banks at distinct periods in 2009. Activities of foreign banks appeared to have been impacted more pronouncedly in the first half of 2009 against domestic banks' activities which were relatively more affected in the later half of 2009. These effects were observed through a contraction of 5.9 per cent in the assets of foreign banks in the first half of 2009 while domestic banks registered an expansion of 9.0 per cent during that same period. The situation changed in the later half of 2009, during which foreign banks' activities picked up by 0.4 per cent while activities of domestic banks grew at a markedly slower pace of 2.5 per cent. This tendency was sustained in the first quarter of 2010. On a consolidated basis, banking sector assets grew by 3.4 per cent in the first quarter of 2010, driven by foreign banks, compared to a growth of 1.1 per cent, in the corresponding period of last year.

Chart 2.1: Evolution of Total Assets

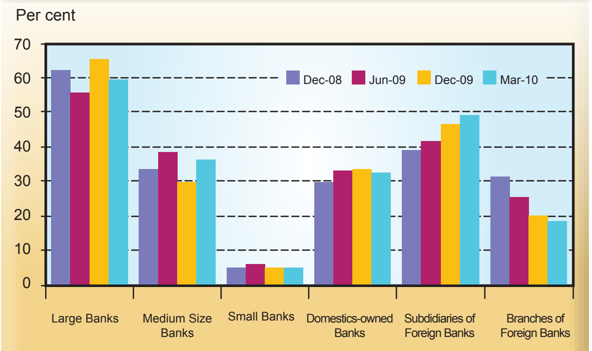


The strong presence of subsidiaries and branches of foreign banks reflects in a larger share of Segment B assets in total assets. With the impact of the crisis on these banks, the share of Segment B assets declined in the six months to September 2009 but improved slightly and continued to account for more than 60 per cent of total banking sector asset as at end-March 2010 (see Chart 2.1). Subsidiaries and branches of foreign banks which are more exposed to the international environment, were impacted more adversely than domestic banks but nevertheless maintained a larger share in the market.

Total Assets by Banks' Size and Ownership

Concentration of assets by bank size and by ownership may have financial stability implications due to systemic risks. The sector is dominated by four large banks which, in aggregate, held around 60 per cent of total banking sector assets as at end-March 2010. Domestic banks held 18.8 per cent share within that group. Medium sized banks accounted around 35 per cent while six small banks held the remaining share in total assets. Chart 2.2 shows the disparity between large banks and small banks in the sector.

Chart 2.2: Total Assets by Bank Size and Group



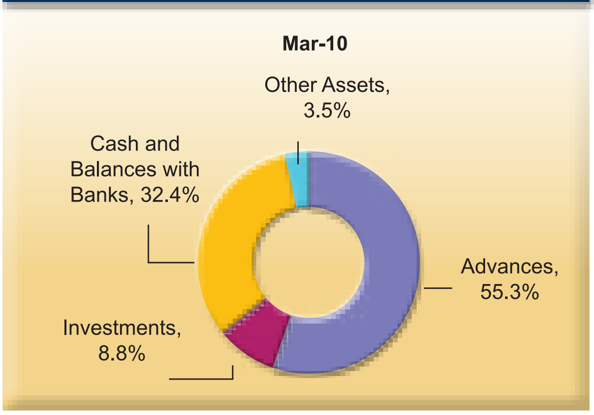
Note: Banks holding more than 10 per cent of total assets - Large Banks
≥ 2 per cent but ≥ 10 per cent of the total assets - Medium Size Banks
≥ 2 per cent of total assets - Small Banks

Over the last four quarters, domestically-owned banks maintained more than 30 per cent share in total assets. Although both subsidiaries of foreign banks and branches of foreign banks operate largely in the Segment B line, the global economic environment appeared to have impacted their activities differently. Comparing the market share of these banks revealed that the former category of banks gained a larger share at the expense of the latter type of banks over the last twelve months.

Asset Composition

Advances continued to be the main component of banks' assets and their share increased slightly from 53.8 per cent at end-March 2009 to 55.3 per cent at end-March 2010. Other components of banks' assets did not experience any major change in their share. The composition of total assets is shown in Chart 2.3.

Chart 2.3: Composition of Total Assets

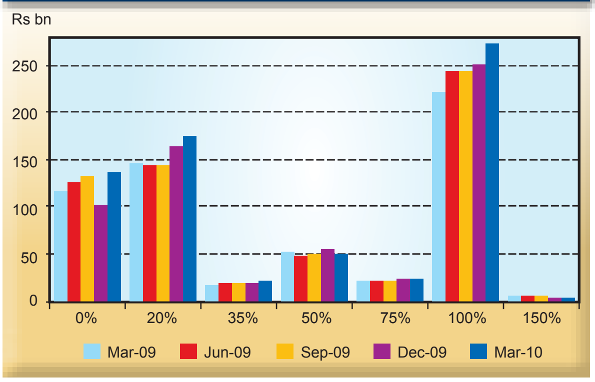


Risk Diversification

Asset diversification is an important determinant of banking sector stability as it allows risk reduction. In Mauritius, banks are subject to the rules of Basel II since March 2009. Analysis made on a consolidated basis showed that, banks' assets are generally concentrated towards the zero, 20 per cent and 100 per cent risk-weight buckets (see Chart 2.4). Over the last four quarters, risk appetite of banks did not change significantly as banks continued to park more than 80 per cent of assets in these same risk buckets.

Assets of domestically-owned banks are concentrated in the risk-free and 100 per cent risk buckets. Foreign banks have similar risk appetite but in addition a large part of their assets is parked in the 20 per cent risk-weight category which relate to placements with head-offices and parent banks.

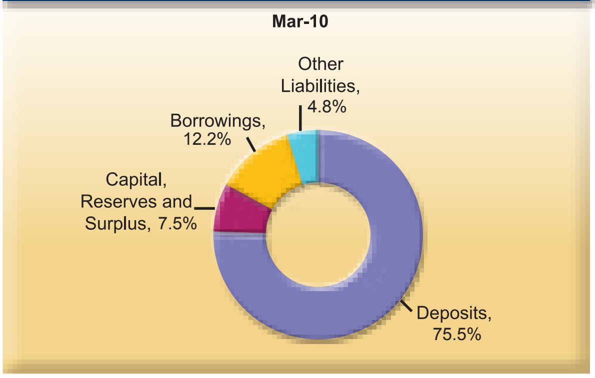
Chart 2.4: Risk Diversification Matrix



Components of Total Liabilities

At end-March 2010, the two major components of banks' liabilities were deposits and borrowings, which constituted 75.5 per cent and 12.2 per cent of total liabilities, respectively. A slight reduction in the share of borrowings and a marginal increase in the share of Capital, Reserves and Surplus were observed in the first three months of 2010. This component is likely to record further increases with inclusion of banks' financial results for the year ended June 2010. The composition of total liabilities is shown in Chart 2.5.

Chart 2.5: Components of Total Liabilities



The dependence of banks on deposits as a source of funding and the lower level of market borrowings provide some comfort from a financial stability point of view.

Market Concentration

The Herfindahl-Hirschmann index (HHI) has been computed to assess the degree of market concentration on a consolidated level as well as from a segmental angle. A low HHI (0-1000) is generally associated with competition while a high HHI (above 1800) would indicate less competition in the market.

Concentration of banking sector assets appears to have diluted over the last five years, trending from the 'moderate concentration' level to 'low concentration' level in December 2009. However, in March 2010 a slight increase in the index was noted. Table 2.1 below shows the evolution of the HHI for the domestic banking sector since December 2005.

The same trend was also observed in the HHI of loans and deposits over the last five years but both these variables continue to lie within the 'moderate concentration' band. The segmental nature of banking activities in Mauritius and the slow penetration of foreign-owned banks and domestically-owned banks into Segment A and Segment B activities, respectively, are the main factors that could have possibly held the HHI within the 'moderate concentration' band.

At end-March 2010, concentration of assets, loans and deposits improved and remained within the 'moderate' band, thus, indicating that the process of bringing more competition in the banking sector has started to take effect.

Table 2.1: Herfindahl-Hirschmann Index for the Banking Sector						
	Dec-05	**Dec-06**	**Dec-07**	**Dec-08**	**Dec-09**	**Mar-10**
Loans	1521	1372	1268	1263	1259	1317
Deposits	1717	1199	1327	1297	1207	1218
Assets	1443	1143	1159	1172	1067	1112

2.2.2 CREDIT GROWTH AND CREDIT RISKS

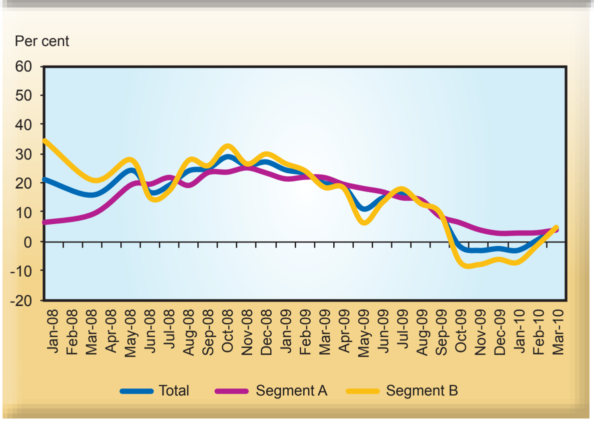
Evolution of Total Credit

Weaker economic activity in the first half of 2009 led to more risk aversion by banks. The evolution of total credit was characterised by a marked decline in advances to Segment B activities, which were more significant than the lower growth of advances to fund Segment A activities. Private sector credit represented around 95 per cent of the latter.

