BANK OF MAURITIUS

Financial Stability Report

August 2011 | Issue No.7

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Financial Stability Report August 2011 | Issue No. 7

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Table of Contents

List of Charts

List of Tables

List of Boxes

List of Acronyms

BoM	Bank of Mauritius
CAR	Capital Adequacy Ratio
CSO	Central Statistics Office
DEM	Development & Enterprise Market
FSC	Financial Services Commission
HHI	Herfindahl-Hirschmann Index
ICT	Information Communication and Technology
IMF	International Monetary Fund
MACSS	Mauritius Automated Clearing and Settlement System
MERI	Mauritius Exchange Rate Index
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital International
NBCTIs	Non-Bank Deposit-Taking Institutions
NPLs	Non-Performing Loans
PIIGS	Portugal, Italy, Ireland, Greece and Spain
ROA	Return on Assets
ROE	Return on Equity
SEM	Stock Exchange of Mauritius
SWIFT	Society for Worldwide Interbank Financial Telecommunication

1. Overview

The global economy continued to recover albeit at a slower-than-expected pace during the first half of 2011. Uncertainties over the growth outlook have increased as a result of the geopolitical disturbances in the Middle East and North Africa, disasters in Japan and increasing concerns over the fiscal situation in advanced economies. Despite the negative developments, financial markets have not been excessively volatile although some parts of the financial markets have reflected to a large extent the increasing doubts about fiscal sustainability in the euro area and the US. In its June 2011 World Economic Outlook Update (WEO), the IMF has projected the global economy to grow at 4.3 per cent in 2011 and at 4.5 per cent in 2012. It has revised downward the expected growth rate of advanced economies but marginally upgraded that of emerging economies.

In Mauritius, according to the Central Statistics Office (CSO), the economy is expected to grow at 4.5 per cent in 2011 compared to 4.3 per cent in 2010. Real estate, renting and business activities, manufacturing and financial intermediation are expected to be the main drivers of growth in 2011. While the growth in final consumption expenditure was moderate, concerns have been raised about the nearly stagnant private sector investment. In addition, the economy remained subjected to a number of risks arising from external developments and, in particular, the inability of advanced economies to raise the pace of economic recovery. The extent to which the advanced economies surmount their economic and fiscal problems will be key to the domestic growth outlook.

The overall balance of payments for the first quarter of 2011 posted a surplus of Rs1,797 million as against a deficit of Rs315 million in the corresponding period of 2010. The current account deficit which represented around 4.5 per cent of GDP in the first quarter of 2011 is not considered a risk to financial stability for the time being. However, the evolution of net FDI inflows warrants close monitoring.

The level of gross official international reserves as at end-June 2011 represented more than 7 months of import cover, much above the usual rule-of-thumb benchmark of 3 months of import cover. They were thus deemed to provide a comfortable cushion to absorb external shocks.

Public sector debt fell to 55.9 per cent of GDP as at end-June 2011 but is projected to reach 60.3 per cent at end-December 2011 and 61.1 per cent at end-December 2012 before coming down to 59.0 per cent at end-December 2013. The debt-service ratio of the country is forecast to hover in the range of 2.8-3.0 per cent between 2011 and 2013.

Households remain among the largest borrower groups in the banking sector and as at end-March 2011, household debt reached 18.3 per cent of GDP up from 16.8 per cent in March 2010. Household funding was channelled to asset-building rather than consumption. The household sector may warrant closer monitoring, particularly with regard to debt repayment capacity.

On the domestic financial market, the Bank tightened monetary policy in the first half of 2011 through two Key Repo Rate hikes totalling 75 basis points. Because of large excess liquidity in the banking system, interbank market rates trended downwards during the first few months of 2011 before moving back up following an increase in the cash reserve ratio and the Bank's issues of its own securities on the domestic money market. These interventions drastically reduced banks' excess reserves, which even turned negative towards end-May 2011. Yields on Government debt securities also increased towards the end of the first semester of 2011.

The rupee exchange rate continued to reflect movements of major currencies on the international markets as well as domestic supply and demand conditions. The Bank intervened on the domestic foreign exchange market on several occasions to purchase and to sell foreign currencies.

The domestic banking sector witnessed a new entrant in March 2011, which increased the number of banks in operation to 20. The new bank is the first entity licensed as a full-fledged Islamic bank. The banking sector remained profitable, with most banks registering commendable profits in 2010. The main risk components of banks were closely monitored and all risk indicators appeared to be at reasonable levels. The capital adequacy ratio hovered well above the minimum of 10 per cent and the non-performing loans ratio for the sector was relatively low. The strong capital position implies that many banks in Mauritius remain well positioned to meet the more demanding Basel III capital standards. The Herfindahl-Hirschmann Index (HHI), a measure of concentration of the banking sector, remained in the 'moderate concentration' band as at end-June 2011.

Asset growth in the insurance sector decelerated in 2010 compared to the previous year, with a deceleration registered in both the long-term insurance business segment and the general insurance business segment. The long-term insurance segment of the insurance industry is highly concentrated, with the three largest firms accounting for 84.7 per cent of total assets while the general insurance business segment is moderately concentrated.

The Non-Bank Deposit-Taking Institutions also registered a deceleration in activity in 2010 compared to 2009 but, on an overall basis, the sector was profitable in 2010. The return on assets and the return on equity improved over the previous year's level.

The payment system infrastructure in Mauritius appears robust enough to cater for the operations of the banking sector. As the regulatory authority, the Bank maintains a rigorous oversight of the infrastructure and ensures that the system keeps up with latest technological advances so that there is no major disruption to banking operations.

2. The International Environment

Widespread optimism about the global economic recovery at the start of 2011 was gradually doused by the Middle-East and North Africa political uprising, the disastrous events in Japan and subdued economic data from the US. While the outlook remained broadly positive, there were increased risks from the euro area sovereign debt crisis and the massive debt overhang in the US that threatened to keep recovery sluggish. These risks were reflected in somewhat more volatile financial markets and higher sovereign debt spreads during the second quarter of 2011, while equities retained their relative attractiveness. The increase in global imbalances from, among others, the expansion of fiscal deficits in advanced economies, can significantly disturb financial markets and the stability of the financial system in general.

2.1 Macro-Financial Developments

2.1.1 The Global Economy

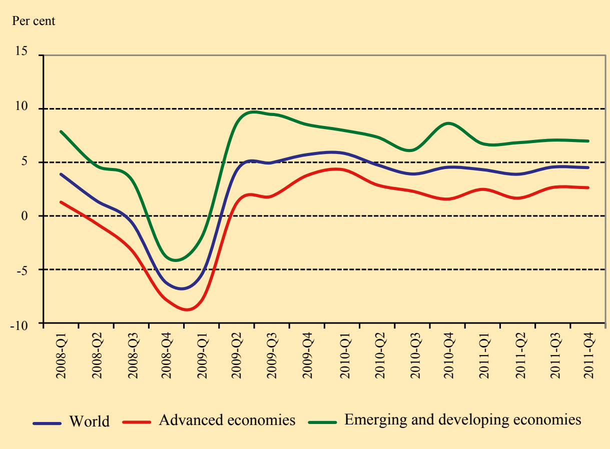
The global economy has continued to grow during the first half of 2011 but has gradually lost momentum, partly as a result of higher oil prices undermining household purchasing power at the start of the year and supply-chain disruptions emanating from the Japanese natural disasters in March. Growth has remained uneven across regions, with emerging and developing economies showing significantly higher rates of economic expansion than advanced economies. China, in particular, has been a major engine of global growth although it has shown tangible signs of overheating, which have forced its central bank to continue to tighten monetary policy and introduce a host of regulatory measures to curb credit. In contrast, hopes for a swift recovery in the US have not materialised as demand remained subdued and supply was affected by the Japanese disaster. Bad weather and an unexpectedly strong cutback in public spending have also affected real output. Real economic activity in UK has continued to be subdued as domestic demand suffered from the high inflation and uncertainty over employment prospects. Overall euro zone growth has consistently been dragged down by the weak performance of peripheral countries.

A rebound in global growth is widely expected in the second half of 2011 although the extent of the upswing could be softer than initially anticipated. In its World Economic Outlook Update released in June 2011, the IMF has reduced the global growth projection by 0.1 percentage point to 4.3 per cent for the year as a whole. It has revised downward the projected growth rate of advanced economies by 0.2 percentage point to 2.2 per cent but upgraded the anticipated growth rate of emerging and developing economies by 0.1 percentage point to 6.6 per cent.

On the positive side, the expected recovery of the Japanese economy as from the second quarter of 2011 is likely to provide a boost to global growth while the relative stabilization in oil prices so far could stimulate global consumer confidence and spending. Moreover, the monetary authorities in advanced economies have kept interest rates at accommodative levels to support the recovery. However, a number of factors continue to pose downside risks to the global growth outlook, notably the prolonged sovereign debt crisis in the euro zone and significant fiscal challenges in the US and UK. In advanced economies moreover, weak labour markets, reflecting the significant amount of economic slack, have added to concerns about the depth of the economic expansion while in emerging and developing economies, monetary policy tightening to counter inflationary pressures and asset bubbles created by the overheating of the real economy have increased the risks of an economic slowdown.

Chart 2.1 depicts actual and projected GDP growth in advanced economies, emerging and developing economies and for the world economy.

Chart 2.1: Global GDP Growth



2.1.2 Implications of Accommodative Policies in Advanced Economies

The sluggish economic recovery and the easing of inflationary pressures have induced monetary authorities in advanced economies to push back the process of interest rate normalisation and implement unconventional measures to stimulate monetary conditions. As such, amid increased speculation over a third round of quantitative easing, the Federal Reserve is not expected to hike its policy rate until early 2013 while the ECB, which is generally more focussed on inflation risks and which has twice raised interest rates by 25 basis points in April and July 2011, may leave interest rate unchanged until the end of 2011. The UK, where inflation has remained above target for some time, has also been holding back interest rate increases to support its flagging economy.

Keeping monetary policy accommodative for such a long period of time is not without its own risks. Low interest rates in the US were one of the factors that caused the global financial crisis. In this economic setup, investors may be prone to take higher risks to increase returns while the household and corporate sectors may take advantage of the low interest rate environment to increase financial leverage. Arguably, the lessons of the crisis have been learnt and there is now more supervision of structured financial products and more prudential requirements for the financial sector. However, higher risk-taking has already contributed to excessive capital flows into emerging economies and the creation of asset-price bubbles. Thus, as investors' growing appetite for risks increases the vulnerability of the financial system to shocks, it is important that interest rates be normalised as soon as economic conditions permit to minimise these risks.

2.1.3 Sovereign Debt, Spreads and Ratings

The financial crisis has highlighted the divergent fiscal situations in advanced and emerging market countries. While fiscal authorities in emerging countries have by and large kept public spending within manageable levels, governments in advanced economies have tended to be more prolific even as revenue was slowing. It is estimated that, on average, the overall fiscal balance of emerging and low-income economies as a percentage of GDP is around half that of advanced economies. Gross debt as a percentage of GDP is estimated to be around 34 per cent on average in emerging economies, while in advanced economies, this ratio is projected to cross 100 per cent on average in 2011, which has raised concerns about debt sustainability. Table 2.1 gives an overview of debt as a percentage of GDP in selected countries.

Episodes of near-defaults and massive bailouts in the euro area as well as the recent tough negotiations over increasing the debt ceiling limit in the US have kept investors on edge and led to continuous re-pricing of sovereign risks, with the result that markets are now thought to be severely distorted in terms of outright and relative valuation. This is particularly visible in the European debt market where the two-year yield spread on Greek 10-year government bonds to German Bunds widened from around 1000 basis points in January 2011 to around 2500 basis points by June 2011 while the spreads on Irish and Portuguese government bonds to German Bunds almost doubled to around 1000 basis points at the

Per cent

Table 2.1 : General Government Gross Debt as a Percentage of GDP

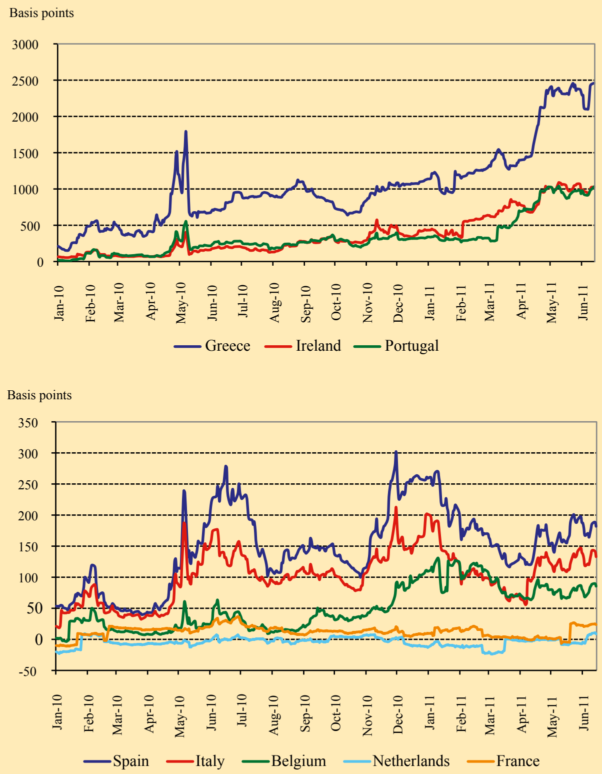
	2008	2009	2010	2011 *Projected*	2012 *Projected*
World	**57.6**	**64.7**	**67.0**	**69.3**	**70.3**
Advanced economies	**79.4**	**91.5**	**96.8**	**101.9**	**104.1**
United States	71.2	84.5	91.2	98.3	102.3
Euro Area	69.7	79.1	85.4	87.9	88.7
France	*68.3*	*79.0*	*82.4*	*84.8*	*86.6*
Germany	*66.3*	*73.4*	*83.2*	*82.3*	*81.0*
Italy	*106.3*	*116.1*	*119.0*	*120.6*	*120.3*
Spain	*39.8*	*53.3*	*60.1*	*67.5*	*69.7*
Japan	195.0	216.3	220.4	233.2	236.7
United Kingdom	52.0	68.3	77.1	82.9	86.5
Emerging economies	**35.3**	**36.7**	**35.3**	**34.6**	**34.3**
China	17.0	17.7	17.0	16.5	15.7
India	74.3	74.0	68.1	66.2	65.9
South Africa	27.3	31.5	36.3	40.5	42.8
Low-income economies	**38.9**	**43.1**	**42.1**	**42.3**	**41.3**

Source: IMF

end of the first semester 2011. The US and UK are not exempt from market distortions as the spreads on 10-year to 30-year bonds neared multi-year highs at around 130 basis points. Besides raising the fundamental question of debt sustainability, distorted yields on government debt are detrimental to financial stability as they permeate to other asset classes and give rise to market volatility and increases in bank funding costs while exposing sovereign debt holders to sovereign debt markets turmoil. Chart 2.2 illustrates the two-year yield spreads of selected Euro area member countries' 10-year government bonds over 10-year German bunds.

The realisation that sovereign debt and financial sector weakness can become intertwined and that market integration multiplies the risks of contagion has forced ratings agencies to downgrade sovereign credit ratings in a number of cases. In the euro area, countries with the worse fiscal performances and/or excessively exposed banking sectors, like Greece, Ireland, Portugal and Spain have had their credit ratings downgraded by several notches. Japan and the UK have also come under the watch list of credit rating agencies whereas the US has been placed on a negative outlook by Moody's and has in August 2011 been downgraded by Standard & Poor's to AA+ with a long-term negative outlook. Table 2.2 shows the evolution of selected countries' credit ratings between December 2010 and June 2011.

Chart 2.2: Spreads on 10-year Government Bonds over 10-year German Bunds (Two-year Yield)



Source: IMF

Table 2.2 : Sovereign Credit Ratings

2010	2011					
Dec	Jan	Feb	Mar	Apr	May	Jun
Ireland *** ↓ Baa1	Japan ↓ AA-	Ireland ↓A-	Portugal *** ↓A3/BBB-	Ireland *** ↓Baa3/BBB+	Italy *** A+	Greece *** ↓ Caa1/CCC
Portugal *** ↓ A+	Greece ↓BB+	Japan *** Aa2	Greece ↓B1/BB-	Portugal ↓Baa1/BBB-	Greece ↓B	
Belgium *** AA+			Spain *** ↓ Aa2	USA *** AAA	Belgium *** AA+	
				Japan *** AA-	Japan *** AA-	

NOTE: ↓ *Refers to downgrade by any of the main rating agencies, Moody's, Fitch and Standard and Poor's.*

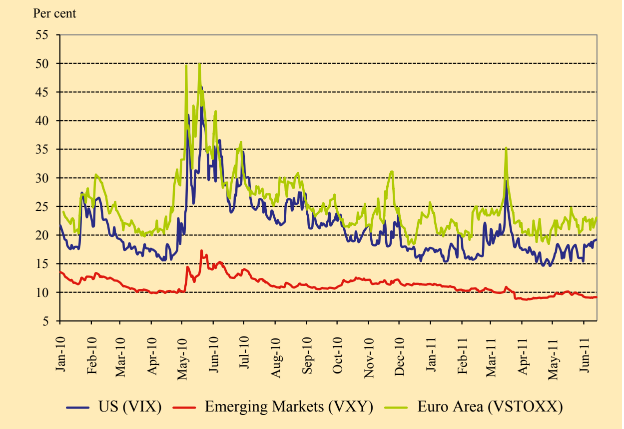
*** *Refers to rating placed on negative outlook by any of the main rating agencies.*

Source: IMF

2.1.4 Global Financial Markets

Volatility in financial markets has generally been contained during the first half of 2011 although the uprising in the Middle East and North African region since late February and the Japanese natural disasters in early March 2011 have raised risk aversion temporarily as markets assessed their potential impact on the world economy. Subsequently, confidence returned to the markets. While news that Greece could default on its debt and soft US economic data increased financial markets volatility somewhat around May and June 2011, it was to a much lesser extent than could have been expected. Chart 2.3 shows volatility in the US, euro area and emerging financial markets.

