45 YEARS OF CENTRAL BANKING

BANK OF MAURITIUS

Financial Stability Report

August 2012

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FINANCIAL STABILITY REPORT

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List of Acronyms

BCS	Bulk Clearing System
BRICS	Brazil, Russia, India, China and South Africa
CAMEL	Capital, Asset, Management, Earnings and Liquidity
CAR	Capital Adequacy Ratio
CDS	Credit Default Swap
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stability Mechanism
ESM	European Stability Mechanism
EU	European Union
FSA	Financial Services Authority
GBCs	Global Business Companies
GOIR	Gross Official International Reserves
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
KRR	Key Repo Rate
LTRO	Long Term Refinancing Operations
MACSS	Mauritius Automated Clearing and Settlement System
MERI	Mauritius Exchange Rate Index
NBDT	Non-Bank Deposit-Taking
NBDTIs	Non-Bank Deposit-Taking Institutions
NPLs	Non-Performing Loans
ORR	Operation Reserves Reconstitution
PE	Price Earnings
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real Time Gross Settlement System
SEM	Stock Exchange of Mauritius
Y-o-y	Year-on-year

1 Overview

In spite of some improvement noted in January and February 2012, the euro area crisis deepened during the remainder of 2012H1, causing global uncertainty to rise and increasing risks to global financial stability. The global economy, which appeared to be doing better at the start of 2012 as financial and funding pressures were contained through the provision of longer-term liquidity to the European banking system by the ECB, weakened significantly in 2012Q2. The intensification of the crisis and the lack of a credible solution have put the euro area under constant pressure of contagion and dampened its economic outlook. Amid persistent uncertainty over the euro area crisis, global economic growth continues to be weak and uneven across regions. Advanced economies are projected to register dismal growth in 2012, while emerging economies' growth is expected to moderate.

Economic developments during the period under review weighed significantly on investor sentiment, causing much stress in global financial markets and spearing volatility. Credit rating agencies were very active, reviewing several country ratings downwards during 2012H1. Most of the changes in countries' credit ratings were directly or indirectly linked to the turmoil in Europe, adding further pressure in global financial markets. The international banking sector was hit by a series of adverse events that revealed its fragile state. Although the US banking sector has been recovering gradually, banks in Europe have come under increasing funding and liquidity pressures. Weak global economic conditions and increasing concerns over euro area crisis may continue to keep financial stability risks elevated.

The domestic economy remained resilient in 2012H1. The further intensification of the euro crisis impacted mostly the export-led sectors. Exports of goods to Europe contracted by 5.3 per cent and tourist arrivals from Europe fell by 6.0 per cent, y-o-y, in 2012H1. Final consumption expenditure grew by 2.8 per cent, with household consumption expanding by 2.8 per cent and government expenditure by 2.7 per cent. Investment grew by 10.4 per cent. According to forecasts made by Statistics Mauritius in June 2012, the economy is expected to grow by 3.5 per cent in 2012, compared to 3.9 per cent in 2011.

The current account, inclusive of GBC1s cross-border transactions, registered a slightly higher deficit of Rs4.3 billion in 2012Q1 compared to a deficit of Rs4.1 billion recorded in the corresponding quarter of 2011. As a percentage of GDP at market prices, the current account deficit stood at 5.3 per cent in 2012Q1, lower than the 5.5 per cent recorded in 2011Q1. The capital and financial account of the balance of payments, inclusive of GBC1s cross-border transactions, posted higher net inflows of Rs5.6 billion in 2012Q1. Portfolio investment and other investment both recorded net outflows. The overall balance of payments posted a deficit of Rs1.6 billion.

The gross external debt, comprising general Government, public corporations, monetary authorities and private sector debt, rose by 9.9 per cent y-o-y to Rs44,749 million as at end-March 2012, driven mainly by an increase in central government and public enterprises external debt. Gross external debt represented 13.6 per cent of GDP as at end-March 2012 compared to 13.3 per cent as at end-March 2011. Government external debt as a percentage of GDP, stood at 8.3 per cent as at end-March 2012, same as at end-December 2011. It is projected to grow steadily and reach 14.7 per cent, 16.2 per cent and 17.2 per cent, respectively as at end-December 2012, 2013 and 2014. The debt-service ratio for the country is forecast to hover in the range of 3.5 per cent to 4.0 per cent between 2012 and 2014.

Public sector debt, comprising debt of General Government and public enterprises, stood at 57.1 per cent of GDP as at end-March 2012, below the 60 per cent prudent threshold. The debt-to-GDP ratio is expected to increase slightly to 57.7 per cent as at end-December 2012 before oscillating between 55.7 per cent and 56.3 per cent in the following two years. The yield curve of government securities shifted downwards as at end-June 2012 compared to end-December 2011, indicating lower borrowing cost for Government.