As economic activity improved in recent quarters, growth of banking sector credit returned to positive territory as from February 2010 (see Chart 2.6). On a year-on-year basis, banking sector credit grew by 4.7 per cent as at end-March 2010 compared to a robust growth of 20.1 per cent at end-March 2009. Advances to Segment A and Segment B activities, which accounted 42.2 per cent and 57.8 per cent, respectively, of total banking sector credit at end-March 2010, grew by 2.1 per cent and 5.3 per cent, respectively, in the first quarter of the year.

A closer analysis shows that in the first three months of 2010, credit expanded by 3.9 per cent against a contraction of 3.0 per cent, in the corresponding period, a year earlier.

Chart 2.6: Year-on-Year Growth of Advances



Along with increasing uncertainties in key economic sectors, growth of credit to the private sector declined steadily as from October 2008 but remained positive through the first quarter of 2010. However, the decline in the growth rate stabilised around November 2009 and credit growth hovered close to 4 per cent in the first three months of 2010. More recently, some resurgence in credit growth is being witnessed.

Foreign Currency Credit

Foreign currency lending may have important financial stability implications as such lending exposes borrowers to the risk of adverse exchange rate movements, especially if their revenues are not in the borrowing currency. Banks may then face increased default rates which can impact on asset quality and profitability.

Given that the banking sector is dominated by subsidiaries and branches of foreign banks which conduct business mainly in foreign currencies with non-residents, such credit accounts for a larger share in total banking sector credit. At end-March 2010, foreign currency loans accounted for 63.7 per cent of total loans granted by the sector. The deterioration of global economic conditions and a worsening in the creditworthiness of non-resident borrowers in some regions impacted on the demand and supply for such credits in 2009. This was reflected in the evolution of growth of foreign currency credit. However, as from February 2010, growth of foreign currency credit improved and grew by 5.4 per cent in the first three months of 2010 compared to a contraction of 4.5 per cent in the corresponding period of 2009.

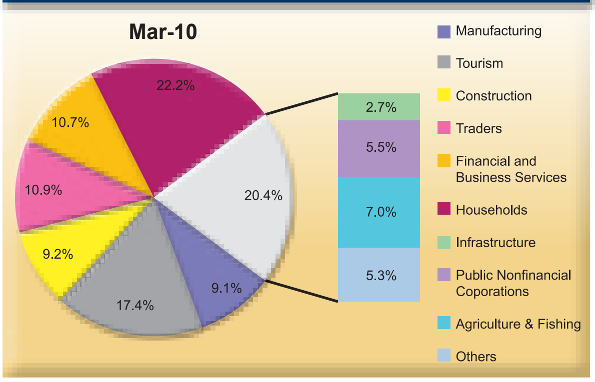
At end-March 2010, domestic banks conducted around 26 per cent of their lending activities in foreign currency. These credits were channelled to various economic sectors, mainly tourism, manufacturing, construction, financial and business services sectors and to Global Business Licence Holders (GBLH). Reflecting the overall lower economic activity, the year-on-year rate of growth of foreign currency lending by domestic banks recorded a remarkable decline at end-March 2010 compared to the corresponding period of 2009.

Risk arising from foreign currency loans granted by domestic banks are considered to be within reasonable levels. Such loans to households account for less than one per cent of total private sector credit.

Distribution of Credit by Sector

The distribution of credit by sectors in the banking industry remained well diversified over the past quarters, hence mitigating sectoral concentration of credit to a large extent. The mostly exposed sectors remained the households, tourism, traders, financial and business services, and construction sectors, which, in aggregate, accounted for 79.6 per cent of total private sector credit at end-March 2010. Chart 2.7 shows the sectorwise distribution of credit to the private sector by banks.

Chart 2.7: Sectorwise Distribution of Credit



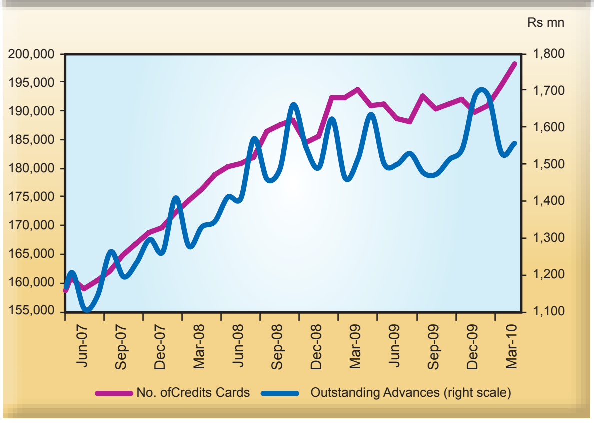
Credit growth to households remained relatively stable and averaged 10.2 per cent and 10.7 per cent in the second half of 2009 and first three months of 2010, respectively. However, advances to the textile industry contracted by an average of 18.0 per cent and 20.5 per cent over the same two periods, respectively. The average rate of credit expansion to the tourism sector, despite being positive, declined in the first quarter of 2010 compared to the later half of 2009.

Further, the average credit growth to most other sectors was lower in the first three months of 2010, compared to the second half of 2009. These highlight some uncertainties that still prevail in the economy.

Credit Card

Outstanding advances on credit cards, on average, accounted for around 4 per cent of loans advanced to the household sector in 2009. Given this relatively small share, the level of credit card debt is not a prime concern for financial stability for the time being. Nevertheless, understanding developments in the credit card market is important, as households make increasing use of this facility and changes in patterns in the use of credit cards may provide early indicators of financial stress in the household sector. Though the number of credit cards in circulation is generally on an upward trend, the number of credit card per capita, being relatively low, does not point towards stability concerns for the time being.

Chart 2.8: Number of Credit Cards in Circulation and Outstanding Advances



Growth of credit card advances averaged 24.6 per cent in 2008, but fell to 7.1 per cent in 2009. In the first three months of 2010, it averaged 7.2 per cent. Although a large decline in the growth rate is observed in 2009, this may be considered as being still robust. Further, the moderate growth of credit card advances recorded in a low interest rate environment is evidence of prudence, both on the part of banks and borrowers.

Chart 2.9: Growth of Advances on Credit Cards

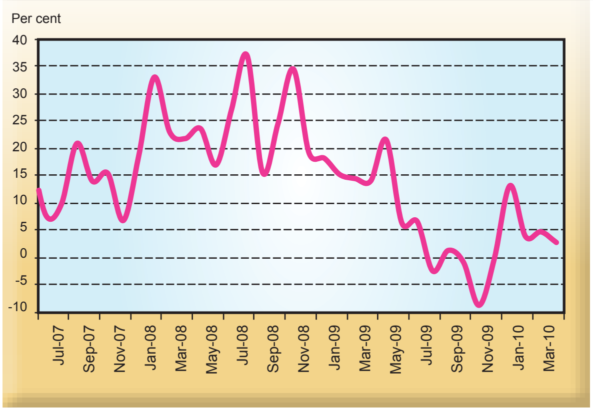
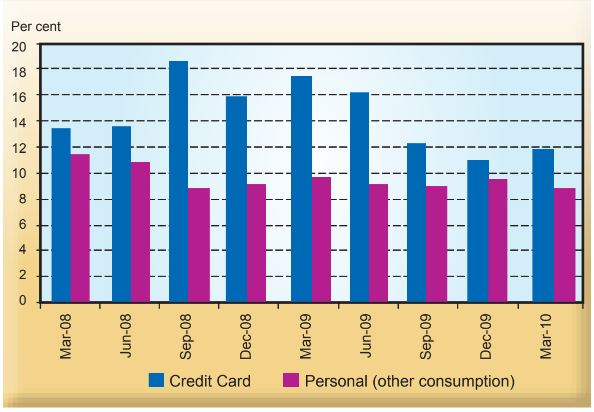


Chart 2.10: Impaired Consumption Loans



Another potentially useful indicator of household financial stress is the rate of growth of delinquent credit card advances. In 2009, impaired credit card advances contracted steadily but increased slightly in the first quarter of 2010. However, the probability of default of credit card advances continued to be higher than that of other consumption loans (see Chart 2.10). At end-March 2010, the ratio of delinquent credit card loans in total credit card advances stood at 11.8 per cent compared to 11.0 per cent the previous quarter.

Non-performing Loans

Although the banking sector registered a marginal deterioration in asset quality in 2009, the share of delinquent loans in total loans continued to decline since the last Financial Stability Report. This improvement was visible both in loans granted in and outside Mauritius. The NPL ratio fell from 2.9 per cent in December 2009 to 2.3 per cent at end-March 2010 and was driven by lower NPLs on loans extended outside Mauritius.

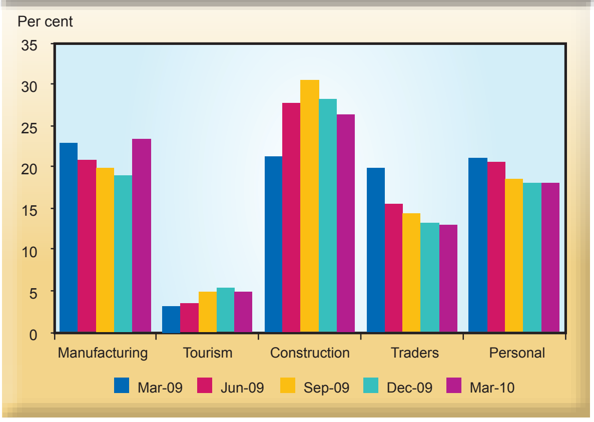
Table 2.2: Non-performing Loans

	Non-performing loans as a percentage to credit extended in Mauritius	Non-performing loans as a percentage to credit extended outside Mauritius	Total non-performing loans as a percentage to total loans by the banking sector
Dec-07	4.4	0.2	2.2
Mar-08	4.7	0.1	2.2
Jun-08	4.4	0.6	2.4
Sep-08	4.0	0.5	2.1
Dec-08	3.8	0.6	2.1
Mar-09	4.0	0.9	2.4
Jun-09	4.0	0.9	2.4
Sep-09	4.5	0.7	2.5
Dec-09	4.5	1.4	2.9
Mar-10	4.3	0.6	2.3

In 2009, NPLs in credit granted to key sectors, on average, accounted for 86.4 per cent of total NPLs in credit extended in Mauritius. The lower NPL ratio recorded in the first quarter of 2010 was partly driven by better asset quality in the construction sector, which registered improved performance as from the second half of 2009. Although the manufacturing sector output returned to positive growth in the third quarter of 2009, NPLs in credit to that sector worsened in the first quarter of 2010, mainly as a result of deterioration of credit to the Export Enterprise Certificate Holders. Slight improvements in the NPLs of the traders and tourism sectors were noted in the first quarter of 2010.