Chart 2.3: Financial Markets Volatility

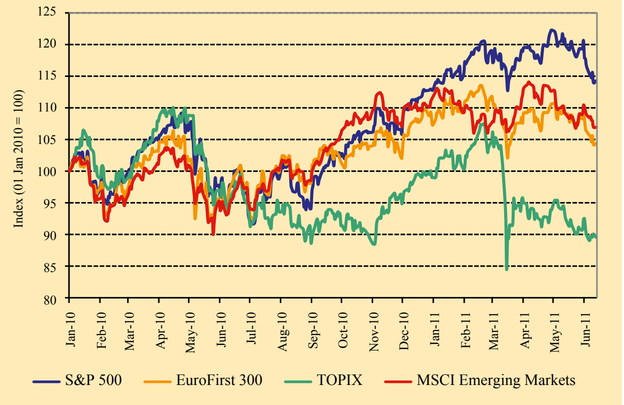


Source: IMF & Reuters

Global Stock Markets

Developed market equities started the year on a positive note, boosted by positive economic news, strong profit reports and an easing of European debt fears, which incited investors to move into riskier assets. In contrast, emerging market equities fell during the first quarter 2011, hit by fears of interest rate hikes to fight off inflationary pressures and, in some cases, an excessive pull-out by foreign institutional investors. Escalating geopolitical concerns in the Middle East and North Africa and the events in Japan, which dampened global sentiment, particularly affected developed markets where equities tumbled in early-March 2011. Thereafter, global equities recovered with the notable exception of the Japanese stock market, which continued to reflect the brunt of disruptions to the manufacturing industry. But the respite was short-lived: the slowdown in global growth as from the second quarter of 2011, doubts about continued supportive Federal Reserve policy, monetary tightening in key emerging markets like China and India and uncertainties about the Greek sovereign debt crisis contributed to further falls in equities. On balance, however, equities have been resilient and remained attractive versus other types of asset classes during the first half of the year. Chart 2.4 depicts the evolution of global equity prices.

Chart 2.4: Global Equity Indices

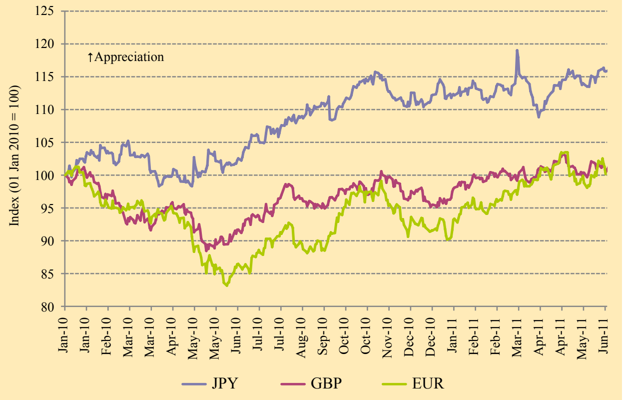


Source: IMF

Currencies

Major currencies have moved in line with market developments during the first semester of 2011 and, partly reflecting the general easing in global risk aversion, broadly appreciated against the US dollar. The latter was kept under pressure during most of the period by the Federal Reserve's easier monetary policy stance compared to the ECB and investors moving into higher-yielding and riskier assets as they drew comfort from strong US corporate earnings data. However, the slowdown in the global recovery and the resurgence of euro area sovereign debt concerns arrested to some

Chart 2.5: Major Exchange Rate Movements Against the US Dollar



Source: Reuters

extent the US dollar's decline against the euro and Pound sterling. The single currency was additionally affected by market expectations that the ECB might not hike interest rates any more after the april 2011 increase while the Pound sterling, which had benefited essentially from the US currency's broad-based weakness, was hit by a series of soft UK data casting serious doubts over the UK's economic recovery. Chart 2.5 shows movements of major exchange rates against the US dollar on the international foreign exchange market.

2.1.5 The International Banking Sector

The financial condition of large and complex banking groups in the euro area was found to be generally better despite significant disparity among them. Several of these banking groups have set higher performance targets for the coming years.

Banks' funding risks remain among the key vulnerabilities which the banking sector in the euro area faces. Several smaller and medium-sized banks have faced funding pressures through higher costs of wholesale and/or deposit funding. Sovereign risk concerns contributed to the wide dispersion of the costs of market funding but other institution-specific factors, such as banks' capitalisation or asset quality, also have a bearing on the variations in funding costs, especially in the case of banks located in countries with fiscal vulnerabilities. Liquidity conditions in euro area funding market improved slightly in the first few months of 2011 especially in the short term segment, but banks in some countries are still facing difficulties both in terms of availability and cost of funds.

Credit risks for banks in the euro area have declined slightly but some banks still face the risk of potential losses stemming from commercial and residential property prices, and the associated deterioration in related assets' quality.

More recently, several banks in the euro area have strengthened their capital base or announced plans to raise capital in the second quarter of 2011. However, some banks still need to reduce their leverage levels and increase their levels of high-quality capital. This will help them build up sufficient capital buffers for any potential future losses and to strengthen investor confidence.

A recent EU-wide stress test conducted in 2011 on a sample of 91 banks concluded that eight banks would fall below the capital threshold of 5 per cent Core Tier 1 over the two-year time horizon, with an overall Core Tier 1 shortfall of EUR2.5 billion while sixteen banks displayed a Core Tier 1 Ratio in the range of 5-6 per cent. It was recommended that national supervisory authorities should require banks whose Core Tier 1 Ratio falls below the 5 per cent threshold to promptly remedy their capital shortfall. National authorities should also request all banks whose Core Tier 1 Ratio is above but close to 5 per cent, and which have sizeable exposures to sovereigns under stress, to take specific steps to strengthen their capital position.

In the US, the supervision framework has been improved based on lessons learnt during the crisis. One of the major new features is the use of stress tests in the Supervisory Capital Assessment Programme and also as an important component of the Comprehensive Capital And Review exercise. The supervisory and regulatory responses have provided strong encouragement for US financial institutions to improve their capital ratios, particularly those ratios that are most appropriate for absorbing losses during stressed economic conditions. US banks have substantially improved their capital ratios since the crisis through retention of earnings, asset sales and new equity issuances.

In South Africa, the Reserve Bank's Financial Stability Committee has been reconstituted and given more responsibility for macro-prudential oversight and policy implementation. The South African authorities consider that there no current threats to domestic financial stability.

Overall, the outlook is much better for international banks. However, developments relating to the euro zone sovereign debt crisis and fiscal problems in the US may increase the vulnerability of banks with significant exposures to those areas.

2.2 Global Imbalances

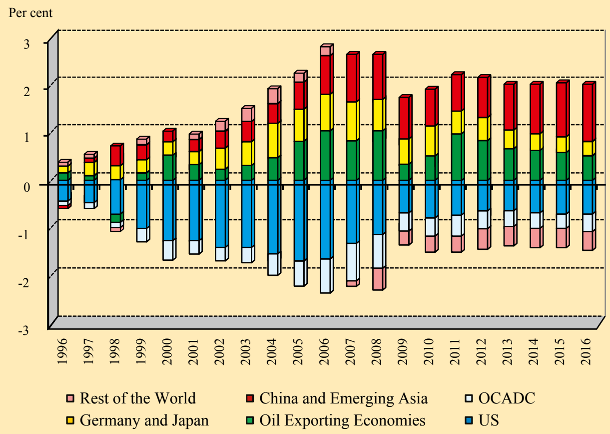
Since the crisis, global imbalances have been recognised as a systemic problem that affects many emerging economies besides advanced countries and influences cross-border capital flows. While imbalances eased during the crisis, they have resumed their uptrend as the global economy started to pick up in 2010. The IMF expects that they will remain elevated up to the end of their forecast period in 2016. Most of the increase in global imbalances has been due to widening current account surpluses in China and oil-exporting countries, while the US current account deficit has also increased, as shown in Chart 2.6. The major underlying factors causing these distortions in countries' current accounts relate to misaligned exchange rates in emerging economies and in China especially, the broadening gap in net savings rate between deficit and surplus countries, the expansion of fiscal deficits in advanced economies and the net preference for 'safe' US assets that makes it possible for that country to finance its external deficit.

Global imbalances pose significant risks to financial stability through volatile and potentially destabilising capital flows. Lately, cross-border capital inflows have mainly benefited emerging economies and commodity exporter countries which, in addition to having better economic fundamentals, have benefited from the near-zero policy rates and perceived low returns in advanced economies. Notwithstanding benefits of capital inflows to financial integration and economic growth, recipient countries have faced serious challenges in designing macroeconomic and prudential policies. Recent experience in the BRICs, for instance, has shown that capital inflows have the ability to generate economic overheating, loss of competitiveness, larger sterilisation costs, asset-price bubbles and significant vulnerability to crises in general.

Furthermore, global imbalances may lead to an accumulation of debt that may weaken the financial system and, in extreme cases, result in sovereign default. The effects of the sovereign debt crisis in the euro zone and, lately, of the US fiscal woes are prime examples of financial instability that may result from the accumulation of debt.

In trying to rebalance the world economy and reduce the threat to financial stability, there is a need for current account surplus countries to encourage higher consumption to stimulate domestic demand and for current account deficit countries to raise savings. China has started to promote domestic demand through salary increases and the US has, to some extent, started to realise the need for more domestic savings, but it will take time for tangible results to be seen. Along the way, greater multilateral macroeconomic coordination, through G20 or IMF initiatives, would also need to be pursued to help resolve global imbalances although economic self-interest may render this process long and difficult.

Chart 2.6: Current Account Balance as a Share of World GDP



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

Source: IMF

BOX I
Implications from the Euro Area Sovereign Debt Crisis and US Fiscal Woes

Euro Area Debt

Imbalances within the euro area have allowed a massive accumulation of debt in certain countries with persistent current account deficits. Given close integration within the euro area, underlying distortions in individual member states have had serious effects on all members, as was made all too clear by the sovereign debt crisis.

Fears of contagion from ailing euro zone nations of the periphery, in particular, to core countries have thus incited the EU – and the IMF – to structure significant bailout packages. However, it would appear that there has been a failure to isolate the Greek crisis and stop the forces of contagion. There are escalating fears that the debt crisis would engulf Italy and Spain and spread to the core region.

Latest financial markets developments have underlined the risks that the euro area sovereign debt crisis poses to financial stability. Banks have become more cautious about future financing conditions and about lending in the interbank market, thus adding to the stresses in the interbank market. In addition, as the crisis intensifies, there are increasing concerns about the quality of banks' assets and the instruments they can offer as collateral. In a March 2011 report, the BIS has estimated that German and French banks carry a combined exposure of US$119 billion to Greek borrowers specifically, and more than US$900 billion to Greece, Spain, Portugal and Ireland combined. The combined exposure of European banks to those four nations is over US$1.8 trillion, nearly half of which is with Spain alone.

The second bailout package agreed in July 2011 reduced Greece's debt burden but actual debt reduction to sustainable levels will require drastic fiscal adjustments. With a large segment of the market doubting that Greece's debt problems will be solved, there has been a growing debate whether Greece should stay in or leave the euro zone. On the one hand, if Greece remains within the euro zone, the stronger countries may find it hard to continue bearing the high economic and political bailout costs while the extent to which Greece itself will be able to follow its radical fiscal adjustment program remains to be seen. On the other hand, a Greek exit from the euro zone is also likely to be painful both for Greece and the region. The country's debt situation will still need to be addressed although more policy independence may facilitate matters. In addition, an exit from the euro may be harmful to French and German banks, which are heavily exposed to the country's debt, and may raise the question whether other countries such as Italy or Portugal should also leave. At the extreme, fears have been expressed about a disintegration of the currency union – and the future of the single currency – and perhaps of the European Union itself but they seem quite far-fetched even if Greece does exit.

Looking ahead, it is becoming more and more apparent that the crisis will continue as long as the soundness of banks remains doubtful and it is therefore imperative that the process of fiscal consolidation within the euro area be continued.

US Fiscal Woes

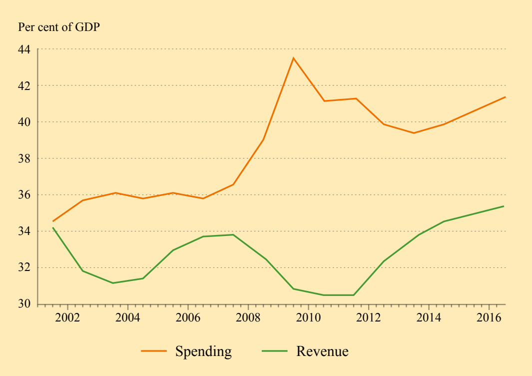
A huge current account deficit and massive inflows into US government debt has led the US on the brink of default. A last minute agreement to raise the debt ceiling, after weeks of partisan battles, has averted a US debt default but failed to prevent an unprecedented downgrade of the US debt, which provoked massive sell-offs in equity markets as risk aversion heightened and confidence was dented.

The budget plan, which provides for increases in the borrowing limit into 2013, calls for spending cuts spread over 10 years and creates a congressional committee to recommend a deficit-reduction package, comes at a time when the economy still needs government support. It has therefore raised concerns about the ability to reverse the faltering recovery in the hope of improving the nation's long-term prosperity. It has also increased pressure on the Federal Reserve to step in with appropriate monetary policy action.

Although the credibility of US Treasury debt has been damaged by the rating downgrade, continued interest has been observed in US debt which investors still perceive as a safe investment. The US Treasury market remains the deepest and most liquid in the world and price transparency in this market seems to outweigh the marginal increase in the credit premium implied by the downgrade. Moreover, since many economies have already heavily invested in the US dollar, they have interest in continuing doing so, especially considering that the next viable alternative, the euro, is not exempt from its own problems.

Going forward, however, the US needs to seriously address the sustainability of its debt and reinforce fiscal consolidation as the risk that investors grudge US Treasuries should not be ignored. In particular, the search for higher returns may divert investors away from US Treasuries. This would contribute to increased volatility on financial markets and raise the threat of financial instability.

Chart I: US Government Spending and Revenue



Source: Courtesy of Reuters

Chart II: Euro area Debt

Source: Eurostat

3. Domestic Macroprudential Assessment

While the domestic economy is expected to continue to recover in 2011, risks from the external sector could alter the growth prospects. The low level of private investment remains a concern and while the current account deficit was financed, the decrease in FDI might have important economic implications. However, gross official international reserves are considered as adequate. Activity in the banking sector was buoyant, with banks continuing to register reasonable profits and maintaining a capital adequacy ratio above the 10 per cent regulatory requirement.

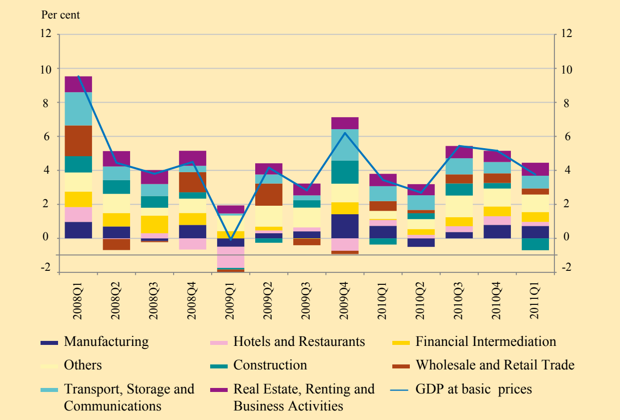
3.1 The Domestic Economy

The growth rate of the domestic economy is expected to pick up to 4.5 per cent in 2011 compared to 4.3 per cent in 2010. Except for the sugarcane and sugar subsectors, which have been affected by adverse climatic conditions, all other sectors of the economy are projected to post positive growth rates. Real estate, renting and business activities, manufacturing and financial intermediation are expected to be the main drivers of economic expansion in 2011, with forecast growth rates of 6.8 per cent, 3.6 per cent and 5.7 per cent, respectively. This tends to be confirmed by the latest data available for the first quarter of 2011, which show that these three sectors contributed relatively more than others to the overall year-on-year growth rate of 3.8 per cent. A notable development during the first quarter of 2011 has been the sharp slowdown in construction, which contracted by 11.7 per cent year-on-year following the completion of major projects.

Final consumption expenditure expanded by 2.6 per cent year-on-year while gross domestic fixed capital formation contracted by 4.7 per cent year-on-year in the first quarter of 2011. For 2011 as a whole, it is expected that final consumption expenditure will grow by 3.0 per cent, taking into consideration subdued household consumption growth of 2.9 per cent, and gross domestic fixed capital formation will expand by 3.6 per cent, led mainly by public sector investment in road infrastructure and airport development. Private sector investment, which is forecast to grow by a meagre 0.6 per cent, is a matter of concern that may potentially weigh on growth going forward.

The current outlook for domestic growth remains broadly positive as business confidence in trade, manufacturing and services continue to recover. The textile sector has been performing well in recent quarters and is expected to continue doing so. Tourism is also improving as increases of 5.8 per cent and 7.5 per cent were noted in tourist arrivals and tourist earnings respectively, in the first semester of 2011 compared to the corresponding period of 2010. Risks to growth, however, are more than ever present especially through the threat of a drastic reduction in external demand in the wake of the current slowdown in the global economy and the persistent debt problems in the euro area. The extent to which these risks eventually materialise will impact on the domestic growth prospects and will indeed have implications for the stability of the country's financial system. Chart 3.1 shows the contributions of the major sectors to economic growth.