Although the Bank has been consistently increasing the Gross Official International Reserves (GOIR), imports of goods and services have been growing at a much faster rate. Consequently, import cover of goods and services has been moderating and on 9 June 2012, the Bank embarked on the Operation Reserves Reconstitution (ORR) programme with the objective to eventually reach six months of import cover. GOIR increased from Rs79.5 billion as at end-May 2012, representing 4.5 months of import cover, to Rs86.7 billion as at end-June 2012, representing 4.9 months of import cover.

During 2012H1, Moody's upgraded Mauritius sovereign ratings as well as the ratings of its two most important domestically-owned banks. It upgraded Mauritius's foreign and local currency Government bond ratings to Baa1 from Baa2 and the foreign currency ceilings for bonds and deposits to A2 from Baa1 and to Baa1 from Baa2, respectively. The country ceilings for local-currency debt and deposits were adjusted to A1 from Aa2 to better capture the default correlation between the Government and other domestic entities through their joint dependence on the real economy, which remains relatively small.

With regard to the corporate sector, most of the Top 100 companies in Mauritius have achieved a combined increase of 16.6 per cent in turnover in 2011. Three companies registered more than Rs15 billion turnover each and more than 75 companies achieved Rs1.0 billion turnover each. The Top 100 companies altogether registered an increase of 37.2 per cent in profits with 7 companies each recording more than Rs1.0 billion profits in 2011. Growth of credit to households hovered at 17.6 per cent as at end-June 2012, up from 15.3 per cent as at end-June 2011.

The banking sector continued to expand despite challenging global and domestic economic conditions. Aggregate banking sector assets grew by an annual rate of 10.8 per cent as at end-March 2012 compared to annual growth rate of 6.3 per cent as at end-March 2011. This was largely driven by growth in global banking activities of banks and, to a lesser extent, by growth in domestic banking business. The CAMEL ratings of banks, which reflect their financial conditions indicated that, as at end-December 2011, all banks remained sound. Non-performing loans in and outside Mauritius increased slightly but remained at relatively low levels. The capital adequacy of banks was well-above the minimum requirement of 10 per cent and exposure of banks' balance sheets to the euro area was quite limited. Financial soundness indicators were also at comfortable levels and pointed to a sound banking system.

The Bank continued to pursue its drive towards modernising the financial infrastructure in Mauritius. After the launch of the Bulk Clearing System (BCS) in September 2011, the Bank introduced in April 2012, the Depository system for Government and Bank of Mauritius securities that provides for a strict deliver-versus-payment mechanism for their issue. MACSS operated with exceptional resilience: 221,589 transactions were settled without any major downtime.

2 The International Environment

In spite of some improvement noted in early 2012, the euro area crisis deepened during the rest of 2012H1, causing global uncertainty to rise and increasing risks to global financial stability. The global economic recovery has slowed down and is poised to remain weak in the medium term. Global financial markets were affected by concerns over the euro area crisis. Accordingly, credit rating agencies reviewed several country ratings downward. Several major international banks' ratings were also downgraded. The international banking sector was hit by a series of adverse events that showed its continued fragility in the wake of the global financial crisis. While the US banking sector has been recovering gradually, banks in Europe came under funding and liquidity pressures.

2.1 The Global Economy

Growth and Outlook

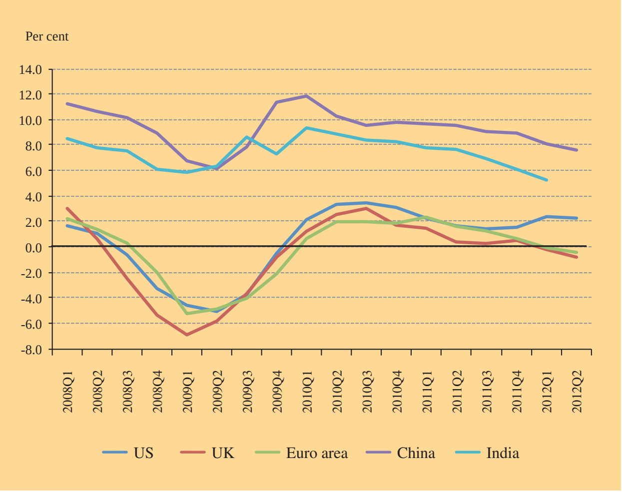
The global economy showed some signs of improvement in early 2012 as financial and funding pressures were contained through the provision of longer-term liquidity to the European banking system by the ECB. However, the resurgence proved to be short-lived. Political deadlock and talks of Greece leaving the euro area as well as worsening fiscal conditions in Italy, banking crisis in Spain and fear of contagion deepened the crisis amid skepticism over any credible solution being found in the short term. The global economy plunged back into uncertainty and economic activity slowed down. Many of the emerging countries that had so far performed relatively well also recorded moderate growth rates given their trade linkages with Europe. BRICS even recorded significant depreciation of their respective currencies as their growth prospects dampened.