Figures covering the last five quarters indicate that the probability of default in the manufacturing sector has gone up in the first quarter of 2010 as compared to the default rate in other key sectors which has declined. The sectoral NPL in key sectors as a ratio of total NPL is depicted in Chart 2.11 below.

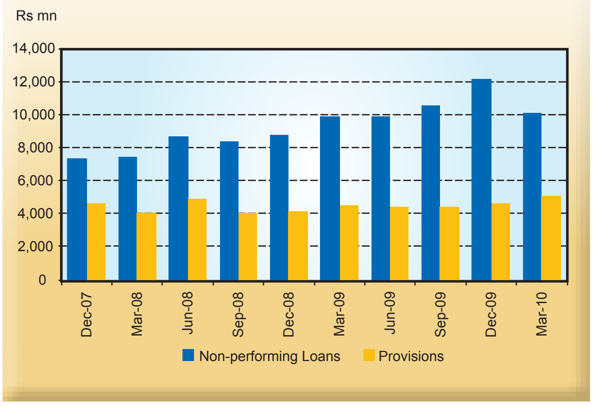
Chart 2.11: Sectoral NPL in Key Sectors as a Ratio of Total NPL



Non-performing Loans and Provisions

Non-performing loans in absolute values generally trended upwards in 2009 and was accompanied by additional specific provisioning on loan losses made mainly in the last quarter of 2009. However, the pace of increase in the specific provisioning on loan losses was lower than the growth in non-performing loans. In the first quarter of 2010, notwithstanding a decline in the amount of non-performing loans, specific provisioning on loan losses continued to rise, increasing the coverage ratio to 50.3 per cent at end-March 2010, from 45.2 per cent, in the corresponding, period a year earlier. The higher coverage ratio increases the inherent strength of the balance sheet of banks and improves their ability to absorb losses arising from non-recoverability of non-performing loans. Chart 2.12 below shows the non-performing loans and provisions from December 2007 to March 2010.

Chart 2.12: Non-performing Loans and Provisions



An analysis of the impact on capital of materialisation of non-performing loans net of provision is made in Chapter 3.

Concentration of Credit Risks

Concentration of credit risks may have financial stability implications depending on the degree of connectedness among borrowers under various economic conditions. The Bank of Mauritius applies international standards to monitor credit concentration risk in the banking sector. Banks continued to operate well below the prudential limit of 800 per cent, though at end-March 2010 credit concentration risk ratio increased to 210.0 per cent of banking sector capital base, from 221.0 per cent at end-December 2009. The 15 largest group of borrowers accounted for 107.9 per cent and 110.1 per cent of the capital base, at end-March 2010 and end-December 2009, respectively.

Table 2.3: Concentration of Credit Risk Ratio		
	Percentage of aggregate large exposures to capital base (per cent)	Percentage of aggregate large exposures to total credit facilities (per cent)
Mar-09	211	26
Jun-09	209	31
Sep-09	212	28
Dec-09	221	25
Mar-10	210	26

Despite the small number of large conglomerates which avail of credit facilities from banks, credit concentration risk was not a cause for concern over the past quarters, even when economic conditions were weak. The well-diversified portfolios of these conglomerates may be one of the factors that has helped them to sustain their activities and thus maintain their debt servicing abilities.

Cross-Border Exposures

Cross-border exposures may pose threats of risks of contagion and impact on the stability of the financial system if the appropriate risk management procedures for such exposures are not in place. Banks in Mauritius are exposed to international borrowers residing mainly in Middle East and Asia, and Europe, which aggregated to Rs 177.2 billion, representing around 47.1 per cent of banking sector credit at end-March 2010. Periodic reports submitted by banks provide an indication of the magnitude and quality of cross-border exposures, including those extended to customers in regions hit by the crisis. The marked deterioration in impaired loans to the European region in December 2009 was driven by a particular bank which subsequently took necessary steps to improve its asset quality. Development in the PIGS countries is likely to have no impact on the banking sector as exposures to these countries amounted to only Rs 24.1 million, representing less than one per cent of total banking sector credit.

On an overall basis, contagion risk is not a cause for concern and asset quality on cross-border exposures is improving in general. The Bank has also recently issued a Guideline on Country Risk Management which will come into effect as from October 2010.

Table 2.4: Cross-Border Exposures						
	September-09		December-09		March-10	
Region	Percentage of total cross-border loans	Percentage of impaired loans*	Percentage of total cross-border loans	Percentage of impaired loans*	Percentage of total cross-border loans	Percentage of impaired loans*
Africa	5.60	10.00	5.70	7.15	6.60	6.15
Asia	68.40	0.10	68.80	0.11	66.00	0.10
Australia	0.30	0.20	0.30	0.13	0.30	0.13
Europe	14.40	1.10	11.90	9.37	12.50	1.65
Middle East	2.30	-	3.20	0.02	3.90	-
USA and Canada	0.60	-	0.70	0.75	0.70	1.73
Others	8.50	0.10	9.40	0.74	10.10	0.12

** Ratio of impaired loans by region to total loans granted to borrowers in that region*

2.2.3 FUNDING AND LIQUIDITY RISKS

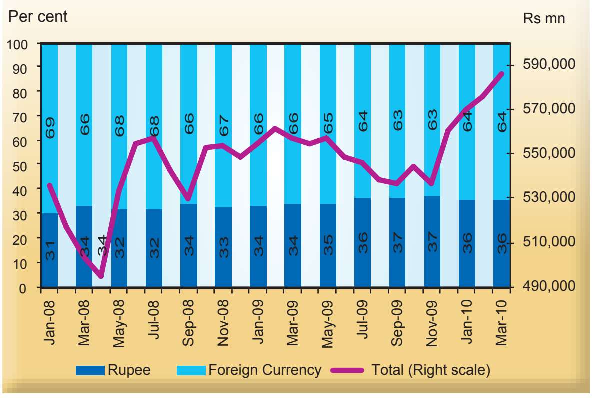
Deposits

Depositors' confidence in the banking sector was not affected by the global financial crisis and continued to remain strong throughout the first six months of 2010. However, with the low interest rate environment, average growth of deposits was lower in 2009, led by foreign currency deposits. Although deposit growth was at times in negative territory in the second half of 2009, this did not cause any stability concerns in the banking sector. In fact, there were no indications that domestic and international banks faced any pressure to raise deposits to fund their lending activities, which were relatively subdued.

Both rupee and foreign currency deposits exceeded the level of loans extended in the respective currencies. Deposit growth improved and as from December 2009 it moved into positive territory, reflecting better economic conditions. This improvement in deposit growth was driven mainly by foreign currency deposits as activities of international banks picked up. The positive trend in deposit growth was sustained through the first quarter of 2010, although interest rates remained unappealing.

Banking sector deposits grew by 4.7 per cent in the first quarter of 2010 compared to a growth of 1.6 per cent in the corresponding quarter of 2009. The effect of global crisis appeared to have impacted differently on domestic and international banks' deposits. Rupee deposits, mainly raised by domestic banks, recorded growth rates of 0.8 per cent and 2.2 per cent in the first quarter of 2010 and 2009, respectively, while foreign currency deposits, which largely originate from non-residents and held mainly by international banks, registered growth rates of 7.0 and 1.2 per cent, respectively over these two said periods.

Chart 2.13: Evolution of Total Deposits



Concentration of Deposits

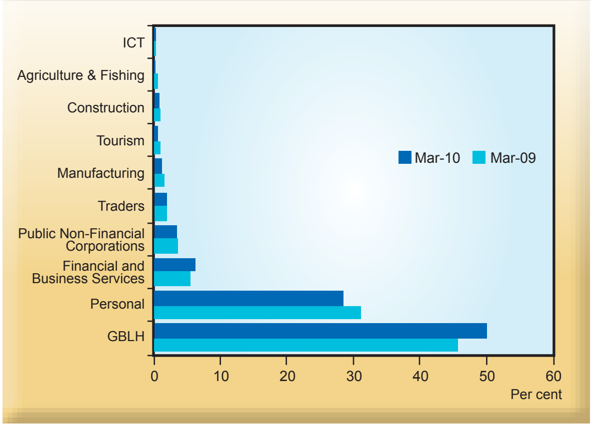
Distribution of deposits across banks indicated that 66.4 per cent of total deposits were held by foreign banks (subsidiaries and branches) at end-March 2010 while domestically-owned banks accounted for the remaining share. Notwithstanding their exposure to global economic conditions, foreign currency deposits maintained a larger share in banking sector deposits.

Deposits raised from the GBLH sector held the major share in the foreign currency deposit base of banks. These deposits, generally held by foreign banks, are important sources of funding. At end-March 2010, around 40 per cent were held in time deposits. The bulk of the remaining GBLH deposits, held as demand deposits, transit in the system for a relatively short period until they are transferred to other countries for investment purposes.