Chart 3.1: Contributions of Major Sectors to GDP Growth



Source: CSO, Government of Mauritius

3.2 External Vulnerabilities

The gross external debt of the country has continued to increase to reach 13.7 per cent of GDP at market prices and 26.6 per cent of exports of goods and services as at end-March 2011 mainly due to higher external borrowing by government. With additional external borrowing of central government in the pipeline, the external debt to GDP ratio is expected to rise further by the end of 2011.

External debt service as a proportion of exports of goods and services remained reasonable at 3.6 per cent for the year ended 31 March 2011, partly as a result of the low interest rate environment and the fact that government borrows at below-market rates from multilateral agencies.

The current account deficit improved to Rs3.4 billion in the first quarter of 2011 compared to a deficit of Rs4.3 billion a year earlier as a higher surplus on the invisible accounts largely offset a higher merchandise trade deficit. As a percentage of GDP at market prices, the current account deficit is estimated at 4.5 per cent, down from 6.3 per cent a year earlier.

The merchandise trade balance deficit increased by 20.6 per cent over the year to Rs15.4 billion. Year-on-year nominal exports grew at a faster pace of 25.6 per cent relative to nominal imports growth of 23.2 per cent. The terms of trade over the year to the first quarter of 2011 deteriorated significantly, with import prices increasing by around 8.1 per cent while export prices edged up by around 0.5 per cent.

The services account surplus rose to Rs8.2 billion, mainly due to robust net travel receipts. The income account posted a higher surplus of Rs2.5 billion owing to larger net income receipts to banks while the surplus on the current transfers account improved significantly from Rs0.1 billion in the first quarter of 2010 to Rs1.3 billion in the first quarter of 2011.

The capital and financial account recorded a lower surplus of Rs1.2 billion in the first quarter of 2011 compared to Rs2.3 billion a year earlier, as higher net inflows from other investment were partly offset by lower FDI inflows. Other investment registered higher net inflows of Rs3.8 billion. Net FDI inflows dropped to Rs0.5 billion, from about Rs2.0 billion a year earlier while portfolio investment recorded lower net outflows of Rs1.2 billion, mainly on account of higher repatriation by resident private equity funds. Chart 3.2 depicts the financing of the current account deficit.

The overall balance of payments for the first quarter of 2011 posted a surplus of Rs1,797 million as against a deficit of Rs315 million recorded in the corresponding period of the preceding year.

Usually, financing of the current account deficit remains a source of concern and may pose potential risks particularly when there is significant reduction in financial flows. Despite successive semesters of current account deficits, an increase in the country's foreign reserves has been noted. The more so, there has also been significant flows over time from direct investment which represents non- debt and stable source of financing. The net errors and omissions that emerge from the balance of payments for the last six months to March 2011 are on the liabilities side, implicit to a possible underestimation of financial flows. This would be a matter of concern if these flows pertain mostly to debt creating flows rather than foreign direct investment flows.

3.2.1 Adequacy of Reserves

Gross official international reserves has climbed steadily to reach Rs81.7 billion as at end-June 2011, mainly as a result of the disbursement of external Government loans and the Bank's intervention on the domestic foreign exchange market. The current level of reserves represents more than 7 months of import cover, way above the commonly used rule-of-thumb benchmark of 3 months of import cover, and thus provides a comfortable cushion to mitigate the impact of external shocks. Chart 3.3 shows the evolution of gross official international reserves and import coverage.

Chart 3.3: Gross Official International Reserves

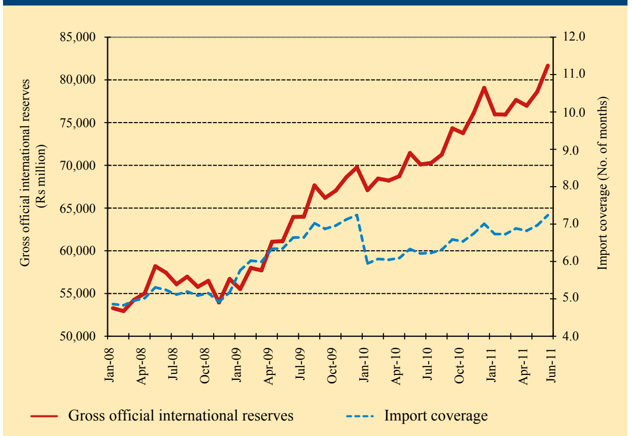
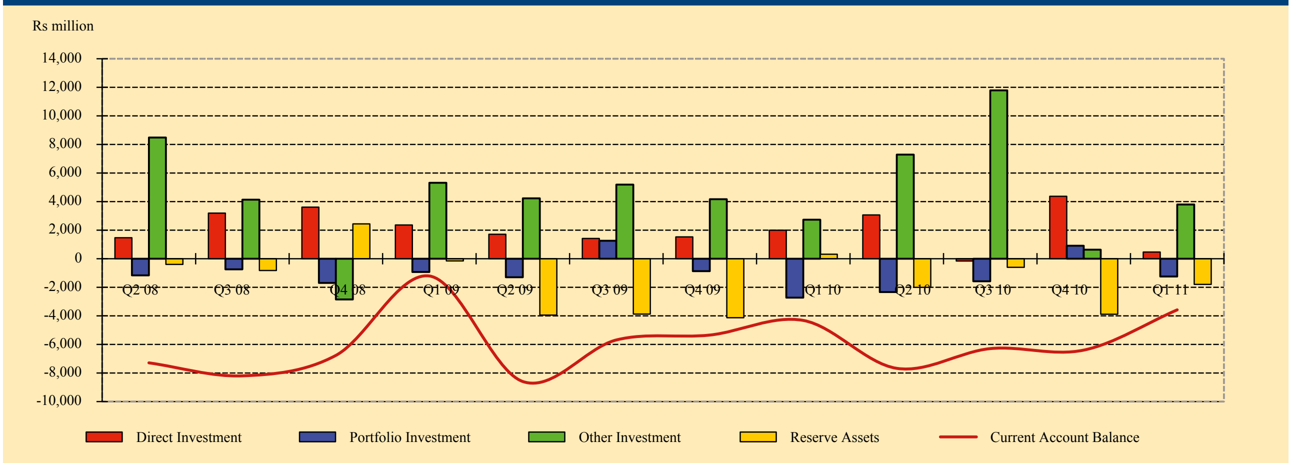


Chart 3.2: Financing of the Current Account Deficit



3.3 Fiscal Sector

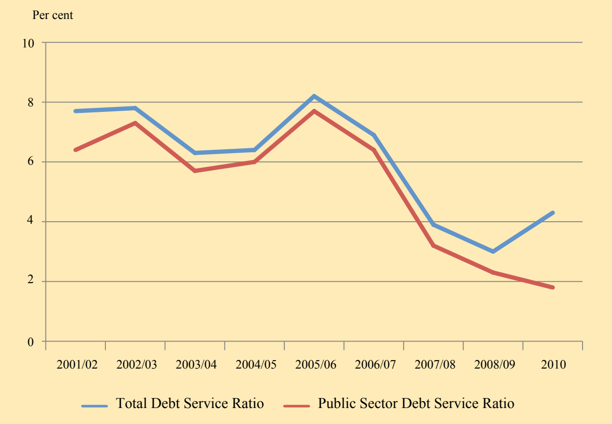
The overall budget deficit of the budgetary central government sector, estimated at 3.2 per cent of GDP in 2010, is estimated to increase to 4.3 per cent of GDP in 2011, reflecting essentially higher capital spending by Government. However, in line with government's fiscal consolidation efforts, the budget deficit to GDP ratio is projected to decline to 4.1 per cent and to 3.9 per cent, respectively, in 2012 and 2013. The primary balance, which was in surplus in 2010 and represented 0.2 per cent of GDP is projected to turn to a deficit of 0.8 per cent of GDP in 2011. The primary deficit to GDP ratio is nonetheless expected to be smaller at 0.5 per cent and 0.4 per cent of GDP in 2012 and 2013, respectively.

As a result of measures taken to lengthen the maturity profile of Government debt as part of the overall strategy to reduce the risks and costs associated with debt management, short-term domestic debt as a proportion of total domestic government debt declined from 42.4 per cent as at end-December 2010 to 41.2 per cent as at end-June 2011 and represented 34.5 per cent of total central Government debt. The main factors causing the reduction in short-term debt were the net redemption of short-term Government securities, issuance of higher amounts of long-term Government Securities and the shift towards long-term external debt to finance borrowing requirements.

Public sector debt, comprising debt of General Government and public enterprises, fell to 55.9 per cent of GDP as at end-June 2011 but is projected to reach 60.3 per cent at end-December 2011 and 61.1 per cent at end-December 2012 before coming down to 59.0 per cent at end-December 2013. Even though public sector debt is expected to slightly breach the statutory level of 60 per cent of GDP as laid down in the Public Debt Management Act (PDMA) of 2008, it is still deemed as sustainable. The PDMA 2008 makes provision for public sector debt to be brought down to 50 per cent of GDP by 2018.

Government external debt as a percentage of GDP went up from 7.4 per cent as at end-December 2010 to 8.2 per cent as at end-June 2011, reflecting increased reliance of Government on foreign funding to finance its budget deficit. The debt-service ratio is forecast to hover in the range of 2.8 per cent to 3.0 per cent between 2011 and 2013. Chart 3.4 illustrates the external debt service ratio for fiscal years 2001/2002 through 2008/2009 and calendar year 2010.

Chart 3.4: External Debt Service Ratio



Source: Bank of Mauritius and Ministry of Finance and Economic Development

Overall, public sector debt remains sustainable and, according to Moody's, Government of Mauritius bonds are rated at Baa2 with a stable outlook. The process of fiscal consolidation is set to continue over the medium term with planned reduction in the budget deficit to GDP ratio. Successful implementation of deficit reduction measures will, nevertheless depend on the way that events currently hitting the global economy unfold in the future, notably whether the advanced economies return to a more buoyant growth path that will help to sustain external demand.

The shift to external debt financing brought about a lengthening of the maturity of Government debt and a moderation in borrowing costs but has increased the exposure to interest rate risks and foreign exchange risks. In the short to medium term, nevertheless, accommodative monetary policies underlying the denominative currencies of the external debt and the strength of the rupee should contribute to keep those risks at manageable levels.

3.4 Household Sector

Total credit to households grew by 15.7 per cent as at end-June 2011 compared to 14.9 per cent as at end-June 2010, higher than the pace of nominal economic activity. Total household credit represented 18.3 per cent of GDP as at end-March 2011 compared to 16.8 per cent as at end-March 2010.

The growth in housing loans continues to be the main driver of household credit growth. As at end-June 2011, housing loans progressed by 21.5 per cent compared to a growth of 16.5 per cent recorded as at end-June 2010. The expansion in personal and professional loans, which comprise loans geared towards educational expenses, the purchase of vehicles and other consumption purposes and which has generally stayed well below the growth rates of housing loans, has been relatively subdued since the beginning of the second semester of 2010 while the growth in credit card advances has been volatile although it does appear to have shifted slightly higher since March 2010. The combined growth of personal and professional loans and credit card advances, which are taken to represent consumption loan expansion, slowed to 8.2 per cent as at end-June 2011 from 12.9 per cent as at end-June 2010. Chart 3.5 shows the evolution of bank credit to households while Chart 3.6 depicts the growth of housing and consumption loans.

As at end-June 2011, 59.3 per cent of total household credit extended by banks consisted of housing loans and 37.8 per cent was for the purpose of personal and professional loans. Credit card advances accounted for the remaining of total household credit, that is, around 2.9 per cent. Over time, a gradual shift of household credit away from personal and professional loans to housing loans has been noted while there has not been much change in credit card advances. Although the economic environment is still uncertain, banks have been keen to extend housing loans as these are collateralised by assets of generally higher value and have a relatively lower probability of default. In addition, competition among banks has given rise to attractive interest rates on housing loans. Chart 3.7 shows the decomposition of banking sector credit to households.

The Continuous Multi-Purpose Household Survey of the Central Statistics Office provides further information about household indebtedness although some caution should be exercised in the interpretation of these results. The survey reveals that around 50 per cent of Mauritian households were indebted to banking or non-banking institutions in 2010. Debt repayment as a share of total household income increased to 18.5 per cent in 2010, from 17.1 per cent in 2009, while the ratio of debt repayment to total household expenditure rose from 19.3 per cent in 2009 to 21.0 per cent in 2010. An analysis of household indebtedness by income groups shows that in 2010, around 80 per cent of households in the income group above Rs30,000 were indebted whereas around 42 per cent of households earning Rs30,000 or less were indebted. Households in the income group ranging between Rs35,001 and Rs40,000

Chart 3.5: Evolution of Bank Credit to Households

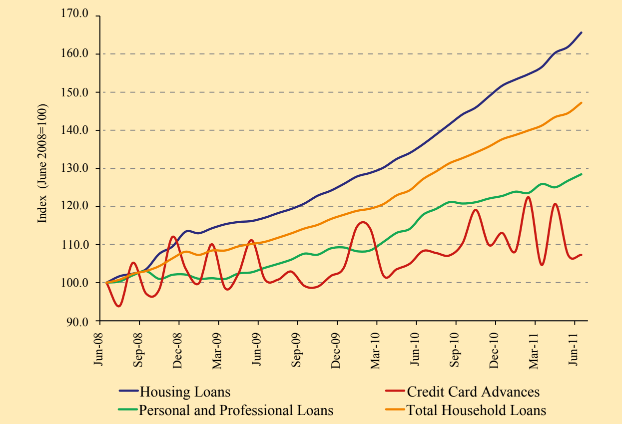


Chart 3.6: Growth of Housing and Consumption Loan

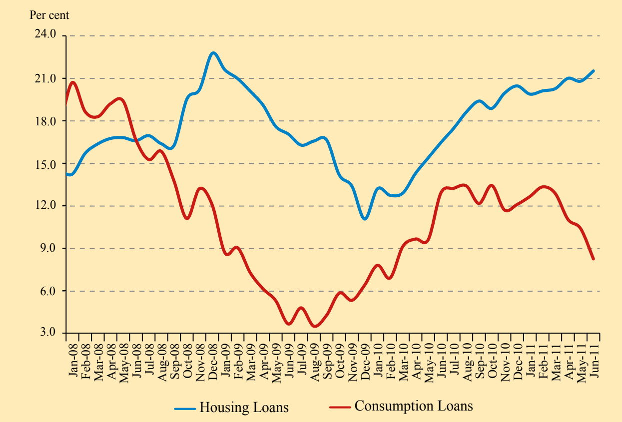


Chart 3.7: Decomposition of Banking Sector Credit to Households

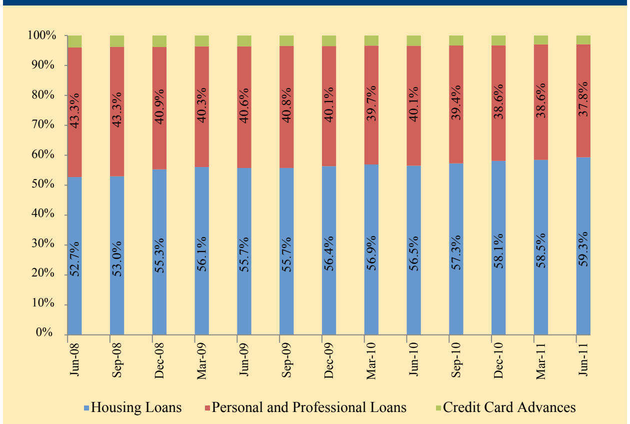
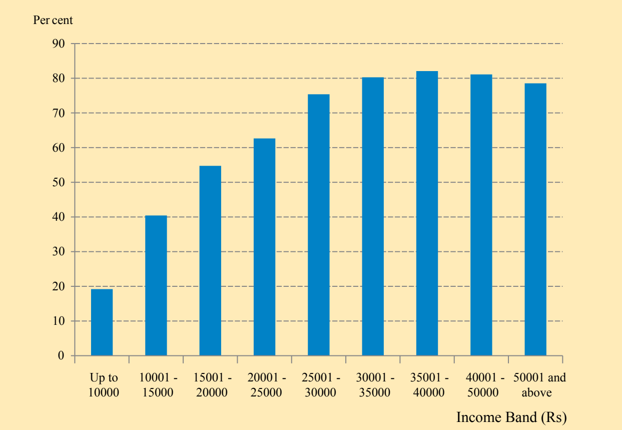
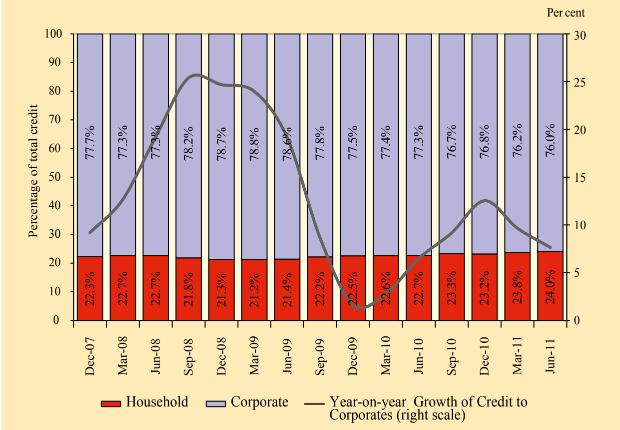


Chart 3.8: Household Indebtedness per Income Group



Source: CSO, Government of Mauritius

Chart 3.9: Evolution of Banks' Exposure to the Corporate Sector



in other income groups. Chart 3.8 illustrates household indebtedness by income group.