It is now widely expected that the global economy will grow at a subdued pace during 2012, and that growth will be uneven across regions. The US economy has continued to grow at a tepid pace and remains vulnerable to fiscal tightening. The euro area is expected to be in mild recession in 2012 and the UK is forecast to contract, mainly on the back of continued turmoil in the euro area, tight credit conditions and fiscal austerity measures. High level of indebtedness in the major advanced economies presents a key source of vulnerability for the global economy.

Growth in emerging market economies eased to some extent, reflecting the lagged effects of past monetary policy tightening and a softening in external demand amid weaker trading partner growth. They also continued to face volatile capital flows, such that they became vulnerable to the risks of surges and sudden stops while excessive exchange rate volatility persisted as a serious stability risk. China continues to be the driver of global growth, albeit to a lower extent as it has also shown some signs of slowing in 2012Q1, while GDP growth in India in the same quarter was the weakest in a decade.

In the IMF's World Economic Outlook Update released in July 2012, world output growth projections were revised down by 0.1 percentage point to 3.5 per cent for 2012 and by 0.2 percentage point to 3.9 per cent for 2013. Growth in advanced economies was forecast at 1.4 per cent for 2012 and 1.9 per cent in 2013. Growth in emerging and developing economies was seen to moderate to 5.6 per cent in 2012, but to improve to 5.9 per cent in 2013.

Chart 2.1: Growth Rates of Selected Economies



Source: Trading Economics.

Credit Ratings of Selected Countries

During 2012H1, credit rating agencies reviewed several country ratings downwards. In mid-February 2012, Moody's, while warning it might cut the triple-A ratings of France, Britain and Austria, downgraded six European nations including Italy, Spain and Portugal, citing growing risks from the euro area crisis and concerns over their ability to undertake reforms and the amount of funds available to address it. The region's weak economy was also expected to undermine austerity measures by governments to fix their public finances. Fitch revised down its outlook on Britain's AAA rating to negative in mid-March 2012, warning that the nation faced a greater than 1-in-2 chance of losing its top-notch status in the next couple of years if the government eased its debt-cutting measures. The revision reflects the very limited fiscal space to absorb further adverse economic shocks in light of elevated debt levels.

In late April 2012, Standard & Poor's further cut its credit rating on Spain by two notches, citing expectations that the government finances would deteriorate even more than previously thought as a result of a contracting economy and an ailing banking sector. In early June 2012, Fitch also cut its rating on Spain's government debt by three notches. Both agencies placed the country on negative outlook. By mid-June 2012, a further downgrade came from Moody's, which cut the rating on Spanish government debt by another three notches. The reasons put forward for the downgrade were the Spanish government "very limited" access to international debt markets, the weakness of the national economy and the increased debt burden seen from the approved euro area plan to help Spanish banks.

Standard & Poor's raised Greece's credit rating to CCC, with a stable outlook in early May 2012, lifting it out of default territory, after Athens completed the biggest sovereign debt restructuring in financial history. However, later in May 2012, Fitch put the whole of the euro area on notice that were Greece to leave the currency bloc, the remaining countries could find their sovereign ratings at risk.

Standard & Poor's cut India's credit rating outlook in late April 2012 to negative from stable against the backdrop of substantial fiscal and current account deficits and political paralysis. India's growth had been moderating on account of slowing exports to Europe. As at end-June 2012, all the three major rating agencies rated India just one notch above non-investment grade or "junk" status.

Table 2.1: Sovereign Credit Ratings of Selected Countries

	January-12			June-12		
	Moody's	S&P	Fitch	Moody's	S&P	Fitch
Euro area						
Germany	Aaa	AAA	AAA	Aaa	AAA	AAA
France	Aaa	AA+	AAA	Aaa	AA+	AAA
Spain	A1	A	A	Baa3	BBB+	BBB
Italy	A2	BBB+	A-	A3	BBB+	A-
Portugal	Ba2	BB	BB+	Ba3	BB	BB+
Greece	Ca	CC	CCC	C	CCC	CCC
Japan	Aa3	AA-	AA-	Aa3	AA-	AA-
United States	Aaa	AA+	AAA	Aaa	AA+	AAA
China	Aa3	AA-	A+	Aa3	AA-	A+
India	Baa3	BBB-	BBB-	Baa3	BBB-	BBB-

Source: Reuters.

Global Imbalances

Global imbalances continued to pose significant risks to global financial stability although latest IMF estimates showed that global imbalances had not widened further as lower surpluses in Japan and oil exporting countries had offset lower deficits from the US and elsewhere. Global demand has declined mainly due to fall in consumption in the US and other deficit countries attributed to contractionary fiscal policies and household deleveraging. Concurrently, surplus economies, like China, have been trying to increase domestic demand. These initiatives have, so far, been insufficient to reduce or cause any meaningful impact on global imbalances.