Banks place these short term deposits,with their parent banks and earn considerable interest income. Shocks to these deposits may arise in the event a double-taxation avoidance treaty is revised causing liquidity hardships. However, such likelihood is quite remote as Mauritius offers more comparative advantages in terms of infrastructure and skills than other offshore markets in the region.

Rupee deposits are mainly raised by domestic banks and the largest share is mobilised from the personal sector. Unlike corporate deposits which are relatively more volatile in nature, deposits from the personal sector may be considered as stable and unlikely to undergo any shocks under present economic conditions. However, developments in the household sector may impact the level of deposits in the personal sector but no significant threat to financial stability is likely to arise from that source.

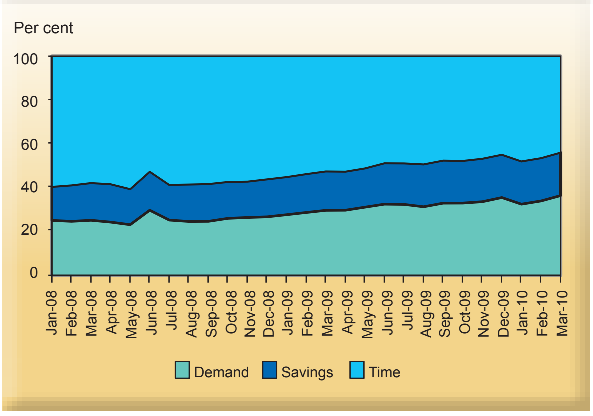
Chart 2.14: Ownership of Deposits



Maturity Preferences

Maturity profiles of banks' deposits showed declining preference for time deposits to the benefit of deposits of shorter maturities (see Chart 2.15). Time deposits, which are essential to fund long-term projects, may continue its downtrend but no abrupt reduction is foreseen in the short-to-medium term. It is therefore expected that banks would continue to operate normally and that the declining levels of time deposits would not impact their activities adversely, given the current economic conditions.

Chart 2.15: Maturity Preferences of Deposits



Liquidity Risk

The Bank monitors liquidity risk management of banks by supervising the policies and processes put in place to reduce the frequency and severity of liquidity problems that banks may have, with a view to lowering their potential impact on the financial system. The revised Guideline on Liquidity Risk Management requires banks to report their assets and liability mismatches on a quarterly basis. These reports allow for a better assessment of risks associated with large mismatches, if any.

The Bank does not prescribe any minimum liquid asset ratio on banks. However, the latter are expected to set their own internal limits and to strictly abide to them. Any departure from these limits has to be notified to the Bank specifying the reasons. Over the last five quarters ended March 2010, the liquid assets ratio ranged between 26.3 per cent and 31.8 per cent. Credit to deposit ratios also stood at comfortable levels over the same period. Further analysis on liquidity ratios is carried out in Chapter 3.

2.2.4 OPERATIONAL RISK

Operational Risk and Financial Stability

Banks in Mauritius have been required, since June 2005, to maintain capital charges for operational risks and most of them have adopted the simplest but more capital intensive approach namely the Basic Indicator Approach (BIA). At end March 2010, 11 banks were applying the BIA and 6 banks used the Standardised Approach to measure operational risk. One branch of a foreign bank does not engage in Segment A activities and hence is not required to hold capital for credit and operational risk. This is catered for by the parent bank at consolidated level. At end-March 2010, risk-weighted assets for operational risks accounted for 7.7 per cent in total risk-weighted assets of banks.

Banks are required to report on a quarterly basis all operational risk-related losses. As at date, all operational risk related losses arising from internal fraud, external fraud, employment practices and workplace safety, clients, products and business practices, damage to physical assets, business disruption and systems failures, execution, delivery and process management have been within manageable levels and did not create any stability concerns.

However, given that the quantification of operational risk-related losses can only be made ex-post, banks are expected to place strong emphasis on the operational risk management policies and processes in place and to regularly upgrade their policies to capture additional sources that may result in operational losses.

2.2.5 FINANCIAL CONDITIONS OF BANKS

Capital Adequacy

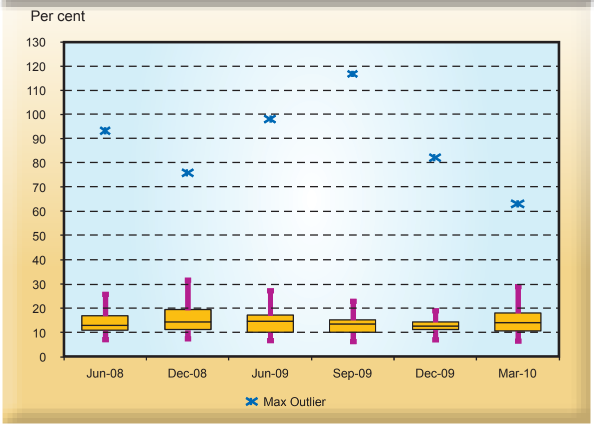
In Mauritius, banks are well capitalised since they all maintained capital adequacy ratios well above the regulatory minimum of 10 per cent imposed by the Bank of Mauritius. At end-March 2010, the total regulatory capital ratio improved to 16.5 per cent, from 15.2 per cent recorded in the previous two quarters. With the implementation of Basel II since March 2009, there has been an overall improvement in the risk management framework in the sector.

Core Tier 1 Capital Ratio

The core tier 1 capital ratio across most banks remains strong reflecting the quality of capital held by banks. The median core tier 1 capital ratio stood at 12.5 per cent at end-December 2009, lower than the 14.2 per cent recorded a year earlier. This was mainly due to the increase in risk-weighted assets resulting from the adoption of Basel II framework. The median reached 14.0 per cent at end-March 2010 mainly on account of the increase in core tier 1 capital of banks.

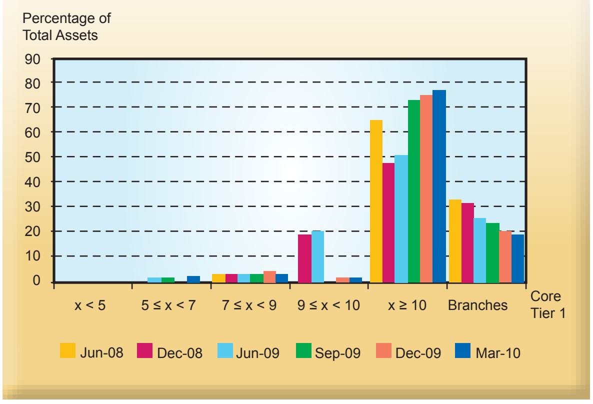
The outlier institutions, consisting of a few branches of foreign-owned banks, usually maintain higher core tier 1 capital ratio as the branches are required by regulation to keep capital only for their domestic operations while their exposures in the non-resident sector are exempted from capital requirements. The regulatory capital requirement of the branches is managed by their parent entity.

Chart 2.16: Distribution of Core Tier 1 Capital Ratio



The core tier 1 capital ratio of the branches of foreign-owned banks ranged from 18.0 per cent to 63.2 per cent at end-March 2010 compared to a range of 18.3-81.7 per cent recorded in the corresponding period of the previous year.

Chart 2.17: Dispersion of Total Assets by Core Tier 1 Capital Ratio



In terms of total assets, about 76.6 per cent of total assets of the banking sector at end-March 2010 were owned by banks (excluding the branches of foreign-owned banks) with a core tier 1 ratio of more than 10 per cent, slightly up from 75.2 per cent recorded at end-December 2009.

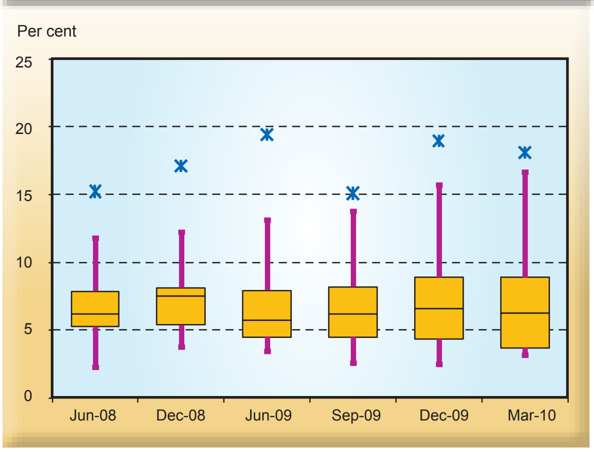
The migration in total assets from 9-10 per cent core tier 1 bucket to the highest bucket over June/September 2009 is associated with the increase in core tier 1 capital ratio of some banks (excluding the branches of foreign-owned banks), whose financial year ends in June, following the capitalisation of their retained earnings in September. This trend is expected to reverse when these banks effect their payment of dividend for the year. There were no major changes in the distribution of total assets during the period September 2009 to March 2010.

Internal simulation exercises show that, on a consolidated basis at end-March 2010, banks can further sustain a growth of around 43.4 per cent in total risk-weighted assets without the core tier 1 ratio going below 10 per cent. Alternatively, core tier 1 capital can absorb losses up to 30.3 per cent at the existing level of activities.

Leverage Ratio

The median leverage across banks (excluding branches of foreign-banks) stood at 6.6 per cent of core tier 1 capital at end-December 2009 compared to 7.5 per cent a year earlier. The ratio fell to 6.3 per cent at end-March 2010 compared to 7.1 per cent, a year earlier.

Chart 2.18: Distribution of Leverage Ratio



Note: Leverage means tier 1 capital to total assets

The decrease in median leverage ratio could be explained by the expansion in total assets of banks (excluding branches of foreign-banks) which outweighed the growth in core tier 1 capital. In general, with the exception of one bank which had to raise additional capital in December 2009, there was no necessity for the remaining banks to raise additional capital to match the increase in their risk-weighted assets.