Data limitations prevent a complete assessment of financial stability risks that may arise from the household sector. However, there are some elements that point to the necessity of maintaining a close watch on developments in this sector. First, while the increase in debt repayment as a percentage of household income and expenditure may not constitute an immediate source of concern, it does nevertheless suggest that some form of vulnerability may be budding, especially if this trend is maintained. Secondly, and perhaps more importantly, the growth in housing loans coupled with the upbeat investment seen in residential building appears to have been accompanied by a rise in housing prices even though the scarcity of land may explain this to some extent.

3.5 Corporate Sector

During the first semester of 2011, corporate credit growth decelerated but, at around 7.6 per cent on average, was still higher than in the corresponding period of the preceding year. As at end-June 2011, credit to the corporate sector accounted for 76.0 per cent of total credit to the private sector down from 77.3 per cent a year earlier. Chart 3.9 depicts the evolution of banks' exposure to the corporate sector.

The subdued growth in corporate sector credit is broadly consistent with the low level of private investment in the economy and shows that the corporate sector has yet to regain its pre-crisis momentum. Anecdotal evidence suggests that this situation is the result of both muted demand for credit on the part of the corporate sector and more cautious approach to lending by banks. This underlines the relative uncertain conditions that still prevail in the economy, thereby posing a risk to growth looking ahead.

3.6 Financial Markets

3.6.1 The Money Market

Bank's excess liquidity, which had been on a growing trend since the last few months of the second semester of 2010, continued to increase at the start of 2011, reaching a high of Rs5.8 billion in February 2011. The main factor driving the increase in banks' excess liquidity was a net redemption of Government securities.

As a result of the growing level of excess reserves held by banks, the Bank eventually raised the cash reserve ratio by 100 basis points to 7.0 per cent effective monitoring period starting 25 February 2011, removing around Rs2.9 billion. It also issued instruments of maturities longer than those normally issued for liquidity management, notably Bank of Mauritius Bills for tenors ranging between 91 and 364 days and Bank of Mauritius Notes of 2-Year, 3-Year and 4-Year maturities, for a total amount of Rs6.3 billion between January and June 2011 to further bring down excess liquidity. As a result of all those measures, the significant excess liquidity that had characterised the domestic money market at the beginning of the year was virtually eliminated, with excess liquidity even turning negative towards the end of May 2011. On a daily average basis, banks' excess reserves stood at Rs1.9 billion during the first six months of 2011 compared to Rs3.8 billion in the first six months of 2010.

The interbank interest rates trended downwards for most of the first semester despite an increase of 50 basis points in the Key Repo Rate to 5.25 per cent in March 2011. However, as liquidity conditions tightened gradually and the Key Repo Rate was again increased by 25 basis points to 5.50 per cent in June 2011, interbank interest rates started rising again. The overnight interbank interest rates ranged between 1.20 per cent and 3.50 per cent during the period under review, while interest rates on short notice and term transactions hovered within a range of 1.35 per cent to 4.00 per cent. The weighted average interbank interest rate ranged between 1.20 per cent and 3.08 per cent compared to a range of 3.19 per cent to 4.74 per cent in the corresponding period of 2010. Chart 3.10 shows banks' excess reserves and interbank transactions and interest rates.

Yields on the primary market for Government securities reflected to a large extent the excess liquidity situation on the money market, that gave rise to increased competition for Government securities, and the successive increases in the Key Repo Rate. The yields on Treasury Bills thus started to rise as from April 2011 and the Bank Rate, which is calculated as the overall weighted average yield on 91-Day, 182-Day and 364-Day Treasury Bills, climbed to 4.47 per cent as at end-June 2011. More or less the same trend emerged at the primary auctions of longer-term Government securities held during the first semester of 2011. Chart 3.11 depicts the evolution of the weighted average yields on Treasury Bills.

Even as they were trending lower during the first half of 2011, the rates of return on Treasury Bills remained attractive compared to LIBOR rates on US dollar and euro deposits. However, foreign purchases of Government of Mauritius securities did not pick up and totalled an insignificant amount of Rs21 million in the first semester of 2011. Chart 3.12 shows the spread on the yield on the 364-day Treasury Bills to the 12-month LIBOR deposit rates on the US dollar and euro.

Chart 3.11: Weighted Average Yields on Treasury Bills

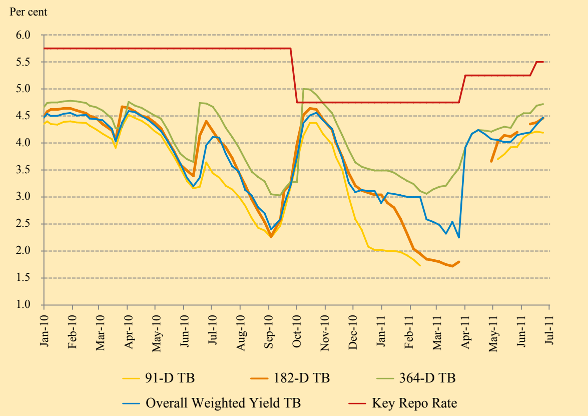


Chart 3.12: Spreads of 1-Year Treasury Bill Yield on US Dollar and Euro LIBOR Deposits

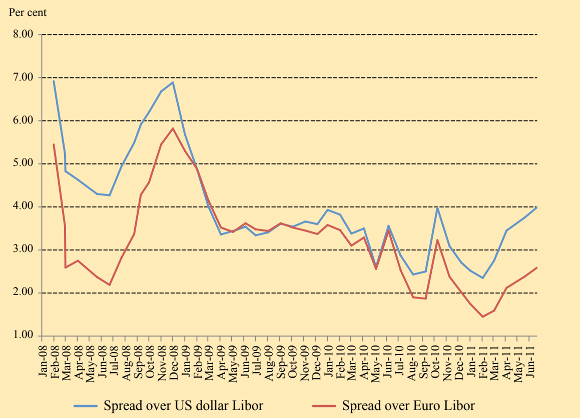
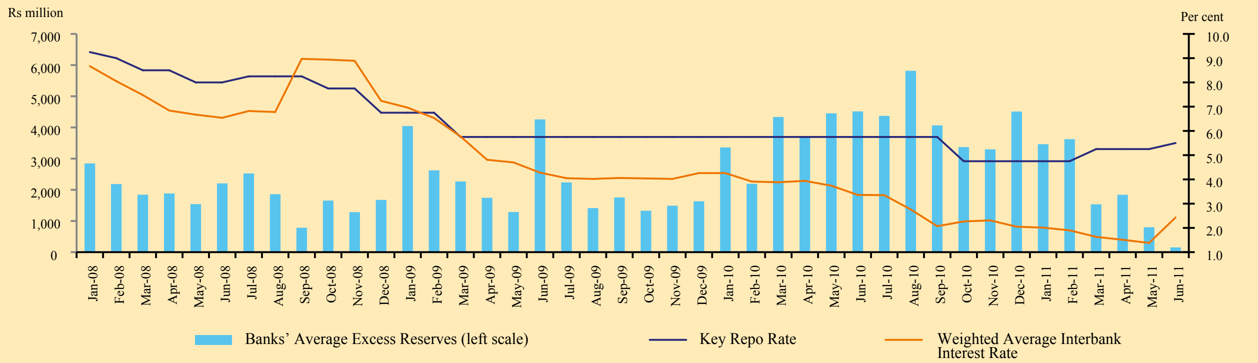


Chart 3.10: Banks' Excess Reserves and Interbank Rates



3.6.2 The Stock Market

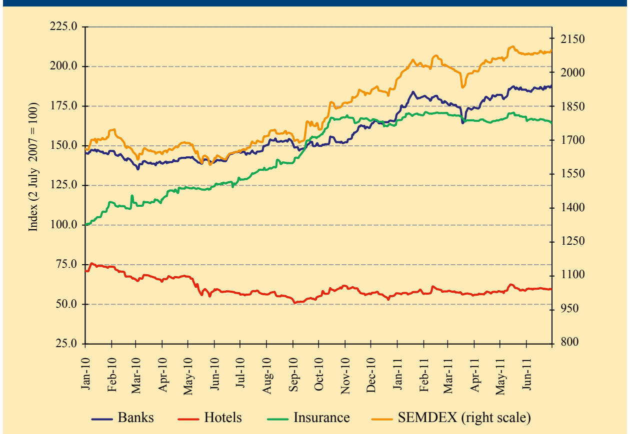
Market capitalisation on the Official Market and the Development & Enterprise Market of the Stock Exchange of Mauritius (SEM) was US$6,505 million as at 30 June 2011 compared to US$5,857 million at end-December 2010.

The local stock market has generally tracked developments abroad in the first semester of 2011. The SEMDEX and SEM-7 rose by 5.5 per cent and 4.8 per cent, respectively, over the period under review despite taking a breather at around March 2011 on rising global risk aversion following geopolitical developments. The gains in the SEMDEX and SEM-7 were, up to March 2011, largely driven by share price increases in banking and non-blue chip stocks but were broad-based thereafter as a number of listed companies announced better financial results, bolstering investors' confidence. Chart 3.13 shows the evolution of the SEMDEX and the performance of banks, hotels and insurance on the SEM.

Net purchases by foreign investors on the domestic stock market slowed drastically in the first half of 2011 Purchases and sales by foreign investors amounted to Rs1,592 million and Rs1,455 million, respectively, resulting in net inflows of Rs137 million compared to almost Rs817 million in the second half of 2010. Foreign purchases represented around 2.7 per cent of the total value traded on the stock market. Foreigners expressed a marked preference for hotel stocks, which attracted Rs277 million of net foreign investment. Chart 3.14 depicts the evolution of investment by foreigners on the SEM.

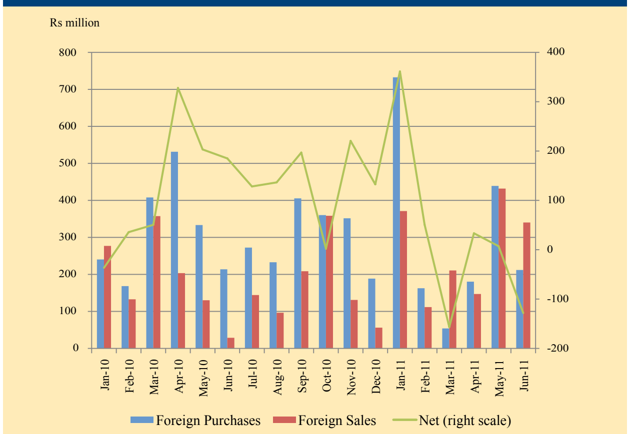
The market price-earnings (PE) ratio rose from 14.05 to 15.43 in the first semester of 2011, with all major sectors registering increases in their PE ratios. While the market PE ratio is just slightly above pre-crisis level, it does not seem to point to significant overvaluation or undervaluation of the market. However, sectoral PE ratios reveal that some sectors, namely the leisure and hotel sector and the sugar sector, may be highly priced relative to their earnings. It is expected that the domestic stock market will continue to reflect global risk aversion, economic developments in major trading partner countries and their impact on the domestic economy.

Chart 3.13: SEMDEX and Selected Sectoral Indices



Source: Stock Exchange of Mauritius

Chart 3.14: Foreign Investment on the SEM



Source: Stock Exchange of Mauritius

3.6.3 The Foreign Exchange Market

The exchange rate of the rupee has continued to reflect movements of major currencies on international markets and domestic supply and demand conditions. The volatility of the rupee against major currencies did not appear excessive during the first half of 2011 although it has shown a tendency to increase in the case of the Rs/US$ exchange rate towards the end of the semester as economic conditions worsened in the US. With banks in Mauritius normally determining the exchange rate of the rupee against the US dollar before adjusting the rupee exchange rate against other currencies, uncertainties about the US dollar on the international foreign exchange market have thus been reflected in the volatility of the Rs/US$ exchange rate. Chart 3.15 shows the daily volatility of the Mauritian rupee against major currencies, based on a standard deviation measure.

Between January and June 2011, on a point-to-point basis, the weighted average dealt rupee ask rate appreciated by 7.64 per cent and 3.44 per cent against the US dollar and Pound sterling, respectively, but depreciated by 0.23 per cent against the euro.

In nominal effective terms, the rupee, which had remained more or less stable over the period August to December 2010, appreciated substantially in the first five months of 2011 as shown in Chart 3.16. MERI1, which is calculated using the currency distribution of trade as weights, appreciated by 5.19 per cent while MERI2, which includes tourism receipts as well in its weight computation, appreciated by 4.95 per cent.

Banks maintained comfortable foreign exchange liquidity position over the period January to June 2011, as evidenced by a daily average foreign exchange exposure of US$29.9 million. The Bank intervened to purchase of US$272.4 million, EUR28.4 million and GBP1.0 million in the first semester, which represented an equivalent amount that was higher than the Bank's sale of foreign currencies, thereby contributing to limit the appreciation of the domestic currency. Transactions on the interbank foreign exchange market, which amounted to US$235.2 million during the period under review, was slightly higher than the level of activity registered in the first semester of 2010 but lower than in the second half of 2010.

Chart 3.15: Daily Rupee Volatility

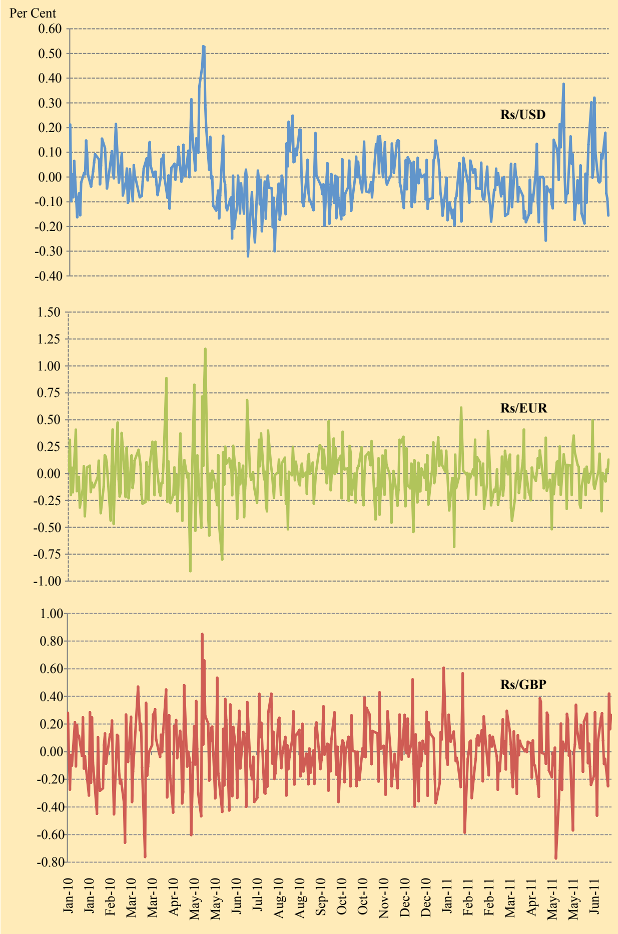
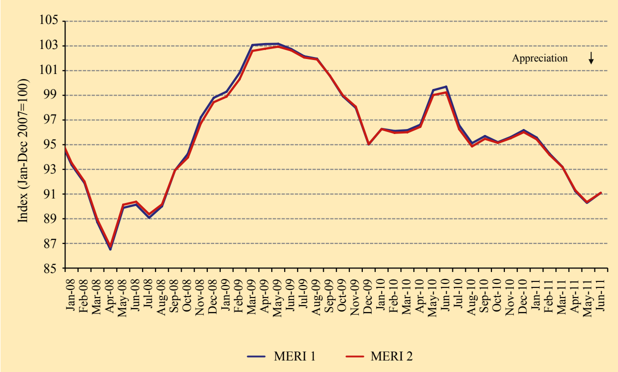


Chart 3.16: Movements of MERI1 and MERI2



3.7 The Banking Sector

The banking sector comprised 20 banks licensed to carry on banking business in Mauritius as at end-June 2011. Of these, eight were domestically-owned banks, seven were subsidiaries of foreign banks and five were branches of international banks. Reflecting efforts undertaken by the Bank to develop the range of services offered by banks in Mauritius, a new entrant joined the banking industry in March 2011 as the first bank licensed to conduct Islamic banking business.

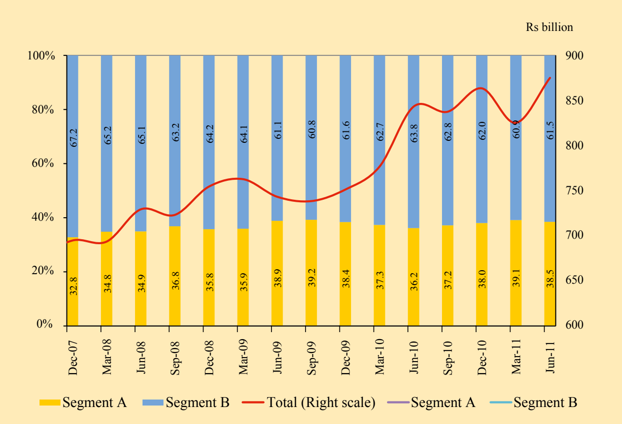
3.7.1 Balance Sheet Structure and Risk Profile

Total Assets

The growth in banks' total assets slowed to 3.8 per cent as at end-June 2011 compared to 13.4 per cent a year earlier, mainly as a result of a deceleration in the growth rate of Segment B assets from 18.4 per cent as at end-June 2010 to almost zero growth as at end-June 2011. Since Segment B assets significantly exceed Segment A assets on account of the large presence of foreign banks in the banking sector, the higher growth rate of 10.4 per cent in Segment A assets as at end-June 2011 – compared to 5.6 per cent a year earlier – was not sufficient to pull up total assets growth.