Advanced economies are currently going through important fiscal and structural adjustments, but it is much unfortunate that it is the global financial crisis that, in some way, has forced such changes on them. The tightening of credit, deleveraging by both corporates and households, contraction of consumption and current account deficits that are being recorded by several advanced economies that did not undertake timely economic reforms are a reminder of the need for policymaking to stay ahead of the curve and shield economic agents from crises. Austerity programs and the undertaking of the much-awaited reforms are part of the necessary conditions for a sustainable growth path. But the sufficient condition that hinges on improving business and consumer sentiment to create the dynamics of growth has so far not been met. That is why countries that still benefit from some degree of confidence in their respective economies are addressing macroeconomic imbalances in priority.

China's latest Five-Year Plan focuses on the promotion of consumption in contrast to investment and exports, closing the income gap through minimum wage hikes and increased social safety nets. In other Asian economies, countercyclical policies adopted to weather the global slowdown have led to increased domestic consumption. But, the move is still timid in comparison to the required adjustment. African and Latin American economies have lagged much behind, in particular, with respect to regional trade, although some progress is noticeable.

Box I: The Euro Area Crisis

In spite of a number of policy initiatives taken by the European Union (EU), a durable solution to the euro area crisis has not yet been found. The region is still mired in contagion fears, while the economic outlook has dampened.

Fears of Greece leaving the euro area have caused much nervousness in financial markets because of the potential adverse domino effect in the region, thus bringing about higher volatility in the value of the euro. The fact that adjustment in Greece is slow and return to growth delayed complicates the situation. Obstacles to reforms, lack of national unity and weak administrative capacity need to be prioritised in order to resolve the Greek problem and protect the market from unwarranted economic costs. The political leadership that emerged from the June 2012 Greek elections may take time to clear these hurdles. Moreover, the problems of banks in Spain and deteriorating fiscal and economic conditions in Italy have brought borrowing costs for these countries to levels which markets perceive as unsustainable. Low growth and high unemployment have also added to the policy dilemma of EU leaders.

Negative news on Greece, Spain and Italy have to a large extent, blurred a few positive developments in other programme countries, namely Ireland and Portugal. The thrust of EU-IMF programmes is to undertake economic reform to return to growth rather than just the much widely publicised fiscal adjustment. In other words, they are essentially about rendering those economies more competitive to get back on a sustainable path of growth. Latest evaluation by the IMF indicates that the programmes of Ireland and Portugal are on track. Ireland returned to growth last year, and Portugal is expected to do so next year. Outside the euro area, Latvia has gone through an internal devaluation with the help of an EU-IMF programme, while Estonia and Lithuania have done so without any programme. All three countries are forecast to grow next year at rates varying between 3.5 per cent and 4 per cent.

Meanwhile, the ECB has seen its role transformed throughout the crisis - it became much more present in financial markets than before. Non-standard measures like Long-Term Refinancing Operations (LTROs) were introduced to ensure that interest rate decisions were transmitted effectively to the broader economy and excessive volatility in financial markets were addressed. The ECB has also been purchasing sovereign bonds of member countries that are under market pressure to prevent borrowing costs from overshooting and lending to banks in Europe against a greater range of acceptable assets as collateral.

Although the ECB will continue to have an active role in the short-term, the European Stability Mechanism (ESM), with an effective lending capacity of EUR500 billion, will supersede the EFSF and the EFSM without seniority status and is expected to provide more stability in the euro area in the medium to long-term. In addition to the agreement for the creation of a single supervisory mechanism for banks in the euro area and direct recapitalisation of banks via the ESM, EU leaders strongly affirmed the possibility of using the EFSF/ESM instruments in a flexible manner to intervene in markets to ensure financial stability in the euro area.

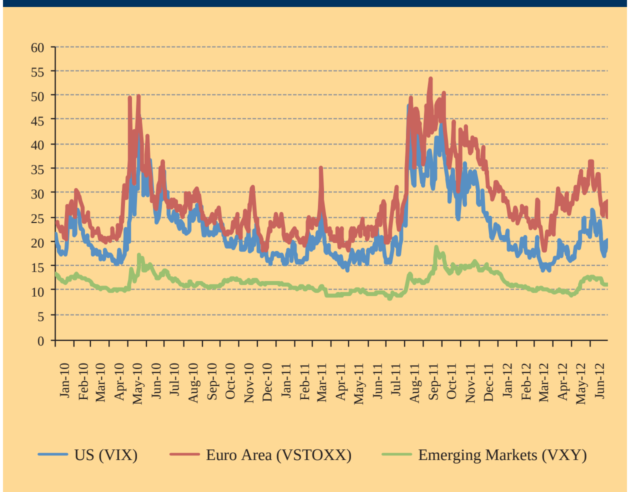
There has been much talk about Eurobonds as a more credible solution to the turmoil. With the joint issuance of common debt, Eurobonds are expected to generate a deep, liquid and stable market for government bonds. But parties opposing these, principally from Germany, claim that it smears the distinction between good and bad performers, re-creating the conditions that led to the crisis. They argue that it is essential to reinforce Europe's economic governance further to ensure fiscal prudence and, thus, avoid moral hazard before moving to Eurobonds.