Profitability

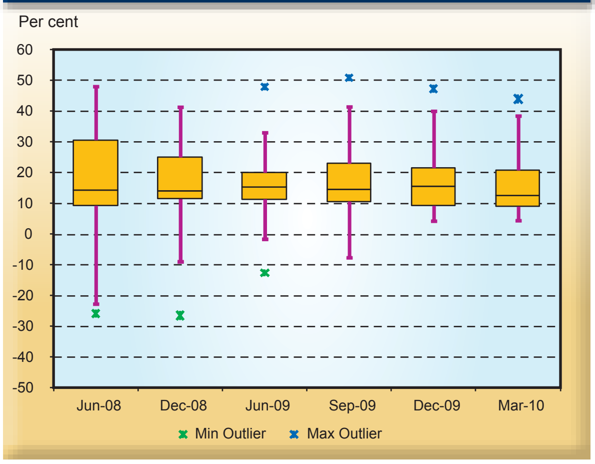
Notwithstanding lower economic activity, the banking sector continued to record sound and reasonable profits. Quarterly reports of banks indicated that the annualised pre-tax profit, which is the sum of pre-tax profits for the last four quarters, stood at Rs 13.7 billion at end-March 2010 compared to Rs13.9 billion and Rs 13.5 billion at end-September 2009 and end-December 2009, respectively.

These results were sustained mainly by the exceptional trading gains registered by a few foreign-owned banks on their international operations at end-September 2009. These gains have been rolled over in the annualised profit figure of the fourth quarter of 2009 and first quarter of 2010. However, upon excluding these institutions, the overall performance of some individual banks was affected due to the tight conditions prevailing in markets.

Rate of Return on Equity

The annualised return on equity (ROE) (using pre-tax profit and shareholders' equity) for the sector declined marginally to 21.2 per cent at end-March 2010 compared to 22.0 per cent a year earlier.

Chart 2.19: Distribution of Return on Equity

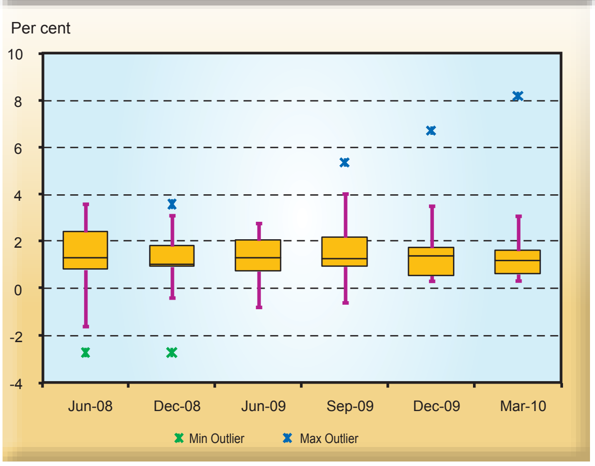


The median annualised ROE dropped to 12.5 per cent at end-March 2010, from 14.2 per cent at end-March 2009. The difference between the sector and median rate widened as the banking sector's ROE was boosted by the higher pre-tax profit of a few outlier banks. These banks recorded exceptional gains on their trading operations in the third quarter of 2009. Further, some branches of foreign banks usually post higher ROE because they hold capital for their operations in Mauritius only.

Return on Assets

Total asset employed in the sector remained well remunerated with the annualised return on asset (ROA) of 1.6 per cent at end-March 2010, similar to the rate recorded a year earlier.

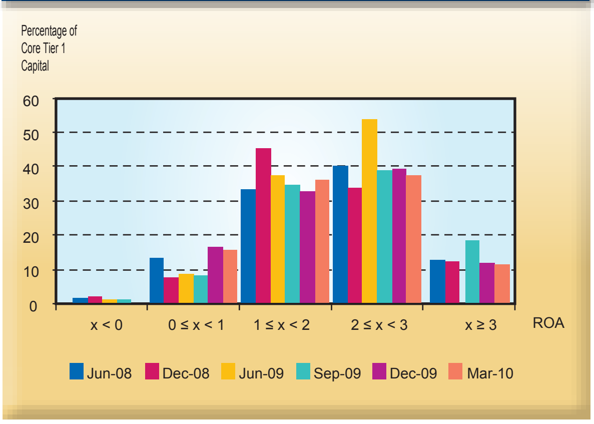
Chart 2.20: Distribution of Return on Assets



The dispersion in ROA has narrowed between June 2009 to March 2010 due to the decline in the income earned principally by some foreign-owned banks on their global business operations. The interquartile range declined to 1.3 per cent at end-June 2009 from 1.6 per cent, a year earlier. At end-March 2010, it went further down to 1.0 per cent. This may be explained by the fact that most of the foreign-owned banks dealt mainly with their head-office and related companies, which paid lower interest to their counterparties on their placements due to continuing low interest rates environment. However, the higher trading income earned by some foreign-owned banks, contributed to amplify their profits and helped to mitigate deterioration in the overall ROA.

From an efficiency viewpoint, 53.6 per cent of total core tier 1 capital in the sector generated a ROA of more than 2 per cent at end-June 2009 compared to 52.8 per cent recorded a year earlier. A decrease of 4.7 per cent was noted at end-March 2010. Overall, most banks were earning a satisfactory return on their core tier 1 capital.

Chart 2.21: Dispersion of ROA by Core Tier 1 Capital



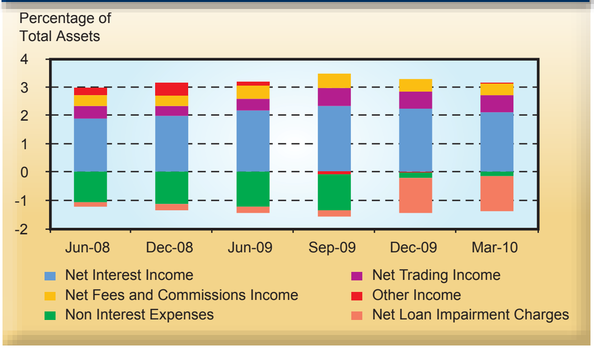
Components of Revenue and Expenses

The net interest income of subsidiaries of foreign-owned banks as a percentage of total assets declined from 1.9 per cent at end-March 2009 to 1.3 per cent end-March 2010 due to the contraction in interest spread on the bulk of their global business. This reduction has been counterbalanced by the increase in net interest income of the remaining institutions, which brought the sector's net interest income as a percentage of total assets to 2.1 per cent at end-March 2010 comparable to the level achieved at end-March 2009.

The net trading income as a percentage of total assets of the domestic banks has dropped from 0.8 per cent at end-March 2009 to 0.5 per cent at end-March 2010 mainly due to volatilities in the local foreign currency market. Overall, the sector's net trading income was boosted by exceptional gains realised by some of the subsidiaries of the foreign banks in Mauritius on their international operations, which increased from 0.4 per cent at end-March 2009 to 0.6 per cent at end-March 2010.

Net fees and commission income, as a percentage of total assets, declined modestly from an aggregate of 0.5 per cent at end-March 2009 to 0.4 per cent at end-March 2010, while components of other income varied only negligibly.

Chart 2.22: Evolution of the Components of Revenue and Expenses



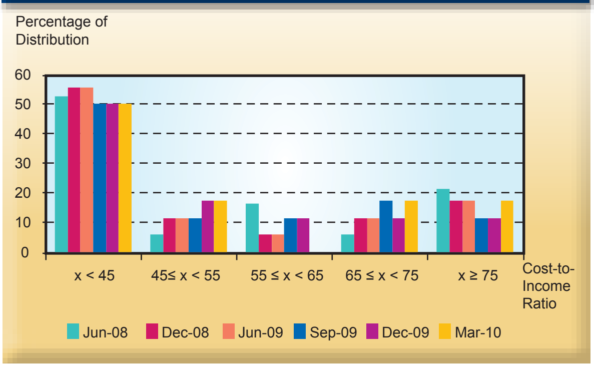
The overall result for the sector was that total operating income as a percentage of total assets stood at 3.1 per cent at end-March 2010 similar to the level achieved at end-March 2009.

Non-interest expenses to total assets ratios of banks were mostly unchanged and ranged from 0.1 per cent to 4.3 per cent at end-March 2010 compared to a range of 0.1-3.9 per cent a year earlier. A marginal increase was observed on the non-interest expenses of domestic banks at end-March 2010. Net loan impairment charges constituted only 0.1 per cent of total assets at end-March 2010 slightly lower than 0.2 per cent recorded at end-March 2009.

Cost-to-Income Ratio

A slight worsening in the cost efficiency ratio was noted at end-March 2010 compared to the previous year. The ratio increased mildly to 39.6 per cent at end-March 2010 as compared to 38.2 per cent at end-March 2009 on account of a slightly faster growth in non-interest expenses compared to income growth.

Chart 2.23: Dispersion of Cost-to-Income Ratio by Individual Banks



2.3 INSURANCE SECTOR

The insurance sector in Mauritius continued to remain sound despite weak economic conditions that prevailed until recently. The sector is relatively well developed and as per the latest Statistical Bulletin of the Financial Services Commission, 10 insurers were involved in both long-term and general business, three insurers were involved in only long-term business and three other insurers focused only in the general business line. The landscape in the sector recently changed with the merger of two major companies involved in both long-term and general business. This merger is in the process of being finalised. Further, due to the provisions of the Insurance Act (2005) which requires, *inter alia*, the segregation of the general and life business segments, the life segment of an insurance company was taken over by a major insurer.