As at end-June 2011, the share of Segment A assets in total assets was 38.5 per cent, up from 36.2 per cent compared to the corresponding period a year earlier, while the share of Segment B assets fell from 63.8 per cent to 61.5 per cent. The growth in banks' total assets and the segmental composition of assets are depicted in Chart 3.17.

Chart 3.17: Evolution of Banks' Total Assets



Asset Composition

Advances and cash and balances with banks remained the two major components of banks' assets, accounting for 59.4 per cent and 27.1 per cent of total banking sector assets, respectively, as at end-June 2011 compared to shares of 58.1 per cent and 29.9 per cent, respectively, as at end-June 2010. The share of other assets in total assets did not experience any significant change. Chart 3.18. shows the components of banks' total assets as at end-June 2010 and 2011.

Asset Diversification Matrix

On a consolidated basis, as at end-March 2011, banking sector assets remained concentrated in the zero, 20 per cent and 100 per cent risk-weight buckets, which in aggregate accounted for 80.8 per cent of total assets. Domestically-owned banks have focused on 100 per cent risk-weight assets while foreign-owned banks have invested mainly in assets that carry risk-weights of zero, 20 per cent, 50 per cent and 100 per cent. The risk diversification matrix of banks is depicted in Chart 3.19.

Chart 3.18: Components of Banks' Total Assets

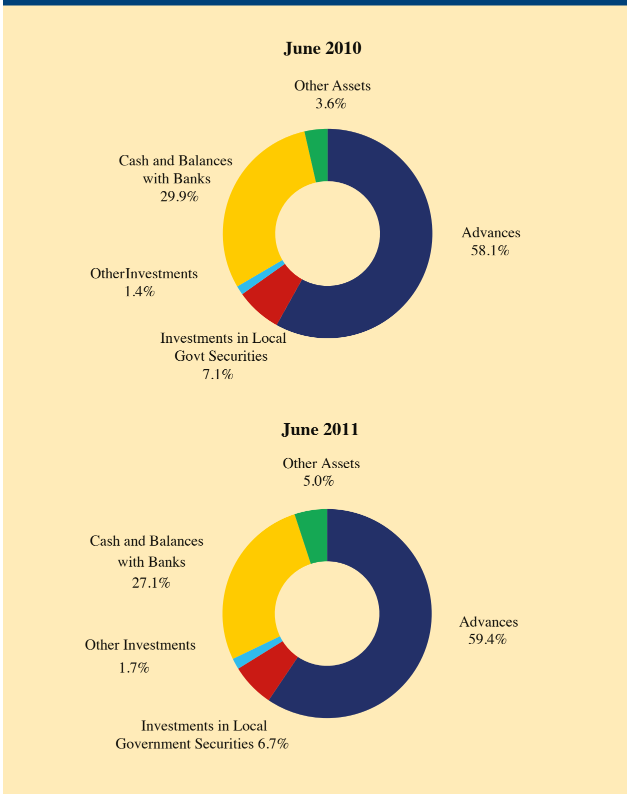


Chart 3.19: Risk Diversification Matrix of Banks

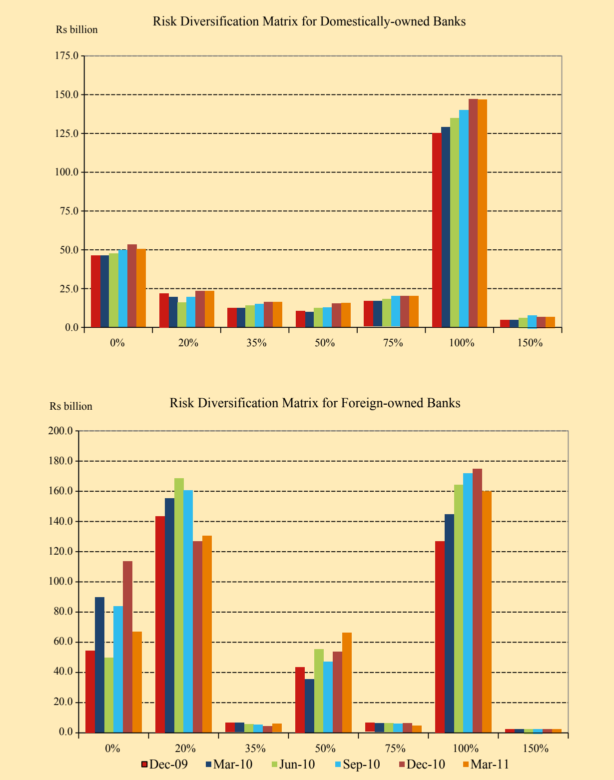
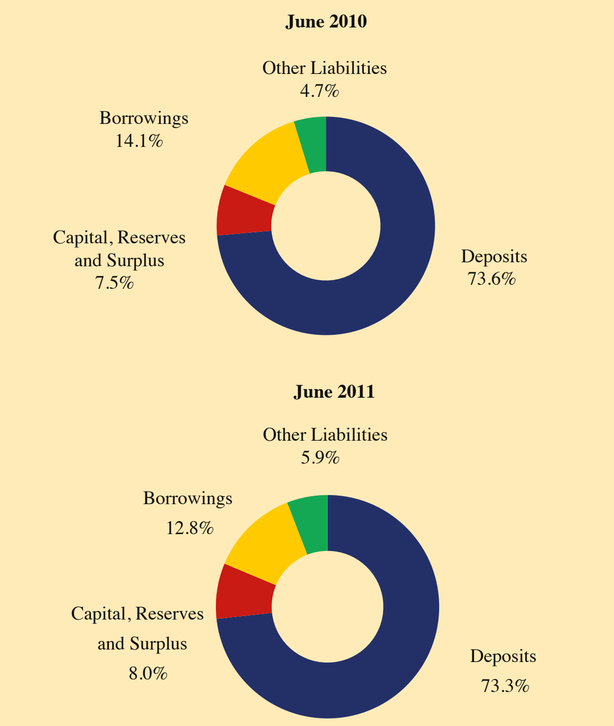


Chart 3.20: Components of Banks' Total Liabilities



Banks' liabilities consisted mostly of deposits, which made up 73.3 per cent of total liabilities as at end-June 2011 compared to 73.6 per cent as at end-June 2010. The share of borrowings, the second largest component of banks' total liabilities, fell to 12.8 per cent of total liabilities while the share of Capital, Reserves and Surplus increased marginally over the year to end-June 2011. The composition of banks' total liabilities as at end-June 2010 and 2011 is shown in Chart 3.20.

Market Concentration

Since June 2010, concentration in the banking sector in terms of loans, deposits and assets has not changed radically. The Herfindahl-Hirschmann Index (HHI), which measures the degree of market concentration, remained at about the same levels when computed for loans, deposits and assets, as shown in Table 3.1. At those levels, the HHI indicates 'moderate concentration' as at end-June 2011.

3.7.2 Credit Growth and Credit Risks

With foreign banks predominant in the domestic banking sector, credit to Segment B activities largely exceeds credit to Segment A activities. As at end-June 2011, the shares of Segment A and Segment B advances in total advances stood at 39.9 per cent and 60.1 per cent, respectively, compared to 38.8 per cent and 61.2 per cent a year earlier.

The growth in total advances, which had accelerated to a high of 21.1 per cent in the second half of 2010, slowed down significantly in the first half of 2011 to reach 6.2 per cent as at end-June 2011, just about one third of the year-on-year growth achieved a year earlier. This was mainly driven by a deceleration in Segment B advances from 27.6 per cent as at end-June 2010 to 4.3 per cent as at end-June 2011. Segment A advances growth also slackened during the first half of 2011 but at a lesser pace, going down from 13.3 per cent as at end-December 2010 to 9.1 per cent as at end-June 2011. Chart 3.21 pictures the growth in advances on a year-on-year basis.

Table 3.1: Herfindahl-Hirschman Index

	Dec-08	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Loans	1,263	1,259	1,317	1,347	1,347	1,293	1,309	1,307
Deposits	1,297	1,207	1,218	1,220	1,190	1,168	1,197	1,209
Assets	1,172	1,067	1,112	1,097	1,068	1,047	1,093	1,082

Private sector credit, which consists mainly of Segment A advances, grew by 9.5 per cent in June 2011 up from, 8.3 per cent compared to the corresponding period of 2010 as shown in Chart 3.21. The largest share of private sector credit has been channelled to the household and tourism sectors. These two sectors in aggregate constituted 43.5 per cent of total private sector credit as at end-June 2011. Credit to the manufacturing sector represented 8.4 per cent of total private sector credit as at end-June 2011, down by 0.5 percentage point compared to a year earlier. Overall, the main economic sectors, including household, tourism, traders, financial and business services, and construction, made up around 75 per cent of total private sector credit, as seen in Chart 3.23.

Private sector credit to financial and business services and traders registered higher growth rates as at end-June 2011 compared to end-June 2010. In contrast, credit growth to the public non-financial corporations sector, which was already negative as at end-June 2010, contracted further as at end-June 2011. Credit growth to agriculture and fishing, which had been quite robust as at end-June 2010, also contracted as at end-June 2011.

Growth of credit to tourism and manufacturing improved over the period under review. Credit to tourism picked up slightly while credit to manufacturing, which had contracted during the most part of 2010, turned positive as from November 2010, driven by credit extended to operators in the non-exports sector. Credit growth to export enterprise certificate holders continued to remain negative. On a year-on-year basis, credit to manufacturing grew by 2.9 per cent as at end-June 2011 as against a contraction of 2.1 per cent in the corresponding period of 2010 while credit to tourism expanded by 19.5 per cent as at end-June 2011 compared to 17.2 per cent a year earlier.

Rupee loans and overdrafts and foreign currency loans accounted for 79.7 per cent and 13.6 per cent, respectively, of total credit to the private sector as at end-June 2011. Rupee loans and overdrafts grew by 11.6 per cent on a year-on-year basis while foreign currency loans contracted by 4.0 per cent. Chart 3.25 shows the evolution of private sector credit by currency. As at end-June 2011, 5.1 per cent of total credit to construction sector was denominated in foreign currencies but tourism and manufacturing availed of foreign currency credit quite substantially:

Chart 3.21: Year-on-year Growth of Advances

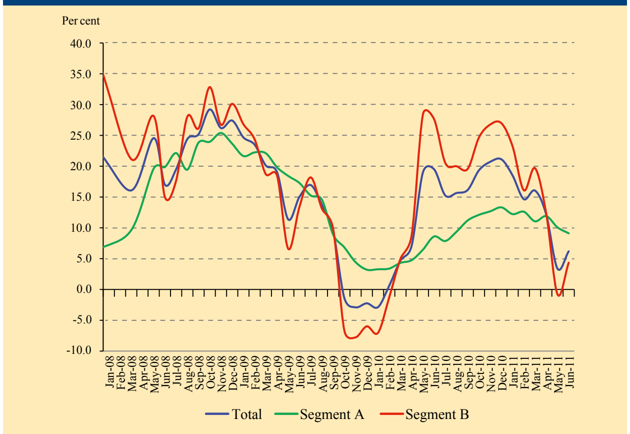


Chart 3.23: Sector-wise Distribution of Credit

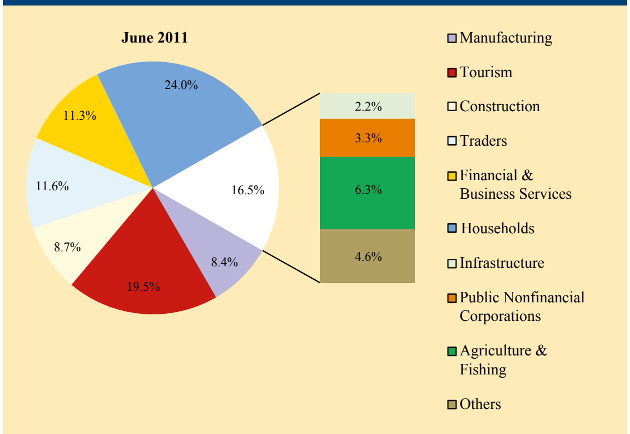


Chart 3.22: Year-on-year Growth of Credit to the Private Sector

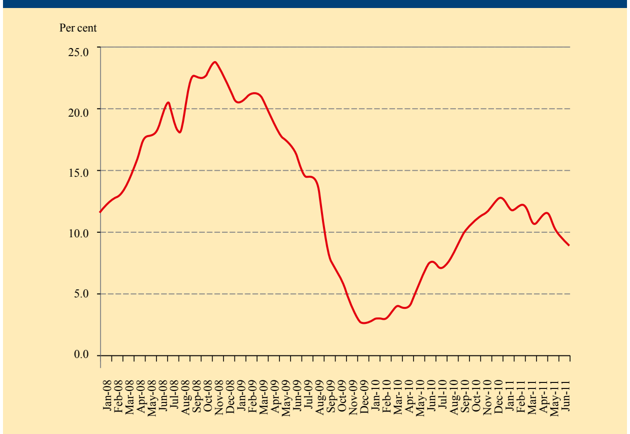
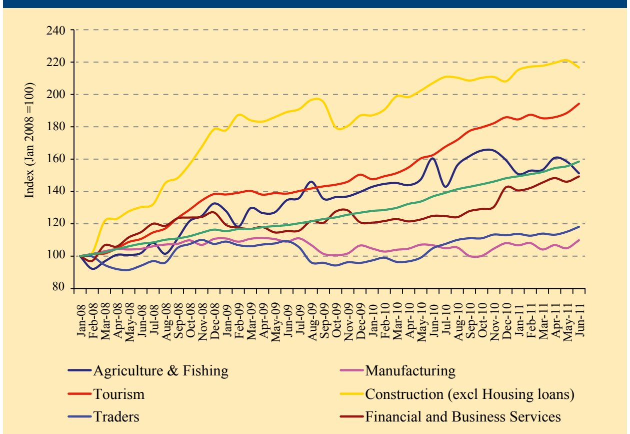


Chart 3.24: Evolution of Sectoral Credit

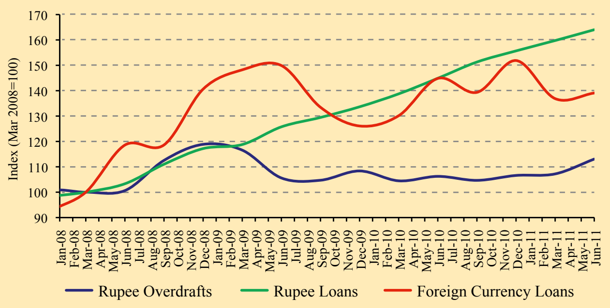


27.6 per cent and 24.4 per cent of total credit extended to these two sectors were in foreign currencies. However, foreign exchange risks may not be as high as expected, as part of the sectors' revenue is also denominated in foreign currencies. In addition, these two sectors may have benefited from lower interest rates on foreign currency loans relative to rupee loans. The main risk to financial stability from borrowing in foreign currencies, especially if the borrowing is not geared towards foreign currency financing but instead converted into rupees, would be an increase in the supply of foreign currencies on the domestic foreign exchange market, accompanied by a distortion of the rupee exchange rate.

Credit Concentration Risk

Currently, credit concentration risk does not appear as a threat to financial stability. The ratio of aggregate large exposures to the banking sector capital base climbed very slightly as from the second half of 2010 but remained well below the aggregate prudential limit of 800 per cent. As a percentage of total credit facilities, large exposures as at end-March 2011 were also not much changed from previous levels. However, further study on the inter-connectedness of large borrowers is required to be able to realistically ascertain credit risk concentration.

Chart 3.25: Evolution of Private Sector Credit



The evolution of the ratio of aggregate large exposures to capital base and the ratio of aggregate large exposures to total credit facilities are given in Table 3.2

Cross-Border Exposures

Around 48.9 per cent of banks' total loans as at end-March 2011 gave rise to cross-border exposures, reflecting the high level of foreign currency funded activities of foreign-owned banks in Mauritius. The largest cross-border exposure of banks is mainly to Asia, namely to India, and to a much lesser extent to Europe and Africa. Despite the different economic conditions in these three regions, the risks to financial stability arising from banks' exposures to these markets are not currently considered to be a concern. The percentage of impaired loans as at end-March 2011 ranged from nil in the case of Asia, which accounts for 66.1 per cent of banks' total cross-border loans, to 2.02 per cent in the case of Africa. Table 3.3 gives a snapshot of cross-border exposures.