It is quite evident that with all the issues discussed above, the euro area crisis may take time to be resolved. There is agreement among euro area member countries that an adequate rate of economic growth is central to successful and sustainable fiscal consolidation. However, Europe must also tackle the lack of regional unity in finding solutions to the crisis.

2.2 Global Financial Markets

During 2012H1, developments in the euro area continued to influence global financial markets. The non-standard measures initiated by the ECB helped to reduce banks' funding pressures and led to a broad-based decline in pressure in financial markets in late 2011. As liquidity conditions of banks improved, risk appetite increased as reflected in the rally in equity markets early in 2012. Some positive economic data releases also supported the relatively more optimistic outlook for the global economy and investors moved into risk-sensitive assets. Though markets were still concerned with a possible Greek default, the increasingly benign environment allowed a rather smooth swap of a EUR200 billion Greek debt in March 2012. However, optimism in financial markets evaporated in the later part of 2012H1 amid increasing fear of a potential Greece exit, possible contagion to weaker economies, and on renewed concerns about euro area growth. Volatility indices rose significantly during most of the semester before subsiding in June 2012 as the pro-bailout party win in Greek elections in that month signalled that Greece would take actions to stay in the euro area. (Chart 2.2).

Chart 2.2: Financial Markets Volatility



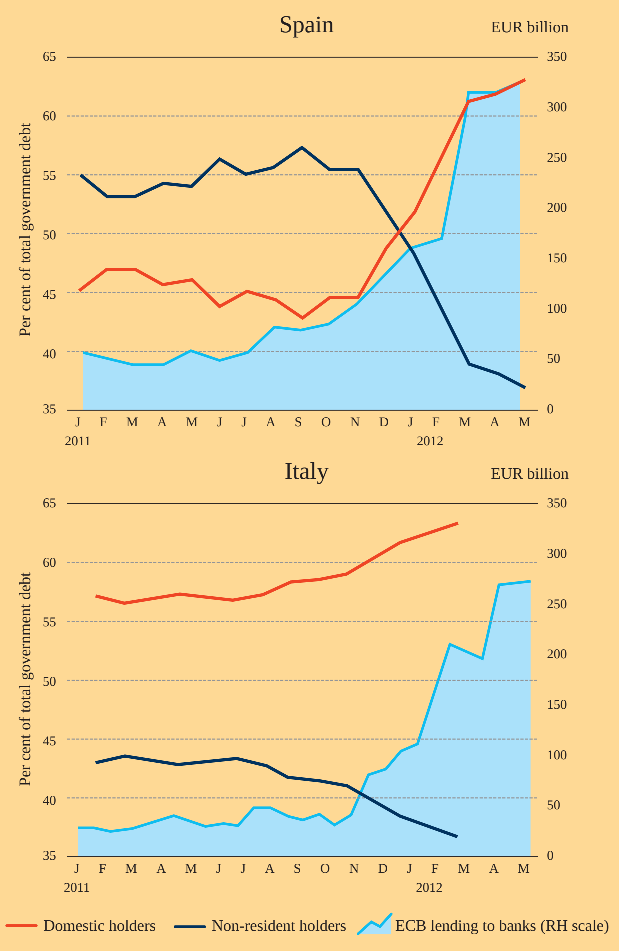
Source: Reuters.

Development in the Bond Market and Spreads

Following the easing of the market turmoil, yields in most of the euro area countries fell in early 2012. In Italy, Spain and Belgium, yields on government bonds fell by around 2 percentage points between November 2011 and March 2012, while yields on Greek bonds drifted down sharply after the rather smooth debt swap. By mid-March 2012, when uncertainty returned to markets and growth concerns resurfaced, many of the euro area sovereigns were downgraded by ratings agencies but concerns were more prominent in Spain and Italy, where the downgrades were more severe. Yields on government bonds in Italy increased sharply to above 6 per cent in June. In Spain, they surged to new record highs at successive auctions and broke the psychological 7 per cent level, which markets perceive as unsustainable. These increases in yields precipitated financial outflows from Spain and Italy (Chart 2.3). At the EU Summit in June 2012, leaders re-affirmed the possibility of using existing tools such as the temporary European Financial Stability Facility and the European Stability Mechanism to consider the purchase of sovereign bonds in secondary markets and this helped to ease stress in Spanish and Italian bond markets to some extent. However, the relief proved to be short-lived as bond yields increased again, as markets focused on the implementation risks of measures announced.