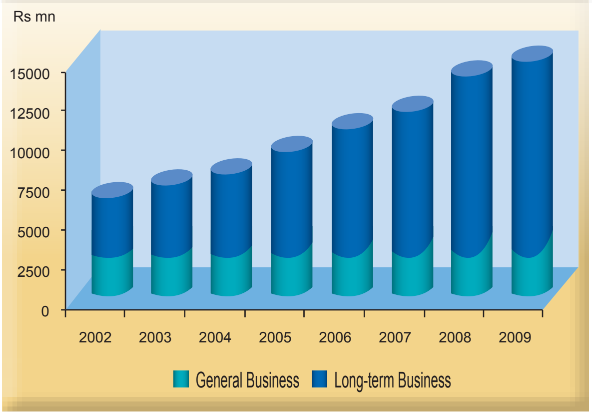
Despite the relatively large number of players in the market, the sector is characterised by a highly oligopolistic structure with a few companies holding a large share of the market. More than 75 per cent of the industry's total assets were held by three insurers in 2009. A closer analysis showed that the three largest companies in the long-term business and the general business segment respectively held 83.7 per cent and 62.1 per cent share of total assets.

Notwithstanding challenging economic conditions, the penetration of the insurance industry in the economy, measured by the ratio of total assets to GDP increased to 28.0 per cent in 2009, from 24.6 per cent in 2008. Activities of insurance companies expanded at a higher rate in 2009 compared to the previous year and was driven by asset growth in both lines of businesses, with the growth in long-term business being more pronounced.

Total annual premium, generated from long-term and general businesses amounted to Rs 14,745 million in 2009, representing 5.4 per cent of GDP. The long-term business which accounted 64.5 per cent of total insurance premium is a further indication of the development of the sector.

Gross premium of the insurance sector grew by 6.6 per cent in 2009 compared to 18.7 per cent in 2008, driven by lower growth rates in the premium of both lines of businesses.

Chart 2.24: Composition of Gross Premium of the Insurance Sector



Source: Financial Services Commission, Mauritius

The risks faced by insurance companies are credit risk, investment risk, risk of losses from catastrophic events exceeding projected losses, contagion risks from banking activities and the possibility that yields on government securities remain at low levels.

In general, the insurance industry has performed relatively well in 2009 and continued to remain profitable. Further, risks appear to have been well contained and there have been no issues that raised stability concerns.

2.4 NON-BANK DEPOSIT TAKING SECTOR

The Non-Bank Deposit Taking (NBDT) sector comprises institutions licensed by the Bank to raise deposits from the public to fund leasing and lending activities. They are governed by the same legislations and regulations as banks. NBDT Institutions (NBDTIs) play an equally important role in financial intermediation by financing households and corporate institutions operating in key economic sectors. In June 2010, one NBDTI was granted a banking licence and another NBDTI merged into its holding company which is also bank. The number of operators in the NBDT sector stood at 11 as at end June 2010.

The sector is dominated by three companies which held 60.7 per cent share of total assets. Among the NBDTIs, one institution forms part of a banking group while two other institutions are owned by insurance companies. The inter-linkages of the NBDT sector with the banking sector is mainly through usual financial intermediating activities.

Balance Sheet Structure

The repercussions of the economic slowdown on the NBDT sector have been mainly through a deceleration in growth of activities and deterioration in the quality of certain specific sectoral exposures. Further, the entrantentry of banks in the leasing market as from August 2008 and the acquisition of full-fledged activities of one NBDT entity may have had a bearing on the growth of the NBDT sector in 2009.

Deposits raised from the public remains the main source of funds of NBDTIs and accounted for 61.8 percent of total liabilities at end-March 2010. These deposits are mainly channeled to loans and leases, which are the largest components of assets of NBDTIs. In 2009, deposits grew by 10.9 per cent compared to 12.5 per cent in 2008 while in the first three months of 2010, it grew by 1.4 per cent compared to 3.6 per cent in the opening three months of 2009. This is in line with banking sector trends.

Total assets registered a growth of 6.7 per cent in 2009, compared to 20.4 per cent in 2008. In the first three months of this year, total assets grew by 1.3 per cent, slightly higher than the 0.5 per cent growth recorded in the corresponding period of last year. Akin to the banking sector, a pick-up could be observed for the NBDT sector, reflecting the overall economic activity.

Performance

The NBDT sector continued to be profitable in 2009 with most companies recording positive results. Interest income constitutes the main contributor to total income of these institutions. In 2009, pre-tax profit grew by 23.0 per cent compared to 1.8 per cent a year earlier. This was mainly driven by a 7.9 per cent growth in interest income. On the cost side, interest expense recorded a reduction mainly as a result of a 1.5 per cent decline in cost of deposits.

Although there is now more competition in the leasing market, the NBDTIs still have some niche areas as banks may grant financial leases but are proscribed from conducting operating leases.

ROA fell from 1.9 per cent in 2008 to 1.8 per cent in 2009 and ROE fell from 11.3 per cent to 10.6 per cent over the same period. The ROE level reflects the recent compliance of NBDTIs in terms of capital requirements.

Capital

NBDTIs have to maintain the same minimum capital levels as banks, namely Rs 200 million. At end-March 2010, the sector was well capitalised with an aggregate capital adequacy ratio (CAR) of 20.7 per cent. The median CAR was 19.9 per cent for the first quarter of 2010 compared to 21.9 per cent in the preceding quarter.

The risk appetite of NBDTIs was geared towards the 35 per cent, 50 per cent and 100 per cent risk-bearing assets, which at end-March 2010 accounted for 85.5 per cent of total assets. This may be explained by the significant amount of loans granted for housing purposes by one state-owned NBDTI to encourage home ownership.

At present, the CAR for NBDTIs only covers credit risk. The inclusion of other risks in the computation of the composite CAR would give a clearer picture on the adequacy of capital buffer of NBDTIs.

Credit Risk

Loans and leases accounted for more than 70 per cent of total assets of NBDTIs and were extended mainly to the construction and personal sectors. At end-March 2010, exposures to these two sectors represented 70.0 per cent of total exposures. Over and above sectoral concentration, credit risks were also concentrated in two main institutions which held 61.6 per cent of the sector's credit risk in their portfolio. The capital of these institution accounted for 53.2 per cent of total capital of the sector.

NPL ratio generally improved from 8.8 per cent to 7.3 per cent over the last five quarters ended March 2010. The construction sector held the largest share in total NPLs. However, this share declined steadily from 69.1 per cent at end-March 2009 to 58.2 per cent at end-March 2010. The NPL ratio in the construction sector in fact improved from 25.7 per cent to 18.5 per cent over the same period.

On an overall basis, coverage ratio for the sector improved to 38.2 per cent at end-March 2010 and is indicative of higher ability of NBDTIs to withstand shocks arising from losses on delinquent exposures.

Liquidity Risk

NBDTIs are still subject to liquidity ratios as they have only recently transited to the same prudential and regulatory requirements as banks. Institutions have to maintain 10 per cent of deposits in liquid instruments. Liquid assets ratio ranged between 13.4 and 16.8 per cent for the period March 2009 to March 2010. NBDTIs operated with credit-deposit ratios exceeding 100 per cent, and funded the extra liquidity requirement through borrowings from the banking sector, from other NBDTIs and from their excess capital and internal resources.

Market Risks

Although NBDTIs generally do not peg their lending and deposit rates with the key Repo Rate, their interest rate decisions are largely influenced by the key Repo Rate. NBDTIs are as such important conduits for monetary policy transmission. NBDTIs are susceptible to market risks as a large part of their assets and liabilities are on fixed interest rates basis. These risks vary asymmetrically with the direction of interest rates movements. To minimise market risks arising therefrom, NBDTIs are slowly migrating to the floating interest rate regime. Further, NBDTIs have not yet started engaging in foreign currency activities. It is therefore considered that financial stability risk arising from market risks is not a major concern in the NBDT sector, for the time being.

Financial Stability Risks in the NBDT Sector

On an overall basis, the sector has remained resilient to the economic slowdown. On balance, financial stability risks may be considered to be moderate in the sector as risks are at manageable levels. The NBDT sector is expected to record reasonable profits this year also.

3 Analysis of Financial Soundness Indicators

The financial crisis has highlighted that financial system stability is much more than just aggregating the health of individual financial institutions as interconnectedness within the financial system and with the rest of the economy also matters. The size of the financial institutions is also important as it may contribute towards systemic risks. Analysis of the financial soundness indicators (FSIs) is based on variables that capture the various sources of risks inherent in banking activities and which might impact on the stability of the sector.

In this chapter, some FSIs are analysed over the last five quarters to end-March 2010. The Bank of Mauritius has been monitoring FSIs for the banking sector since the year 2002 and these indicators have, so far, pointed towards soundness of the banking system. Box III gives a list of those FSIs. The Bank is also envisaging to monitor the soundness of NBDTIs in the near future.

The analysis of the FSIs has been enhanced, in this chapter, through disaggregation of the FSIs by bank types (domestic banks, branches of foreign banks, and subsidiaries of foreign banks) with a view to identifying idiosyncratic vulnerabilities within these bank types.

Capital Adequacy Indicators

The adequacy of capital determines the robustness of financial institutions to resist shocks to their balance sheets. Monitoring of capital adequacy ratios is useful in tracking the most important financial risks.

In general, banks in Mauritius have Tier 1 capital which exceeds 80 per cent of total capital. The regulatory capital to risk-weighted assets ratio and ratio of core capital to risk-weighted assets stayed at comfortable levels over the last five quarters ended March 2010. On a peer group basis, domestic banks were seen to operate in the range of 12.9-14.1 per cent while subsidiaries and branches of foreign banks held higher regulatory capital ratios. This is due to the fact that foreign banks are relatively more capitalised and credit risks arising from the Segment B activities of branches of foreign banks are captured in their parent banks' capital.