Table 3.2: Concentration of Credit Risk Ratio

	Percentage of aggregate large exposures to capital base	Percentage of aggregate large exposures to total credit facilities
Mar-09	211	26
Jun-09	209	31
Sep-09	212	28
Dec-09	197	24
Mar-10	209	26
Jun-10	197	23
Sep-10	197	25
Dec-10	221	26
Mar-11	200	23

Table 3.3: Banks' Cross-Border Exposures

	June-10		September-10		December-10		March-11	
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*	Percentage of total cross-border loans	Percentage of impaired loans*
Africa	5.63	6.44	6.21	3.76	6.68	2.80	9.61	2.02
Asia	69.72	0.08	70.17	0.07	69.28	0.03	66.14	0.00
Australia	0.27	0.27	0.26	0.16	0.41	0.10	0.46	0.11
Europe	10.27	2.32	9.61	2.20	11.12	1.41	10.70	1.39
Middle East	3.41	0.00	3.29	0.00	2.71	0.82	3.94	0.42
USA & Canada	1.23	0.46	1.36	0.39	1.27	0.24	1.03	0.31
Others	9.46	0.10	9.09	0.10	8.53	2.43	8.12	4.43

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

BOX II

Banks' Exposures to Peripheral Europe

Sovereign risks and persistent weaknesses in the European banking sector could have spillover effects on the stability of the global financial system. Banks in Mauritius are not directly exposed to European sovereign debts: their total placements with banks and loans and advances to non-bank private sector in Portugal, Ireland and Greece represent only around 0.3 per cent of the total assets of the banking sector. Losses from direct exposure to these countries would therefore be contained although, under severe stress scenarios, banks could still face some losses in terms of second round effects. Charts I and II depict banks' exposures to Europe.

Chart I: Banks Total Claims to Europe as a Percentage of Total Assets, 2011 Q1

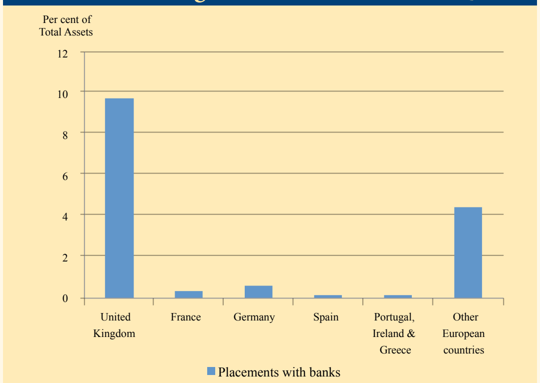
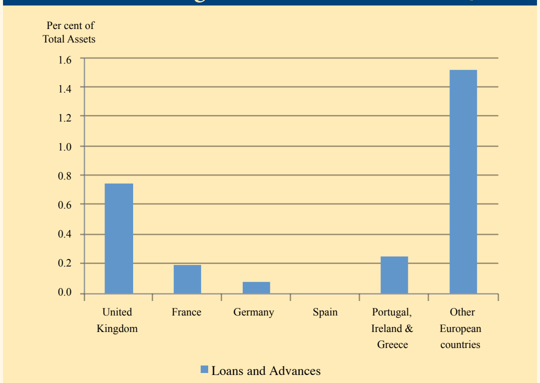


Chart II: Banks Total Claims to Europe as a Percentage of Total Assets, 2011 Q1



In general, however, higher capitalisation over the years has improved banks' ability to withstand adverse shocks. Internal simulation exercises have shown that, on a consolidated basis, at end-March 2011, banks (excluding the branches of foreign owned banks) could absorb losses up to a maximum of 38.0 per cent at the existing level of total regulatory capital. Alternatively, they could sustain growth of around 61.0 per cent in total risk-weighted assets without the total regulatory capital adequacy ratio going below 10 per cent.

Impaired Assets

Total non-performing loans as a percentage to total loans in the banking sector edged up to 2.4 per cent in March 2011, from 2.3 per cent in March 2010, suggesting a mild deterioration in the asset quality of credit extended during that period. The non-performing loans (NPLs) ratios associated with credit extended outside Mauritius remained basically unchanged, as shown in Table 3.4.

The level of NPLs associated with credit granted to key economic sectors accounted for 82.3 per cent of total NPLs in Mauritius as at end-March 2011. The construction sector, inclusive of housing, continued to record a relatively larger share of delinquent loans in total NPLs, as displayed in Chart 3.27. It is noteworthy that the bulk of construction loans is extended as housing loans. However, the default rate on housing loans has been relatively low.

Non-Performing Loans and Provisions

Non-performing loans went up consistently between June 2010 and March 2011. On a quarter-to-quarter basis, non-performing loans expanded by 7.9 per cent and 12.5 per cent, respectively, in the last two quarters of 2010 but contracted slightly by 1.4 per cent in the first quarter of 2011. The increase in non-performing loans in the second half of 2010 was nevertheless accompanied with higher provisioning, which was sustained despite the fall in non-performing loans in the first quarter of 2011. This brought about a rise in the coverage ratio, which stood at 54.2 per cent as at end-March 2011 compared to 50.3 per cent a year earlier. Chart 3.28 depicts non-performing loans and provisions from December 2007 through March 2011.

Table 3.4: 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
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
Jun-10	4.0	0.5	2.1
Sep-10	4.2	0.4	2.1
Dec-10	4.6	0.5	2.4
Mar-11	4.5	0.6	2.4

Chart 3.26: NPLs in Key Sectors as a Ratio to Total NPLs

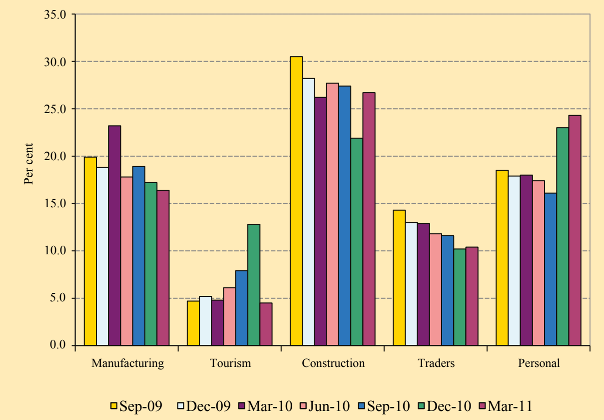


Chart 3.27: Ratio of NPLs to Advances to Key Sectors

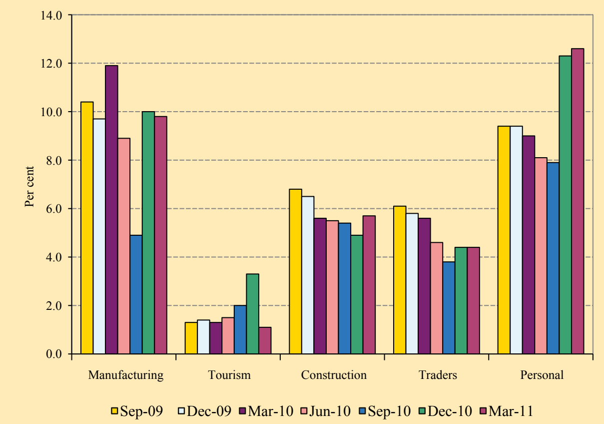
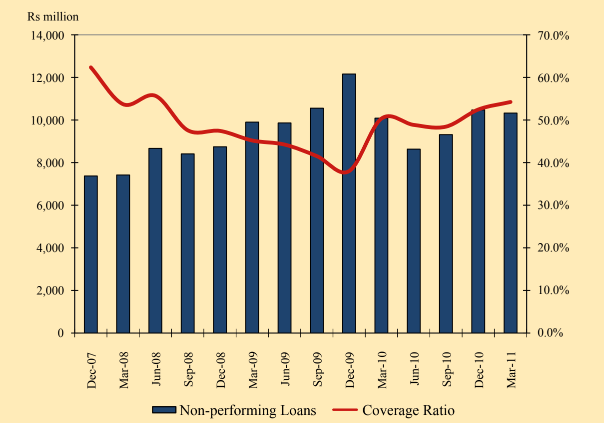


Chart 3.28: Non-Performing Loans and Coverage Ratio



Stress Test

As at end-March 2011, a significant part of the distribution of credit to major sectors was principally geared towards banks with a capital adequacy of more than 10 per cent, as shown in Chart 3.29.

A stress test has been conducted on the financial condition of banks as at end-March 2011 to assess their ability to absorb the impact of a shock on their credit portfolio from a general weakening in economic activity, causing non-performing loans to increase by 15 per cent in key sectors and by 5 per cent in the remaining sectors.

The results of the stress test showed that the size of the impact of the shock varied between banks depending on the composition and quality of their portfolios and the amount of capital they have to withstand the shock. Chart 3.30 shows the pre-shock and post-shock tier 1 capital ratio.

In general, banks that maintain a post-shock tier 1 capital ratio of more than 5 per cent are considered stable. Results concluded that banks (excluding branches of foreign owned banks) would generally be resilient to the shock to economic activity as at end-March 2011. Banks' tier 1 capital ratio would move from 13.7 per cent to 10.3 per cent while the interquartile range would contract by 40 basis points.

3.7.3 Funding and Liquidity Risks

Deposits, whether in rupee or foreign currencies, remained the main source of funding for banks in Mauritius. Deposits at domestic banks are mostly in rupee while deposits at foreign banks are largely in foreign currencies to fund lending activities also denominated in foreign currencies. Foreign currency deposits accounted for 64.1 per cent of total banking sector deposits as at end-June 2011. The evolution of total banking sector deposits, and rupee and foreign currency deposits is depicted in Chart 3.31.

As at end-June 2011, total deposits grew by 3.3 per cent year-on-year compared to 13.3 per cent as at end-June 2010 as the growth of both rupee deposits and foreign currency deposits decelerated. The reduction in the pace of deposit growth was mostly noted in the first half of 2011.

Chart 3.29: Sectorwise Distribution of Credit Exposure by Tier 1 Capital

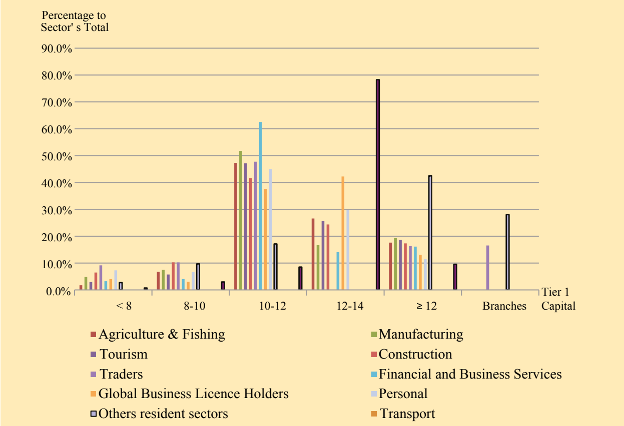


Chart 3.30: Distribution of CAR after Stress Test Scenarios

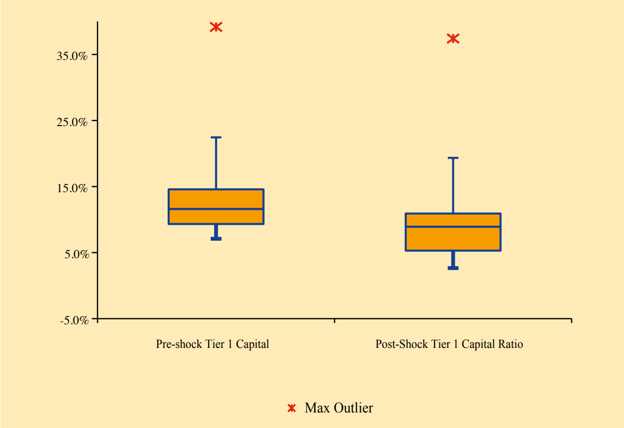
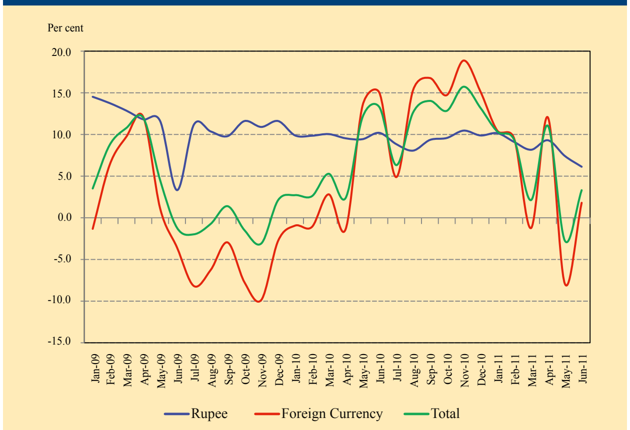


Chart 3.31: Year-on-Year Growth of Deposits



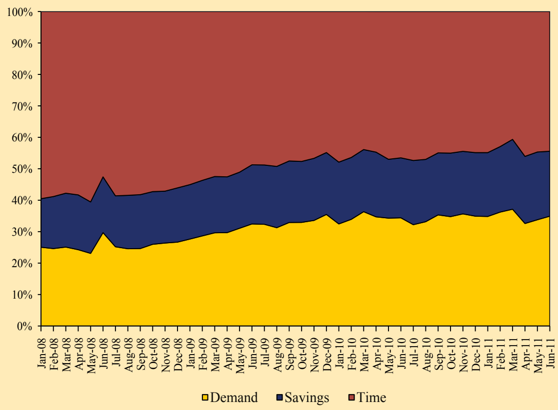
Concentration of Deposits

Foreign banks accounted for the largest share of total deposits held. As at end-June 2011, they held 62.6 per cent of total banking sector deposits and the remainder was being held by domestic banks. In terms of banks' size, 62.8 per cent of deposits were held by large banks, 32.1 per cent by medium-sized banks and 5.1 per cent by small banks. Chart 3.32 provides more details on banking sector deposits by bank size and group.

Maturity Preferences

Customers maintained their preference for time deposits, which made up around 44 per cent of total banking sector deposits as at end-June 2011. Savings deposits represented around 20 per cent of total banking sector deposits and demand deposits accounted for the remainder. There has been almost no change in preference for the various maturities over the first six months of 2011 although over the year to June 2011, a slight shift away from time deposits to savings deposits was noted. Chart 3.33 provides details on the maturity preference of deposits.

Chart 3.33: Maturity Preference of Deposits



3.7.4 Financial Condition of Banks

Despite the uncertain global economic environment, activity in the domestic banking system remains buoyant, driven in part by the relative strength of the domestic economy. Banks' capital adequacy ratio remains comfortably above the 10 per cent regulatory capital requirement.

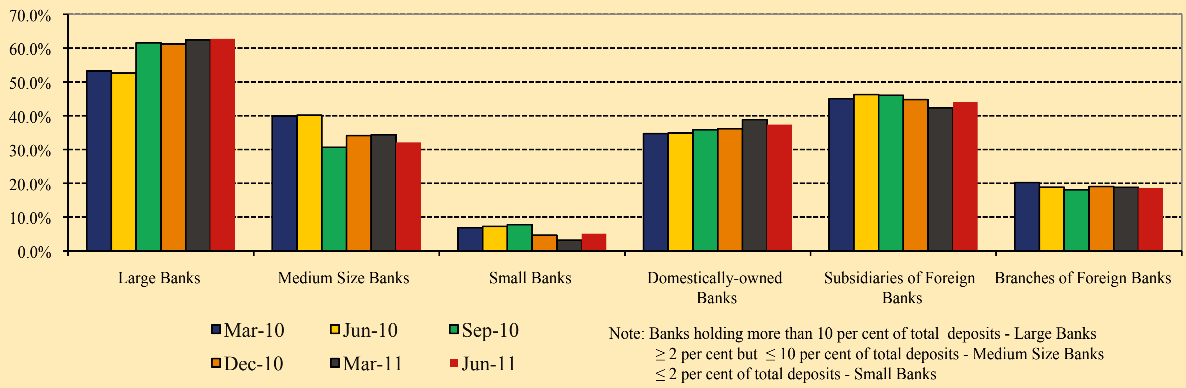
As at end-March 2011 the banking sector's total regulatory capital ratio increased to 17.2 per cent from 16.7 per cent recorded a year earlier. During this period, individual banks have relied mostly on their profits to generate internal capital to sustain balance sheet growth. They have not had any need of capital injection from the public sector, nor have they had to deleverage by shedding assets.

Tier 1 Capital

The capital adequacy of banks is most often assessed on the basis of Tier 1 capital as a ratio of risk-weighted assets. The sector's tier 1 capital ratio (excluding branches of foreign-owned banks) edged up marginally from 13.6 per cent as at end-March 2010 to 13.7 per cent as at end-March 2011. Tier 1 capital increased by 15.6 per cent during this period, of which 77.0 per cent originated from retained earnings. The tier 1 capital across most banks is composed mainly of common equity, which is the component of capital having the highest loss-absorbing capacity. Chart 3.34 shows the distribution of tier 1 capital ratio.

As at end-March 2011, the median tier 1 capital ratio of banks (excluding branches of foreign-owned banks) stood at 12.0 per cent, similar to the level recorded a year earlier, while the interquartile measure increased by 100 basis points to 5.2 per cent. This is explained by the fact that the increase in the level of business activities of most banks during this period was more or less proportional to the increase in tier 1 capital.