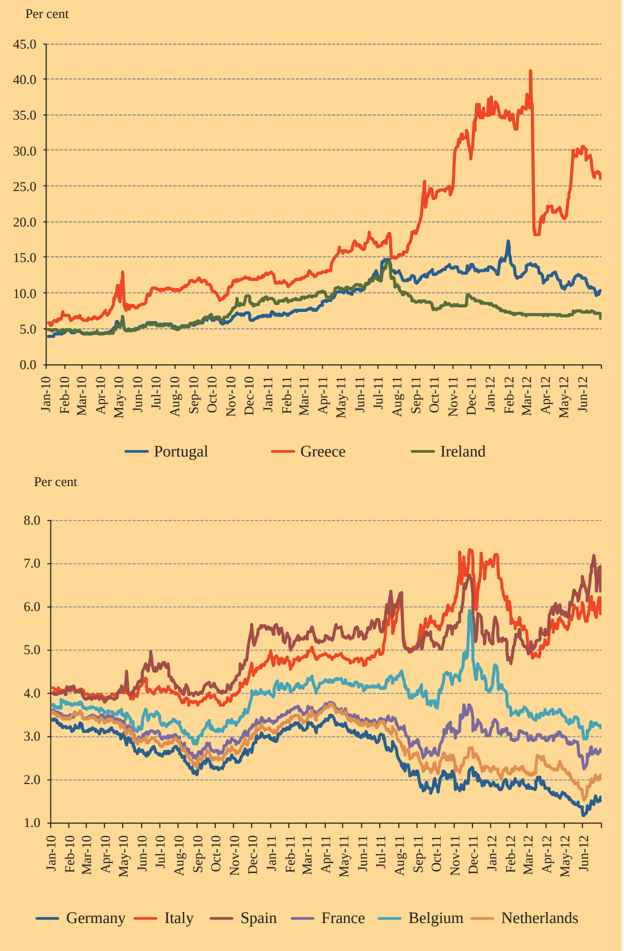
Notwithstanding the jump in yields on government bonds in Italy and Spain, AAA-rated euro area government bond yields maintained a general downward trend through early May 2012. Yields on comparable long-term government bonds in the United States evolved broadly in line with those in the euro area over the whole review period. The spreads of 10-year sovereign bond yields vis-à-vis German sovereign bunds widened for Italy and Spain, while they remained broadly stable for Belgium, Ireland and the Netherlands. In contrast, bond spreads declined in Greece and Portugal when compared to their January 2012 levels.

Chart 2.3: Spanish & Italian Government Bondholders



Source: Reuters.

Chart 2.4: 10-Year Yields on Government Bonds



Source: Reuters.

Global Stock Markets

In global financial markets, equity prices rebounded in January and February 2012 as policy actions to address the debt problems in the euro area led to a return in investors' risk appetite. Equities in US and Asia rose the most in 2012Q1 on better economic prospects in these regions compared to the debt-laden euro area, and were up by around 12 per cent and 15 per cent, respectively (Chart 2.5). In 2012Q2, however, major stock markets reversed the uptrend and gyrated to policy uncertainty in Greece. European markets suffered the heaviest losses compared to US equity markets. Investors remained on edge on the possibility of a Greek exit from the euro area as concerns about the health of the Spanish banking system increased. A slew of data releases, reflecting increased downside risks to global growth, encouraged flight to safety. Moreover, the downgraded ratings of several European financial institutions increased uncertainty in markets.

Movements of Major Currencies

During 2012H1, the movements of major currencies broadly reflected prevailing market sentiment. Though improving economic conditions at the start of 2012 helped the euro recoup some of its losses against the US dollar, the single currency was subsequently heavily weighed down as euro area debt problems intensified and global uncertainty increased again. The sovereign rating downgrades of several euro area countries and political uncertainty in Greece further pressured the euro. Even after the results of the Greek elections, the euro remained bearish as focus shifted to Spain and Italy.

The US dollar remained one of the best performing currencies during 2012H1, benefiting mainly from its safe haven status amid heightened global risk aversion. Expectations at that time that the US Federal Reserve would be the first among major central banks to increase interest rates supported the US dollar. However, towards the end of 2012H1, though European leaders were not able to fully convince markets with a durable solution, the euro managed to edge higher as incoming data from the US pointed to a slowdown of the economy.

The Pound sterling recovered in early 2012 and maintained its uptrend on a run of improved economic data releases in the United Kingdom. With inflation flying high, investors pared back expectations of further stimulus from the Bank of England. The Pound sterling rose to multi-months high by the end of April as it remained a popular alternative to the troubled euro. It slipped when data showed the British economy had slid into recession, with a second consecutive contraction of GDP in 2012Q1. The British currency, thus, tumbled against the US dollar, tracking losses in the euro versus the US currency. In Japan, safe-haven inflows following increased risk aversion led to an appreciation of the yen.