Non-performing loans net of provision to capital ratio is an important indicator of the capacity of banks' capital to withstand losses arising from non-performing loans. During the period under review, this ratio averaged 10.7 per cent for the banking sector. Peer group analysis indicates that subsidiaries of foreign banks held an average ratio of 4.6 per cent compared to branches of foreign banks which operated with an average ratio of 27.4 per cent. This ratio, despite being high for branches of foreign banks, does not indicate any weakness as capital for Segment B activities are not included in the ratio. However, the numerator includes non-performing loans net of provision for both Segment A and Segment B activities.

On the assumption that total non-performing loans net of provisions becomes irrecoverable, an impact analysis showed that banks' capital would still be adequate to sustain the credit risks on their balance sheets.

Asset Quality Indicators

Monitoring of indicators of asset quality is important as risks to the solvency of financial institutions often arise from impairment of assets.

Over the last five quarters to March 2010, domestic banks registered consistent improvement in asset quality as against branches of foreign banks which recorded a gradual increase in the NPLs ratio. Subsidiaries of foreign banks recorded the lowest NPLs ratio hovering around 0.8 per cent at end-March 2010. On an overall basis, asset quality in the banking sector is considered satisfactory as the NPLs ratio ranged from 2.5 per cent to 3.3 per cent.

The sectoral distribution of loans to total loans indicates that the highest share is held by non-residents and non-financial corporations, which at end-March 2010 aggregated to 82.2 per cent. Although it appears that credit is concentrated in those two sectors, risks arising from developments in those sectors may not impact heavily on the financial system stability due to wide geographical and sectoral diversification of non-resident and non-financial corporations borrowers, respectively.

Earnings and Profitability Indicators

Monitoring profitability of financial institutions is equally important as chronically unprofitable financial institutions risk insolvency. While declining trend of these indicators points to problems relating to profitability, too much profits may also signal excessive risk-taking.

The non-interest expenses to gross income ratio which measures the size of administrative expenses within gross income, hovered around 39 per cent over the last five quarters ended March 2010. However, it was observed that domestic banks and branches of foreign banks operated with ratios higher than that of the sector. The cost-efficiency ratios of subsidiaries of foreign banks were well below the average ratio of the sector. This disparity should not be interpreted as domestic banks and branches of foreign banks being less cost-efficient than subsidiaries of foreign banks. In fact, a closer analysis showed that this disparity is a consequence of some inter-bank arrangements on transfer of service fees. On an overall basis, the three types of bank groups held comparable cost-efficiency ratios.

The ratio of interest margin to gross income measures the relative importance of net interest earnings within gross income. Net interest income accounted for an average share of 68.5 per cent in banking sector's gross income. Subsidiaries of foreign banks held higher interest margin to gross income ratios than the other bank groups. This may be indicative of the less reliance on activities that generate non-interest income.

Liquidity Indicators

Liquidity indicators provide a broad measure of a financial institution's ability to meet expected and unexpected demand for cash.

On average, banks kept 28.4 per cent of their total assets in liquid instruments. A comparative analysis showed that subsidiaries and branches of foreign banks maintained higher liquid assets ratios compared to domestic banks. This may be partly explained by the short-term GBLH deposits held by subsidiaries and branches of foreign banks, which are invested in liquid instruments. As such, the high liquid assets ratio of these banks does not necessarily point to any asset-liability mismatches that could threaten the stability of the banking sector.

Monitoring of asset-liability mismatches of banks is being enhanced by the Bank through the recently introduced reporting requirements on liquidity.

Sensitivity to Market Risk Indicators

Banks' increased involvement in diversified operations makes market risk more relevant. However, in Mauritius, market risk in banks' books is relatively small and arises mainly from interest rate fluctuations and exchange rate volatility. Banks are required to maintain a maximum foreign exchange exposure of 20 per cent of Tier 1 Capital.

On average, banks operated with an exposure of 5.3 per cent, throughout the period under review and, thus, were far below the prudential limit. Domestic banks, which deal largely in rupees, operated with a higher average net open positions in foreign exchange to capital compared to the other banking groups. Subsidiaries and branches of foreign banks deal almost entirely with non-residents and their exposure to foreign exchange risks is relatively smaller than domestic banks.

Value of Large Exposures to Capital

Banks maintained an average large exposures to capital ratio of 210.6 per cent over the last five quarters ended March 2010. Domestic banks and subsidiaries of foreign banks held large exposures to capital ratio above 200 per cent on average compared to branches of foreign banks which operated with ratios slightly above 150 per cent. Large exposures by branches of foreign banks and held in foreign currencies are exempted from the prudential limit of 800 per cent as such exposures are captured, at consolidated level, by the parent banks. On an overall basis, banks operated well below the prudential limit imposed on such exposures.

Conclusion

Although, the monitoring of FSIs constitutes an important tool for the surveillance of the banking sector, some caution should be exercised when interpreting them. The use of other analytical tools to complement the FSIs would help to identify risks to the stability of the system as a whole.

To further improve the approach to macroprudential surveillance, the monitoring of financial soundness indicators could be extended to the insurance sector, and other remaining segments of the financial sector.

Box II:
Selected Financial Stability Indicators

Core Set of Financial Soundness Indicators	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10
Capital-based					
Regulatory capital to risk-weighted assets	17.2%	16.0%	15.2%	15.2%	16.5%
Regulatory Tier 1 capital to risk-weighted assets	15.1%	13.8%	13.2%	13.3%	14.6%
Nonperforming loans net of provisions to capital	10.1%	10.6%	11.1%	13.4%	8.1%
Asset quality					
Nonperforming loans to total gross loans	2.5%	2.6%	2.6%	3.3%	2.7%
Sectoral distribution of loans to total loans					
Interbank loans	0.3%	0.4%	0.3%	0.3%	0.2%
Central bank	0.0%	0.0%	0.0%	0.0%	0.0%
Sectoral distribution of loans to total loans	0.0%	0.0%	0.0%	0.0%	0.0%
Other financial corporations	1.4%	1.4%	1.3%	1.2%	1.4%
Nonfinancial corporations	33.4%	34.7%	32.8%	34.7%	35.2%
Other domestic sectors	13.5%	14.4%	14.4%	15.6%	16.1%
Nonresidents	51.4%	49.1%	51.2%	48.2%	47.0%
Earnings and Profitability					
Return on assets	1.6%	1.7%	1.8%	1.7%	1.6%
Return on equity	22.0%	22.7%	22.1%	21.1%	21.2%
Interest margin to gross income	68.9%	68.6%	69.0%	69.1%	67.0%
Noninterest expenses to gross income	38.2%	38.8%	37.6%	38.9%	39.6%
Liquidity					
Liquid assets to total assets	31.8%	28.7%	26.3%	27.8%	27.5%
Liquid assets to short-term liabilities	36.7%	34.4%	31.8%	34.4%	35.4%
Sensitivity to Market Risk					
Net open position in foreign exchange to capital	6.0%	6.5%	5.2%	5.3%	3.8%
Encouraged Set of Financial Soundness Indicators					
Capital to assets	8.0%	7.9%	7.8%	7.6%	7.3%
Value of large exposures to capital	196.3%	213.2%	217.7%	216.9%	208.9%
Customer deposits to total (noninterbank) loans	142.9%	146.0%	138.7%	153.1%	160.3%
Residential real estate loans to total loans	5.7%	6.0%	6.3%	6.8%	7.1%
Commercial real estate loans to total loans	1.9%	2.1%	2.1%	2.1%	2.1%
Trading income to total income	12.4%	12.6%	18.5%	18.5%	19.0%
Personnel expenses to noninterest expenses	51.0%	51.0%	51.0%	51.9%	51.5%
Macroeconomic Indicators	**Mar-09**	**Jun-09**	**Sep-09**	**Dec-09**	**Mar-10**
Headline Inflation	8.5%	6.9%	4.4%	2.5%	1.9%
Year-on-Year Inflation	4.8%	3.3%	0.9%	1.5%	2.3%
Key Repo Rate (end of period)	5.75%	5.75%	5.75%	5.75%	5.75%
Bank Rate (end of period)	5.28%	4.76%	4.67%	4.38%	4.38%
Total Public Sector Debt/GDP (end of period)	55.7%	59.1%	58.7%	61.7%	59.4%
Total External Public Sector Debt/GDP (end of period)	8.0%	9.5%	9.4%	10.4%	9.9%
Import Coverage of Net International Reserves (No. of months)	9.3	10.2	9.8	11.0	10.8
Deposit/Broad Money Liabilities*	84.3%	83.9%	83.6%	83.7%	84.8%
Household Debt/GDP (end of period)**	14.8%	15.0%	15.4%	15.7%	15.9%
Corporate Debt/GDP (end of period)**	52.4%	52.6%	51.6%	51.5%	52.1%
	1st Quarter 2009	2nd Quarter 2009	3rd Quarter 2009	4th Quarter 2009	1st Quarter 2010
Real GDP Growth***	1.1%	1.8%	3.3%	6.7%	3.6%
Unemployment Rate	8.0%	8.3%	7.4%	6.3%	8.4%
Current Account Deficit/GDP	2.0%	13.0%	8.6%	7.4%	5.8%

** Banks Deposits excluding GBL deposits, deposits from non-residents, Banks outside Mauritius, government deposits and Deposit from Banks inside Mauritius.*
*** Debts contracted with banks only*
**** Percentage change over corresponding period of previous year*
Notes: 1. FSIs are calculated on a domestic consolidation basis using the Financial Soundness Indicators Compilation Guide of the International Monetary Fund. Figures may be slightly differenent from other parts of this report.
2. Total loans include advances to nonresident sectors.