Chart 3.32: Deposits by Bank Size and Group



Note: Banks holding more than 10 per cent of total deposits - Large Banks
$\geq$ 2 per cent but $\leq$ 10 per cent of total deposits - Medium Size Banks
$\leq$ 2 per cent of total deposits - Small Banks

Chart 3.34: Distribution of Tier 1 Capital Ratio

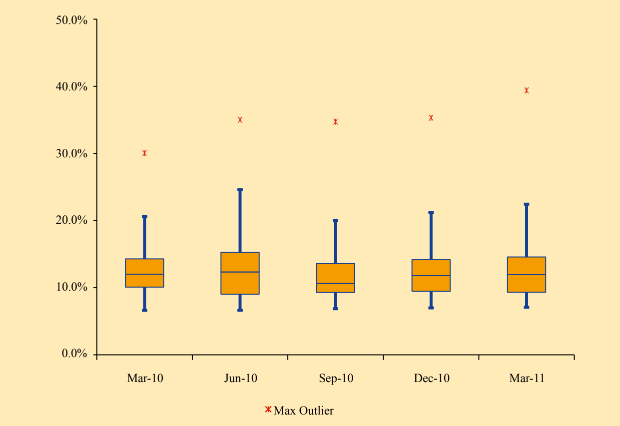
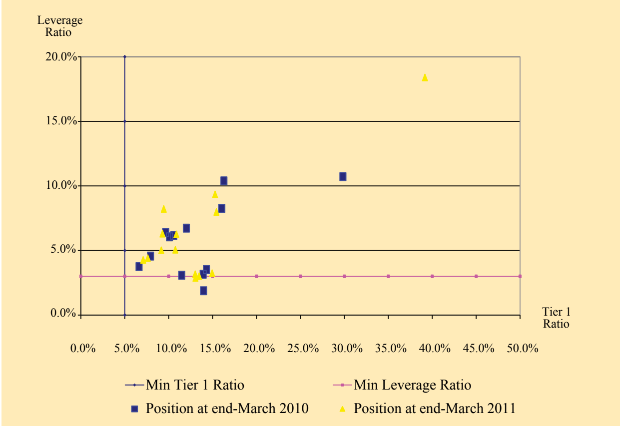


Chart 3.35: Distribution of Capital Adequacy Ratio/Leverage Ratio



In general, banks' strong capital positions in Mauritius mean that many of them are well positioned to meet the more demanding Basel III capital standards when they would be phased in.

Leverage

Excessive leverage in the balance sheets of banks in advanced countries has contributed to the global financial crisis. The pervasive incentive for banks to structure products in order to qualify for lower capital requirements encouraged banks to build disproportionately elevated leverage in their balance sheets. This high concentration of structured exposures, subject to low regulatory capital requirements, created excessive risk in the system that was not gauged in the present risk-based measure. Therefore, in the run up to the crisis, many banks that were severely affected were still reporting high tier 1 capital ratios.

The leverage ratio in the domestic banking sector (excluding branches of foreign banks) stood at 5.5 per cent as at end-March 2011 compared to 5.1 per cent as at end-March 2010. During this period, most banks upheld a comparatively equitable mix between the relative sizes of their total assets and risk-weighted assets and they could even sustain balance sheet growth at the existing level of capital while maintaining adequate leverage, as shown in Chart 3.35.

On the whole, there was no immediate pressure on the few remaining banks that did not meet the 3 per cent minimum leverage ratio to deleverage or raise additional common equity given that their balance sheets were robust.

Banks' Profitability

Banks' profits have generally increased since the publication of last Financial Stability Report. Quarterly reports indicated that the annualised pre-tax profits of banks, which constitute the sum of pre-tax profits over the previous four quarters, stood at an aggregate of Rs14.2 billion as at end-March 2011 compared to Rs13.7 billion recorded as at end-March 2010. Although the figures relating to these two quarters were pumped up by some exceptional gains, the adjusted pre-tax profits in March 2011 were still higher, driven by the stronger performance of the local banks. The revenue of some foreign banks was still lagging behind due to the prolonged period of low interest rates abroad.

Components of Revenue and Expenses

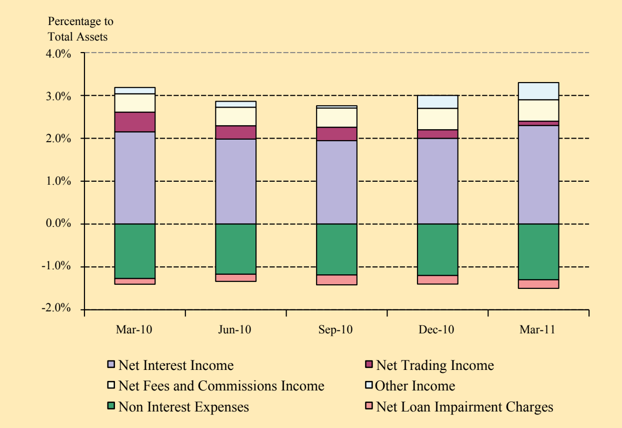
Net interest income remains the dominant source of revenue for the sector. Net interest income as a percentage to total assets increased slightly from 2.2 per cent as at end-M arch 2010 to 2.3 as at end-March 2011. The improvement was notable despite falling yields on Treasury Bills and a hike in the cash reserve ratio requirement during this period.

Net trading income as a percentage of total assets fell from 0.5 per cent as at end-March 2010 to 0.1 per cent as at end-March 2011 due to volatility on foreign exchange markets. Net fees and commissions income fared relatively well during the same period, going up to 0.5 per cent of total assets as at end-March 2011, from 0.1 per cent in the previous year.

The other components of income improved to 0.4 per cent of total assets as at end-March 2011 compared to a modest 0.1 per cent recorded a year earlier due to the exceptional gains recorded by a bank on the disposal of its custody business.

The overall picture for the sector was a mild improvement in total operating income which, as a percentage of total assets, edged up from 3.2 per cent as at end-March 2010 to 3.3 per cent as at end-March 2011.

Chart 3.36: Components of Revenue and Expenses as a Percentage of Total Assets



The share of non-interest expenses in total assets of banks were unchanged at 1.3 per cent while net loan impairment charges stabilised at around 0.2 per cent as at end-March 2011.

As a result, the sector's cost-to-income ratio contracted by 60 basis points, from 39.9 per cent as at end-March 2010 to 39.3 per cent as at end-March 2011, representing a slight improvement compared to the previous year. Chart 3.36 depicts the components of revenue and expenses.

Return on Equity

The annualised return on equity (ROE) has improved as at end-March 2011, with the median ROE increasing to 14.9 per cent, from 12.6 per cent as at end-March 2010. Chart 3.37 shows the distribution of return on equity.

Return on Assets

An alternative measure of profitability, the annualized return on assets (ROA), followed broadly the same trend with an increase in the median ROA to 1.2 per cent as at end-March 2011, from 1.1 per cent as at end-March 2010. Chart 3.38 shows the distribution of return on assets.

Overall, the outlook for profits remains favourable given that bad and doubtful debt charges are not expected to rise in the near future. Lending activities may also recover in some key sectors on account of stronger corporate earnings and improved business confidence, provided renewed uncertainty on international financial markets do not persist and affect growth prospects.

Chart 3.37: Distribution of Return on Equity

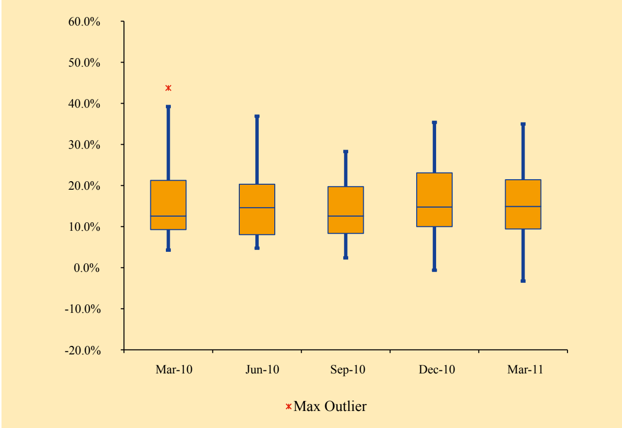
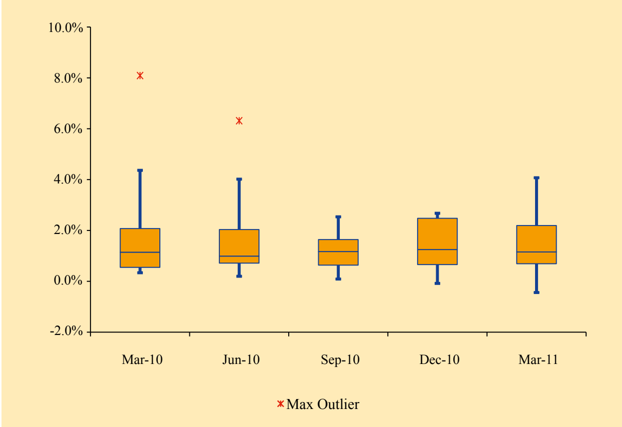


Chart 3.38: Distribution of Return on Assets



Box III provides a summary of selected financial stability indicators.

Box III: Selected Financial Stability Indicators

Core Set of Financial Soundness Indicators	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Capital-based					
Regulatory capital to risk-weighted assets	16.7%	16.5%	15.9%	15.8%	17.2%
Regulatory Tier 1 capital to risk-weighted assets	14.6%	14.2%	13.6%	13.6%	15.0%
Nonperforming loans net of provisions to capital	8.1%	7.6%	8.6%	9.1%	8.2%
Asset Quality					
Nonperforming loans to total gross loans	2.7%	2.4%	2.5%	2.8%	2.8%
Sectoral distribution of loans to total loans					
Interbank loans	*0.2%*	*0.3%*	*0.3%*	*0.3%*	*0.3%*
Central bank	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
General Government	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Other financial corporations	*1.4%*	*1.3%*	*1.2%*	*1.1%*	*1.4%*
Nonfinancial corporations	*35.2%*	*33.5%*	*33.9%*	*33.7%*	*34.2%*
Other domestic sectors	*16.1%*	*15.0%*	*15.9%*	*16.1%*	*15.3%*
Nonresidents	*47.0%*	*49.9%*	*48.8%*	*48.8%*	*48.9%*
Earnings and Profitability					
Return on assets	1.7%	1.5%	1.2%	1.4%	1.4%
Return on equity	21.4%	19.5%	16.7%	20.0%	19.3%
Interest margin to gross income	67.6%	69.3%	70.5%	67.1%	70.0%
Noninterest expenses to gross income	39.9%	40.9%	43.0%	38.9%	39.3%
Sensitivity to Market Risk					
Net open position in foreign exchange to capital	3.8%	1.8%	4.3%	7.0%	2.6%
Encouraged Set of Financial Soundness Indicators					
Capital to assets	7.4%	7.1%	7.0%	7.3%	7.5%
Value of large exposures to capital	208.9%	193.9%	217.0%	222.5%	197.4%
Customer deposits to total (non-interbank) loans	160.3%	153.1%	148.8%	149.6%	140.3%
Residential real estate loans to total loans	7.1%	6.8%	6.9%	6.8%	6.9%
Commercial real estate loans to total loans	2.1%	3.2%	3.2%	5.6%	6.2%
Trading income to total income	14.4%	10.9%	11.4%	7.8%	2.1%
Personnel expenses to non-interest expenses	49.4%	51.2%	50.9%	52.8%	54.5%
Macroeconomic Indicators	**Mar-10**	**Jun-10**	**Sep-10**	**Dec-10**	**Mar-11**
Headline Inflation	1.9%	1.7%	2.0%	2.9%	4.0%
Year-on-Year Inflation	2.3%	2.4%	2.5%	6.1%	7.2%
Key Repo Rate (end of period)	5.75%	5.75%	4.75%	4.75%	5.25%
Total Public Sector Debt/GDP (end of period)	57.7%	57.6%	58.5%	57.7%	56.8%
Total External Public Sector Debt/GDP (end of period)	9.7%	9.3%	10.0%	10.8%	11.4%
Import Coverage of Net International Reserves (No. of months)	9.2	9.1	8.6	9.6	9.6
Deposit/Broad Money Liabilities*	84.8%	85.2%	84.5%	83.8%	84.1%
Household Debt/GDP (end of period)**	16.7%	17.4%	18.1%	18.3%	18.3%
Corporate Debt/GDP (end of period)**	57.2%	59.4%	59.2%	60.7%	58.9%
	1st Quarter 2010	**2nd Quarter 2010**	**3rd Quarter 2010**	**4th Quarter 2010**	**1st Quarter 2011**
Real GDP Growth***	3.4%	2.7%	5.4%	5.1%	3.8%
Unemployment Rate	8.4%	7.6%	7.6%	7.2%	8.3%
Current Account Deficit/GDP	6.3%	10.7%	8.5%	7.5%	4.7%

** Banks Deposits excluding GBL deposits, deposits from non-residents, Banks outside Mauritius, government deposits and Deposit from Banks inside Mauritius.*

*** Debt contracted with banks only*

**** Percentage change over corresponding period of previous year*

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 differerent from other parts of this report.

2. Total loans include advances to nonresidents.

3. Figures may not add up due to rounding.

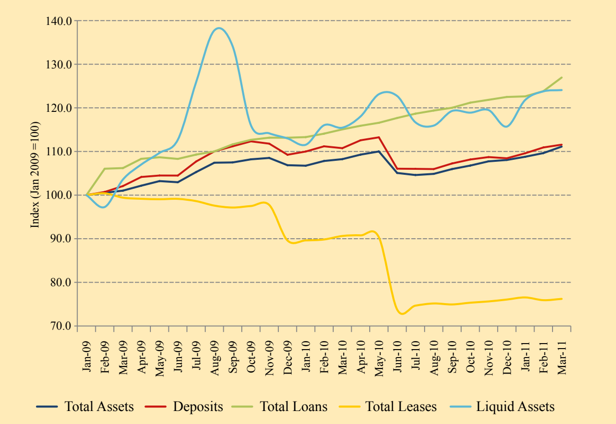
3.8 Non-Bank Deposit-Taking Institutions

The assets of Non-Bank Deposit-Taking Institutions (NBDTIs) represented around 6 per cent of total assets of banks. The growth of this sector has been relatively slow with total assets registering negative year-on-year growth rates between July and November 2010. As from December 2010, growth moved into positive territory to reach 2.7 per cent as at end-March 2011 compared to a 7.1 per cent growth rate at end-March 2010.

Leasing facilities and loans are the main components of the assets of NBDTIs. As at end-March 2011, loans grew at a higher rate of 10.3 per cent compared to 8.4 per cent a year earlier. Leasing facilities, however, registered a larger contraction of 15.9 per cent as against a contraction of 8.8 per cent a year earlier. On the liabilities side, NBDTIs recorded a growth of 0.7 per cent in their deposits as at end-March 2011 compared to a growth of 8.5 per cent at end-March 2010.

Liquidity at NBDTIs was comfortable at around 14 per cent throughout the period March 2010 to March 2011, well above the minimum requirement of 10 per cent. Chart 3.39 illustrates the evolution of total assets, deposits, loans, leases and liquid assets at NBDTIs.

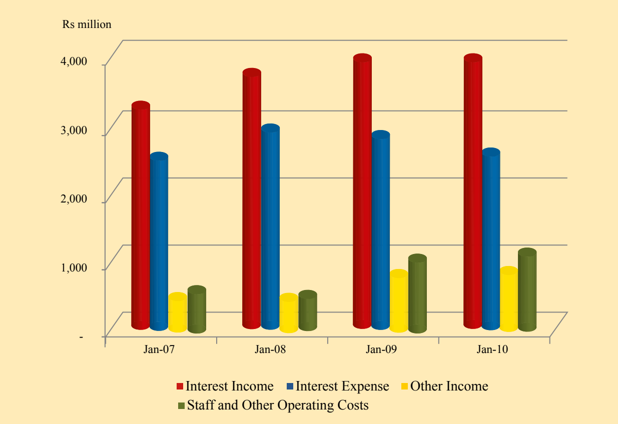
Chart 3.39: Evolution of Total Assets, Deposits, Total Loans, Total Leases and Liquid Assets



Performance

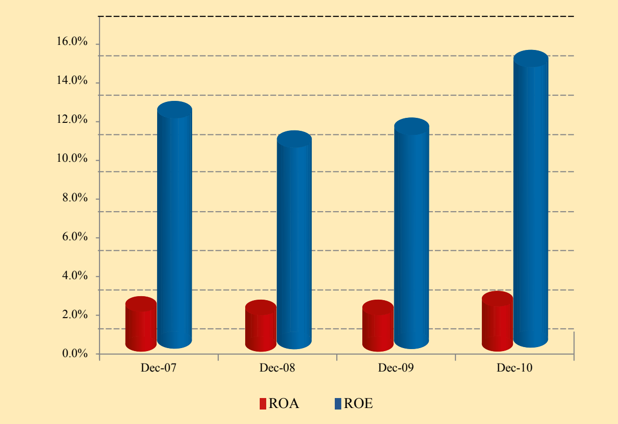
Interest income and interest expenses are the main profitability components of NBDTIs. The major sources of interest income are loans and leases while interest expense arises mainly on deposits. In 2010, NBDTIs continued to perform well, with an increase in net profits of 35.0 per cent compared to 20.6 per cent in 2009. Net interest income grew by 19.4 per cent compared to 48.8 per cent a year earlier as a result of contraction in both interest income and interest expense by 1.2 per cent and 9.8 per cent respectively, in 2010. These two items registered a growth rate of 7.9 per cent and a contraction of 3.2 per cent, respectively, in 2009. Chart 3.40 depicts the revenue and expenses of NBDTIs.

Chart 3.40: Revenue and Expense of Non-Bank Deposit-Taking Institutions



The profitability of the sector has also been reflected in the Return on Assets (ROA), which stood at 2.5 per cent in 2010 compared to 1.9 per cent a year earlier. The return on equity (ROE) also improved from 11.3 per cent to 14.7 per cent over the same period. Chart 3.41 depicts the ROA and ROE of NBDTIs over the last four years.

Chart 3.41: ROA and ROE of Non-Bank Deposit-Taking Institutions



Sector-wise Distribution of Credit

As at end-March 2011, the largest share of credit extended by NBDTIs was to the Personal sector followed by the construction sector, which in aggregate represented 76 per cent of total credit granted by NBDTIs. Traders, manufacturing and transport each accounted for 5 per cent or less of total credit. Except for credit to the personal sector, which rose by 16 per cent, credit growth to most sectors has declined relative to end-March 2010.