Chart 2.5: Global Equity Indices

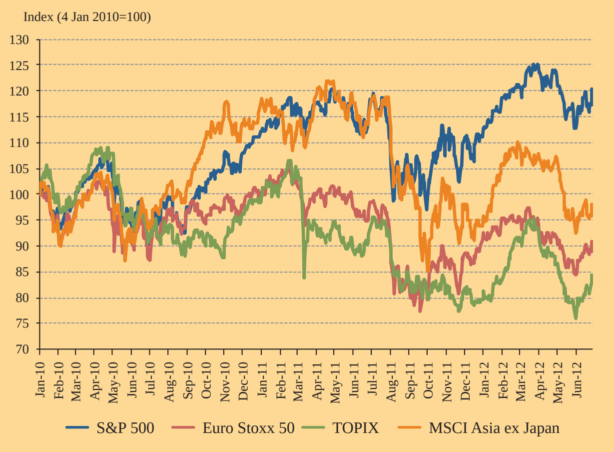
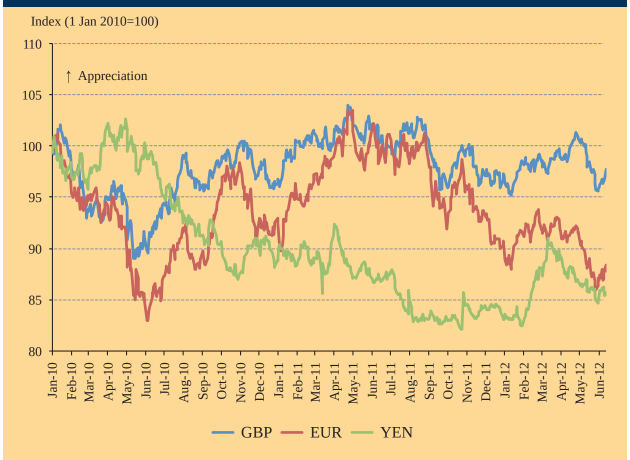


Chart 2.6: Exchange Rate Movements against the US Dollar



Source: Reuters.

2.3 International Banking Sector

The international banking sector continued to be hit by a series of adverse events that have undermined the trust and confidence it benefited prior to the global financial crisis. While the US banking sector has been recovering gradually, banks in Europe have come under increasing pressure as a consequence of the on-going sovereign debt turmoil in the euro area. Moody's downgraded 17 major banks that were most exposed to euro area sovereign debt in June 2012. Though markets have been expecting the rating actions since February 2012, when Moody's launched the review, the surprise came from the severity of the downgrades for some perceived strong institutions. The rating reviews by Moody's were instigated by dim prospects for profitability and growth due to the difficult operating environment and increased regulation, among other factors. Adding to the troubles of the European banking sector, an investigation in the UK by the Financial Services Authority (FSA) revealed that several banks manipulated the Libor, leading to one major international bank being fined a record fee. In another investigation, the FSA reported that it has found evidence that banks misled customers by selling products to protect small businesses against a rise in interest rates.

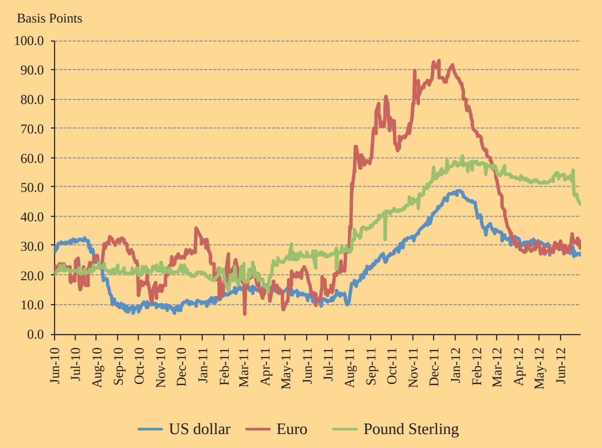
Interbank Liquidity and Access to Funding in Europe

Following non-conventional policy measures by the ECB, funding and liquidity conditions of European banks improved. ECB's Long-Term Refinancing Operations (LTROs) conducted in December 2011 and February 2012 for a combined total of slightly more than EUR1 trillion helped to prevent more serious credit crunches. However, highlighting the asymmetry of liquidity in the euro area, banks in Spain and Italy made bids for a large proportion of the funds allocated in the first tranche of the LTRO, while banks in Germany, Luxemburg and Finland did not draw much LTRO funds. At the second round of the LTRO, participation and fund raising increased as the ECB approved new eligibility criteria and financial subsidiaries from European companies were encouraged to fund themselves with this cheap money.

As policy actions spurred optimism, the easing of funding stress was highly visible in money markets. By early March 2012, Libor-OIS spreads tightened noticeably both in the US dollar market and the euro market, falling by around 10 and 50 basis points, respectively, while in the Pound sterling market it was only marginally down (Chart 2.7).

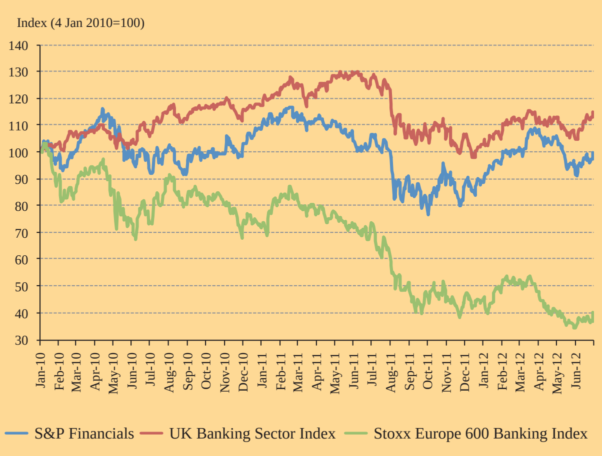
Optimism in financial markets evaporated towards end-March 2012 on renewed concerns about euro area growth. A slew of poor economic data releases created further doubts over the strength of the global economic recovery. As fear increased, liquidity conditions tightened again but were less severe compared to the credit crunch towards the end of 2011 as the impact of the LTROs faded. Global equity prices tumbled in late March and banks equity prices in the euro area and US continued to underperform the market. Market capitalisation of euro area banks fell drastically. Growth opportunities and earnings

Chart 2.7: Three-month Libor-OIS Spreads



Source: Reuters.