4 Financial System Infrastructure

4.1 COMPONENTS OF THE PAYMENT SYSTEMS

The Payment Systems in Mauritius consist of five interconnecting blocks that enable all payment activities in Mauritius:

1. The Mauritius Automated and Clearing and Settlement System (MACSS)

The MACSS is a Real Time Gross Settlement (RTGS) system with guaranteed finality of payment, based on the credit push principle. It is operated by the Bank of Mauritius.

2. The Port Louis Automated Clearing House (PLACH)

Also operated by the Bank of Mauritius and fully integrated with the MACSS, the PLACH performs netting on cheque data that are sent to the clearing house by electronic means and performs settlement at each clearing cycle on the MACSS.

3. Contribution Network Project (CNP)

Operated by the Mauritius Network Services (MNS), the CNP connects all large employers, and the majority of small ones, to the revenue authority via a single point of contact. The final settlements are done through the MACSS at the Bank of Mauritius which maintains the accounts of the Mauritius Revenue Authority.

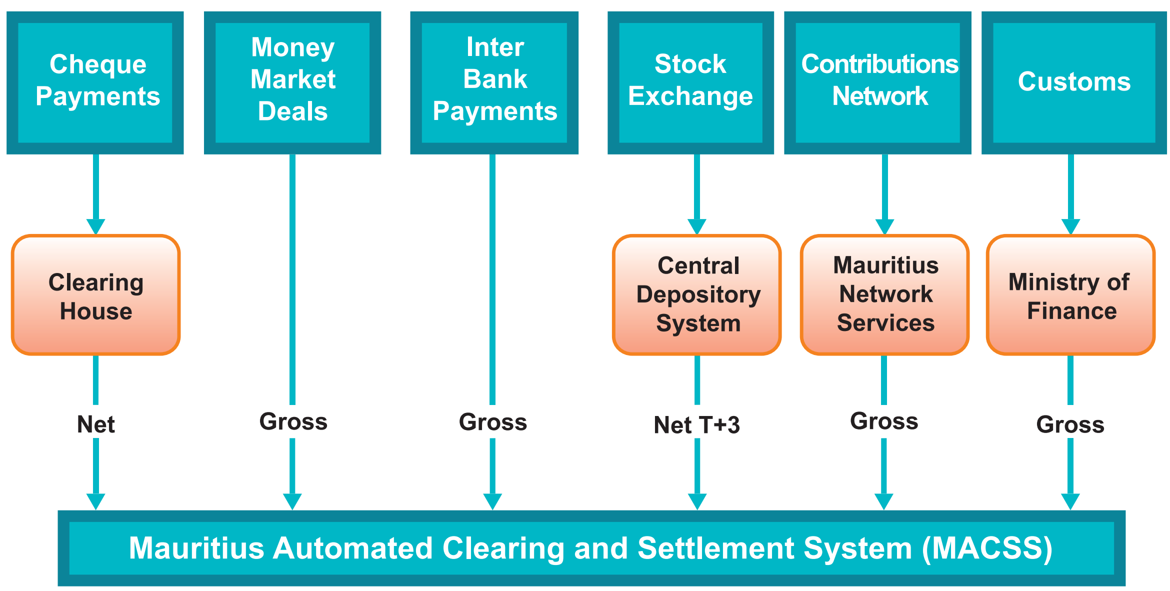
4. Central Depository System (CDS)

This system is operated by the Stock Exchange of Mauritius and allows delivery versus payment of stock exchange transactions on a T+3 rotating basis via the MACSS.

5. Card Settlement Systems

This is private initiative on behalf of banks to settle inter-bank rupee transactions made through credit and debit cards.

Chart 4.1 Structure of the Payment Systems



4.2 PERFORMANCE OF THE PAYMENT SYSTEMS

The payment and settlement systems in Mauritius remained resilient and continued to operate smoothly, contributing to the stability of the financial system. The Mauritius Automated and Clearing System (MACSS), which is the only large value payment system of the country, settled 237,769 transactions amounting to Rs 979 billion during the period January to June 2010. This represents an increase of 25 per cent in volume terms and 12 per cent in value terms compared to the same period in 2009.

Additionally, the MACSS multi-currency feature was launched in December 2009 and 2,337 transactions in foreign currencies were processed in real time without affecting the performance of the rupee transactions. The foreign currency transactions on MACSS are provided in Table 4.1 below.

Table 4.1 Foreign Currency Transactions on MACCS

	Value in Foreign Currency		
	USD	GBP	euro
Jan-10	5,914		1,734
Feb-10	36,283		
Mar-10	5,631,262	2,527	25,135
Apr-10	261,209	141,027	285,999
May-10	317,114	1,834	680
Jun-10	17,493,394	109,726	737,439

Transactions Throughput on MACSS

During the first six months of 2010, MACSS processed approximately 1,400 transactions a day with an average montly value of Rs6.8 billion representing a 36 per cent increase in volume and 17 per cent increase in value compared to the same period in 2009. At its peak, MACSS processed 7,678 transactions within a day with a total value of Rs 15.3 billion.

Despite increase in usage, MACSS operated smoothly without any major disruption and achieved higher than the targeted 99.9 per cent availability during the first semester of 2010.

Proportion of Low and High Value Transactions on MACSS

MACSS is designed to process transactions in real time on gross basis with immediate finality. However, due to the absence of a separate low value clearing system, an increasing number of low value transactions are settled on MACSS. Although there is no restriction on the usage of MACSS with regards to low and high value payments, a high proportion of low value payments, particularly at the end of the day, may pose settlement risks on high value payments which might me of systemic importance. The value proportion of payments on MACSS for the periods January to June 2009 and 2010 are compared below.

Table 4.2 Distribution of Payments by Value Range

	Jan 09 - Jun 09		Jan 10 - Jun 10	
	Volume	Value (Rs million)	Volume	Value (Rs million)
Less than 10,000	41,225	174	55,029	235
10,000-100,000	61,443	2,433	77,519	3,003
above 100,000	87,737	969,522	105,221	975,813
Total	190,405	972,129	237,769	979,052

MACSS is still dominated by high value payments, but compared to 2009, the number of low value payments have increased by 33 per cent while the high value payments have increased by about 20 per cent. This trend further indicates that the payment infrastructure of the country requires a low value clearing system which settles on the MACSS at prescribed times. Such a system will drastically reduce the need for liquidity in the system. As there were only 369 rejected messages (0.11 per cent of the total number of payments) on MACSS during the period January to June 2010, low value payments had insignificant impact on the total volume of payments.

4.3 ASSESSMENT OF RISK AND MITIGATION

MACSS is designed to ensure payments between participants on a real time basis with finality. Through this approach, the system eliminates credit risk in the settlement process. However, the amount of liquidity required can be substantial given that each individual payment is made on a gross basis throughout the day. MACSS has not faced any problem of liquidity so far as participants are allowed to use the same account for their cash reserve ratio purposes. However, mechanisms are in place, both at the application level and operational level to ensure efficient liquidity management which is vital to minimise the incidence of payment gridlock and ensure the smooth flow of payments.

Business Continuity

The MACSS rules and procedures describe the business continuity plan for the system which is tested on the second Tuesday of every quarter. On this day, the MACSS application at the main site is turned off and participants are expected to run from the fallback site.

4.4 CONCLUSION

The Payment Systems in Mauritius comply with the Core Principles of Systemically Important Payment Systems. The design of the MACSS ensures that credit, legal, operational and systemic risks are carefully controlled. The only liquidity risk in the system may arise as a result of cheque settlement obligation, but monitoring and oversight measures ensure such risks do not arise. The forthcoming cheque truncation system will allow cap limits and real time liquidity monitoring to be effected.

5 Risks to and Outlook for Financial Stability

Mauritius has important economic and financial linkages with Europe. The recent measures taken by the European Union are expected to restore confidence in that region and mitigate negative spillover effects on the domestic economy. National Accounts Estimates of the CSO suggest positive growth rates in the export-led sectors, namely tourism and textiles for 2010. Although the growth forecast has recently been downgraded to 4.2 per cent for 2010, the economy is expected to maintain its resilience and stability this year also. Inflationary pressures remain subdued in the short-term but there are potential upside risks in the medium to long-term.

On the external front, the current account deficit as a percentage of GDP is expected to widen to 8.9 per cent in 2010. However, the foreign financing needs of the country should be met without undue pressure on the foreign exchange market and on the level of international reserves. While budget deficits increased substantially in most developed countries, the fiscal deficit in Mauritius has been contained at a level that does not jeopardise financial stability. Public sector debt as a percentage of GDP, which stood close to the threshold limit of 60 per cent at end-March 2010, does not presently pose stability concerns.

The financial intermediation sector is forecast to continue to grow in 2010, albeit at a lower pace compared to the pre-crisis level. Prospects for the sector are expected to remain positive given current economic conditions. Banks which are the main component of the financial sector, continue to hold robust capital. Credit, liquidity, market and operational risks are expected to remain within reasonable levels and exposures to the PIGS countries, and to the rest of Europe, being low, isolate the banking system from stability risks that may arise therefrom.

Indicators of asset quality for the banking sector are foreseen to remain at reasonable levels. However, although the construction, personal and manufacturing sectors recorded higher default rates as compared to other sectors, no threat to financial stability is likely to arise from asset quality of banks.

Banks are also considered to be shielded from funding risk as their major source of deposits is considered to remain stable.

The Bank maintains its ongoing efforts and commitments to ensure stability and soundness of the banking sector through reinforced supervision.

Overall, the financial sector is expected to remain sound and resilient this year also amid improving economic conditions. Although risks to financial stability are likely to be moderate, concerns remain with renewed financial turbulence in Europe.