Capital Adequacy

Generally, the assets of NBDTIs are concentrated in the 20, 50 and 100 per cent risk-weight bearing assets. At end-March 2011, 75 per cent of on-balance sheet assets were parked in those risk categories. The capital adequacy ratio of NBDTIs was 22.5 per cent as at end-March 2011 compared to 20.1 per cent as at end-March 2010.

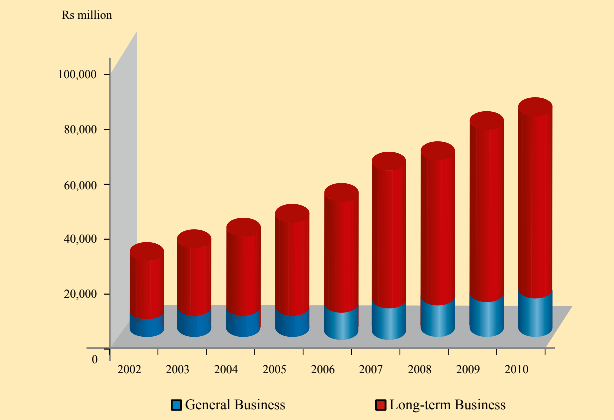
Non-Performing Loans

As at end-March 2011, non-performing loans at NBDTIs increased by 2.7 per cent year-on-year. The ratio of NPLs for the sector stood at 7.6 per cent at end-March 2011, marginally higher than the NPL ratio recorded as at end-March 2010. Credit to most sectors registered a decline in impairment but the personal and construction sectors recorded higher NPLs as at end-March 2011. Impaired assets in these two sectors represented around 77 per cent of total non-performing loans. In terms of specific provisioning, the coverage ratio for the NBDT sector stood comfortably at 36.5 per cent although it was lower than the 38.2 per cent recorded a year earlier.

3.9 Insurance Sector

The insurance sector makes up about one-third of the financial intermediation sector and contributes about 2.9 per cent to GDP. The total assets of the insurance sector have increased steadily over time although growth has been uneven more recently. The growth in total assets, which averaged 17.1 per cent between 2002 and 2007, decelerated to 5.4 per cent in 2008 but picked up strongly in 2009 to 18.1 per cent before easing again to 15.3 per cent in 2010. The insurance sector consists of the long-term insurance business and the general insurance business, with the long-term insurance business accounting for more than 80 per cent of the total assets of the insurance sector. Chart 3.42 shows the growth in total assets of the insurance sector.

Chart 3.42: Total Assets of the Insurance Sector



Source: FSC

3.9.1 Long-term Insurance Business

The total assets of the long-term insurance business expanded by 16.1 per cent in 2010 compared to a growth of 18.8 per cent in 2009. The assets of individual

Table 3.5: Distribution of Selected Assets of Long-Term Insurance Business

Per cent

	2009		2010	
	Maximum	Average	Maximum	Average
Land and Buildings	29.1	3.4	33.1	3.1
Investment in related companies	61.6	6.5	55.8	6.3
Equity Securities - Listed locally	50.9	14.8	52.3	15.6
Equity Securities - Unlisted locally	25.2	3.9	26.6	4.2
Equity Securities - Listed overseas	16.0	2.7	18.7	3.2
Equity Securities - Unlisted overseas	17.1	3.3	18.0	2.8
Governement Debt Securities	43.2	10.4	38.1	10.2
Mortgage loans - Residential	41.8	11.4	36.1	10.0
Mortgage loans - Commercial	2.1	0.4	2.4	0.3
Cash at bank	17.7	5.6	20.0	4.7
Deposits - Bank	43.4	14.2	50.4	17.4
Deposits - Other financial institutions	22.3	4.6	19.0	2.7
Premium Receivables	2.4	0.4	2.5	0.4
Other Assets	8.0	1.8	11.6	2.5

Source: Internal calculation based on FSC data

companies in this line of insurance business were quite heterogeneous but they were on average distributed in four main asset classes, notably deposits with banks, equity securities listed locally, Government debt securities and residential mortgage loans. The share of those asset classes to total assets was below 17 per cent on average in 2010. However, at some individual insurance companies, the share of one asset class could exceed 50 per cent of total assets, which would potentially expose the company to adverse shocks affecting the return on that asset class. Table 3.5 provides details on the distribution of assets in the long-term insurance business in 2009 and 2010.

Many companies operating in the long-term insurance business have significant investments in government securities. While residential mortgage loans represent a common asset class for long-term insurance business, commercial mortgage loans appear to be less of an alternative, accounting on average for only 0.3 per cent of total assets of the long-term insurance business. Around half of long-term insurance companies do not offer commercial mortgage loans at all.

The long-term insurance business segment of the insurance industry is highly concentrated with the three largest firms accounting for 84.7 per cent of total assets. The Herfindahl-Hirschmann Index (HHI) computed for the years 2008 to 2010 confirms the high concentration in the sector both in terms of total assets and gross premiums and shows that concentration may have deepened since 2008. Table 3.6 shows the Herfindahl-Hirschmann Index for the long-term insurance business.

Table 3.6 :Herfindahl-Hirschmann Index for Long-Term Insurance Business

Year	Assets	Gross Premiums
2008	2,494	2,814
2009	2,403	2,899
2010	2,443	3,303

Source: Internal calculation based on FSC data

3.9.2 General Insurance Business

The total assets in the general insurance business grew by 11.1 per cent in 2010 compared to 14.2 per cent in 2009. This segment of the insurance sector is of a shorter term nature than the long-term insurance business and this is reflected in the distribution of its assets in relatively more liquid asset classes. In 2010, assets were mainly distributed in deposits with banks, premium receivables, cash at bank and receivables from reinsurers. Table 3.7 provides details of the distribution of assets in the general insurance business in 2009 and 2010.

Table 3.7 :Distribution of Assets of General Insurance Business

Per cent

	2009		2010	
	Maximum	Average	Maximum	Average
Land and Buildings	35.9	7.4	30.5	6.7
Investment in related companies	18.6	4.6	38.7	5.8
Equity Securities - Listed locally	45.1	7.8	25.4	5.5
Equity Securities - Unlisted locally	15.8	1.7	14.4	1.5
Equity Securities - Listed overseas	11.7	1.1	12.8	1.1
Equity Securities - Unlisted overseas	9.3	1.3	6.3	0.8
Governement Debt Securities	36.3	6.0	37.4	5.6
Mortgage loans - Residential	14.7	1.6	12.0	1.4
Mortgage loans - Commercial	0.1	0.0	0.1	0.0
Cash at bank	43.6	12.3	39.9	9.4
Deposits - Bank	40.9	15.5	56.8	22.4
Deposits - Other financial institutions	19.1	3.4	26.3	4.1
Premium Receivables	19.6	10.0	18.2	9.3
Receivables from related companies	27.0	4.7	27.3	4.9
Receivables from Reinsurers	41.9	9.4	28.1	7.8
Receivables from Insurers	13.6	1.8	8.7	1.2
Other receivables	9.9	2.4	12.9	2.9

Source: Internal calculation based on FSC data

The ratio of gross claims to gross premiums was fairly stable at around 50 per cent in 2010. However, the return on assets fell to an average of 5.1 per cent in 2010 compared to an average of 7.6 per cent in 2009. Management expense as a percentage of gross premiums almost doubled, from 17.7 per cent in 2009 to 30.8 per cent in 2010, but it was to a large extent driven by two loss-making companies that together represented only 0.2 per cent of market share in terms of gross premium. Table 3.8 presents selected performance ratios for the general insurance business.

Compared to the long-term insurance business, there appears to be more competition in the general insurance business, with an HHI below 1800. An HHI between 1000 and 1800 is generally taken to mean that concentration of firms in an industry is moderately competitive. Table 3.9 shows the HHI for the general insurance business.

Table 3.9: Herfindahl-Hirschmann Index - General Insurance Business

Year	Assets	Gross Premiums
2008	1,580	1,273
2009	1,655	1,250
2010	1,650	1,300

Source: Internal calculation based on FSC data

Table 3.8 : Performance Ratios

	2009			2010		
	Minimum	Maximum	Average	Minimum	Maximum	Average
Return on Assets	-15.0	35.9	7.6	-14.4	14.1	5.1
Return on Equity	-113.2	98.1	7.5	-30.8	238.3	29.3
Gross Claims /Gross Premium	31.4	67.0	50.7	0.0	129.50	50.5
Management Expenses/Gross Premium	7.3	32.7	17.7	7.7	134.00	30.8

Source: Internal calculation based on FSC data

4. Financial System Infrastructure

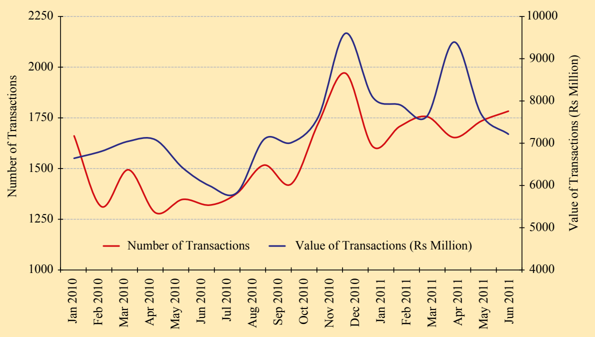
4.1 The Payment System

The Mauritius Automated Clearing and Settlement System (MACSS), the only large value payment system of the country, has been designed to cater for high throughput and is capable of handling very large transactions. During the first half of 2011, it has shown that it has adequate capacity and resilience to meet the needs of the payment traffic safely and in a timely manner. No disruptions, delays or loss of funds were encountered during that period. No payment was rejected as a result of system imperfections and there was no return of funds.

The MACSS processed 210,381 transactions for a total amount of Rs980 billion during the first six months of 2011. This represented an increase of 27 per cent, in volume terms, and a 14 per cent rise, in value terms, compared to the corresponding period in 2010. The MACSS processed a daily average of 1,700 transactions for an average total value of Rs8.0 billion, that is, a rise of 20 per cent, in volume terms, and of 16 per cent, in value terms, compared to the corresponding period of the preceding year. Chart 4.1 depicts the monthly average of daily rupee transactions on the MACSS.

During the first semester of 2011, the SWIFT network outages, which were beyond the control of the Bank, caused disruptions to the operations of MACSS. Contingency procedures were deployed and all payments were effected with same day value. While the SWIFT network has a built-in redundancy feature whereby failure of the main connection automatically results into a switch-over to the dial-up mode, which still enables payments to be effected albeit at a lower speed, the increase in the volume of MACSS transactions and expected future growth has motivated the Bank to take steps to upgrade its SWIFT. This will result in higher connectivity for the main as well as the back-up lines. Consequently, disruptions arising from temporary unavailability of the SWIFT main connection will not recur in the future. In parallel, the Bank is also envisaging to subscribe to a SWIFT Premium support, which will provide a number of advantages, namely faster resolution time, a single point of contact for all support related enquiries and more effective problem resolution, SWIFT knowledge of the infrastructure and mitigation of availability risks.

Chart 4.1: Monthly Average of Daily MACSS Rupee Transactions



4.2 Cheque Clearing

The volume and value of cheques processed at the clearing house have continued to expand, with annual growth rates of 1.8 per cent and 4.5 per cent, respectively, in the first semester of 2011. With the amount of cheques cleared representing about 15 per cent of the total value of MACSS transactions, there are potential systemic risks to the financial system from the fact that cheques carry intrinsic credit and settlement risks. To mitigate such risks, the Bank has introduced the Bulk Clearing System which will allow electronic clearing of low value instruments and truncation of cheques. As such, this new system will allow the identification of high value cheques that will be routed through the MACSS rather than being cleared at the Bank. A gain of 1 to 2 days in the clearing of cheques is anticipated under the cheque truncation system. Table 4.1 shows the amount of cheques cleared and the value of MACSS transactions

Table 4.1: Amount of Cheques Cleared and Value of MACSS Transactions

	Amount of Cheques Cleared (Rs million)	Value of MACSS Transactions (Rs million)
Jan-10	19,484	146,156
Feb-10	17,757	122,529
Mar-10	21,814	147,960
Apr-10	22,600	155,766
May-10	20,193	128,348
Jun-10	21,051	157,459
Jul-10	21,885	131,775
Aug-10	21,023	128,293
Sep-10	20,727	148,964
Oct-10	21,052	147,274
Nov-10	22,094	152,572
Dec-10	29,386	220,826
Jan-11	18,665	153,705
Feb-11	20,755	142,370
Mar-11	22,666	168,058
Apr-11	20,514	187,887
May-11	22,338	169,093
Jun-11	23,452	158,713

during January 2010 to June 2011.

Overall, the payment system infrastructure in Mauritius remains robust enough to cater for the needs of the banking sector. As the regulatory authority, the Bank maintains a rigorous oversight of the infrastructure and keeps up with latest technological advances to ensure that there is no major disruption to operations that may weaken the payment system infrastructure.

5. Risks to Financial Stability

The global economy continues to face a number of risks to financial stability despite major economic and financial progress accomplished after the global financial crisis.

Macroeconomic developments in the first half of 2011 have turned gradually disappointing, especially during the second quarter. While emerging economies have continued to post strong expansion rates and driven global growth, advanced countries have in general been unable to pull their economies out of weak recovery. The slow healing of the US economy, in particular, has had a negative bearing on global growth prospects. In addition, significant economic slack in some advanced economies has contributed to keep unemployment high and has, at the same time, constrained domestic demand. Softer economic fundamentals are, in turn, impacting on market sentiment and confidence and are increasing the vulnerability of the global economy to economic and financial shocks.

The deterioration in macroeconomic conditions itself has important implications for the sustainability of government debt as a weaker economic situation induces government to spend more to support growth. Vast injections of money into their respective financial systems by the US and euro area authorities after the crisis in order to prop up their economies have already significantly eroded fiscal sustainability. If further support is warranted, this would affect even more some governments' capacity to repay their debt. Moreover, euro area peripheral countries such as Greece, Portugal and Ireland, which had obtained support packages based on certain estimates of GDP growth, would see these estimates being revised downward and government debt to GDP ratios would increase. Under these conditions, systemic risks for banks, still highly exposed to the periphery, are far from being resolved.

Doubts over fiscal sustainability in advanced economies have shown that they have the potential to derail the financial system and increase the risk to financial stability. While the euro area sovereign debt crisis has been a long-standing feature time and again stressing financial markets, the latest US debt ceiling debate has brought out forcefully the dangers of running excessive fiscal deficits. Coming on top of a near Greek debt default, which had kept markets on edge until a bail-out package was worked out, the US fiscal woes and the subsequent downgrade of its credit rating by Standard and Poor's on grounds that the agreed fiscal consolidation plan remained insufficient have sent financial markets into a tailspin. With investor fear linked to the slow economic recovery in the US, which might necessitate further rounds of quantitative easing and an extended period of low interest rates, any negative economic news in the future may pose the risk of further market turmoil.

Another factor underlying market volatility and uncertainty has been the danger that a temporary liquidity problem may evolve into a solvency problem as a result of higher sovereign debt spreads for some of the weaker countries. If sovereign interest rates remain elevated during a prolonged period of time, mounting interest payments may widen fiscal deficits even more and cause debts to balloon while increasing the risk of a liquidity crunch as banks' funding costs mount.

With the most recent spate of market turmoil having focussed on the risks mentioned above, it will take continuing coordinated action, including fiscal discipline efforts, to deliver substantial deficit reduction over the medium-term, to break out of the vicious circle and place advanced economies on a higher growth path.

From the emerging countries' perspective, the main risk to financial stability lies in the huge capital flows that have been pouring into their economies. While capital inflows can be beneficial to economic development, excessive capital inflows that cannot be readily absorbed by the domestic financial system has led to the overheating of certain emerging economies and brought increased inflationary pressures against a background of currency appreciation. The resort to monetary policy tightening to tackle inflation has curtailed growth in some emerging economies but the most important risks to financial stability would arise in case of sudden stop or reversal of capital inflows if investor risk aversion unexpectedly shoots up.

On the domestic front, real economic growth has picked up but there are increased risks arising from uncertain conditions in the global economy. While public sector debt is expected to remain quite close to the statutory level of 60 per cent of GDP up to end-2013, its actual evolution in the future will also depend on the domestic economy's resilience to economic and financial developments in main trading partner countries. The shift towards more external financing of the fiscal deficit may raise interest rate and foreign exchange risks but these are not currently considered to be important at the moment.

At around 4.5 per cent of GDP, the current account deficit does not appear to constitute a major imbalance. However, FDI inflows have come down significantly in the first quarter of 2011 and, should this trend be maintained, the financing of the current account deficit may become a source of concern through its implications for the rupee exchange rate. Gross official international reserves are, however, at a comfortable level representing more than 7 months of imports as at end-June 2011.

More than 40 per cent of private sector credit has been channeled to the household and tourism sectors as at end-June 2011. In the case of households, about 60 per cent of credit extended by banks comprised housing loans. There does not appear to be any major risk arising from the household sector as default on debt has generally been relatively low. However, there are some elements with regard to household debt that may warrant a closer watch, notably the debt repayment capacity of households. The corporate sector, which represents banks' major credit exposure, is projected to register a healthy growth rate in 2011 on current trends but the performance of this sector will eventually be reliant on the evolution of macroeconomic conditions.

The domestic banking sector has been resilient on the back of its asset mix and is not expected to face any major upheaval going forward. Domestic banks are not overly exposed to external financial markets developments and their strong capital positions indicate that they are already well positioned to meet the more demanding Basel III capital requirements. With the favorable outlook for profits, the banking sector does not appear to pose significant risks to overall financial stability.

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