Chart 2.8: Financial Indices



Source: Reuters.

potential were considered as bleak and the continued lack of loss recognition and downgrades by the rating agencies added further uncertainty. Banks' CDS premia remained relatively high in the euro area.

International Banking Sector Outlook

The outlook for the international banking sector remains beset with uncertainty as developments in Europe and regulatory reforms are expected to have important bearing on costs and revenues. Compared to a EUR26.1 billion shortfall in banking capital in Spain noted in the EU-wide stress tests carried in 2011, an independent audit of Spain's banks in June 2012 showed that they would need up to EUR62 billion in extra funding. The deteriorating conditions highlight the urgency for more firm actions to resolve the euro area sovereign debt crisis. Moreover, some banks in France, Netherlands, Belgium, Luxembourg, Germany and US have been downgraded by at least one of the three major rating agencies, namely Standard and Poor's, Moody's and Fitch.

Faced with all these shocks and falling confidence in the banking sector, accelerating reforms that were initiated post the global financial crisis remain a key priority worldwide for rebuilding trust in the sector. Various initiatives, principally led by the Bank for International Settlements (BIS), have been undertaken to review practices, and regulatory and supervisory frameworks worldwide. The new wave of reforms has several cost and revenue implications for the international banking sector. Nonetheless, it is hoped that these new regulations and standards will promote more prudent banking business and, thus, avert the severity of crises. New regulation requiring higher capital buffers, specific regulation of systemically important banks and more data reporting requirements would lead to higher costs in the banking sector. Concurrently, banking sector revenues are expected to grow moderately in 2012, as the global slowdown and the lack of a credible solution to euro area turmoil continue to have adverse repercussions on sentiment and confidence.

3 Domestic Macroprudential Assessment

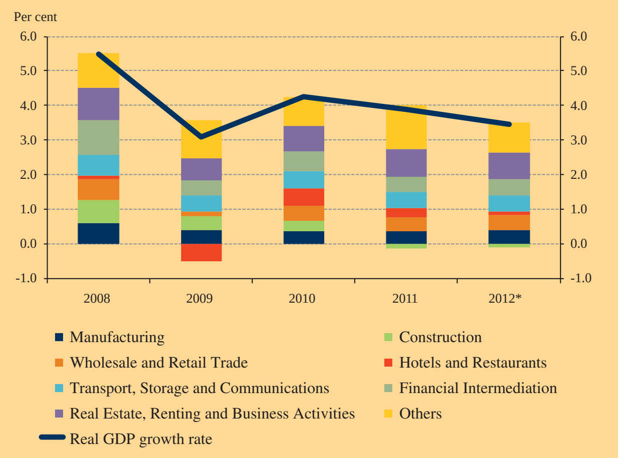
In 2012H1, the domestic economy was adversely affected by the on-going euro area crisis and weakening global economic outlook. The economy, however, remained resilient. Moody's upgraded Mauritius sovereign credit ratings. The immediate impact of these developments was the upgrade of long-term foreign currency deposit rating of the two largest domestically-owned banks. The Bank embarked on the Operation Reserves Reconstitution (ORR) programme to improve its reserves buffer. Households' indebtedness with banks maintained a rather stable growth rate and was driven by mortgage loans. Banking sector activity continued to expand at a relatively reasonable pace with well capitalised banks, low non-performing loans ratio, adequate loan loss coverage, capital adequacy level above the minimum 10 per cent requirement and little balance sheet exposures to the euro area. Overall, the financial sector remained sound and resilient in 2012H1.

3.1 The Domestic Economy

As a consequence of the lingering euro area crisis, the domestic economy slowed down in 2012H1. The adverse impact of the deepening of the crisis was felt more by the export-led sectors. Exports of goods to Europe contracted by 5.3 per cent and tourist arrivals from Europe fell by 6.0 per cent, y-o-y, in 2012H1. Moreover, the fall of the euro on international markets complicated the situation further. While the Bank of Mauritius had been intervening in the market to contain the appreciation of the rupee, in June 2012 it strengthened its approach and succeeded in limiting the appreciation of the rupee against the euro.

According to estimates made in June 2012 by Statistics Mauritius, the economy grew by 2.8 per cent in 2012Q1. The main contributing sectors were *Real Estate, Renting and Business Activities, Financial Intermediation, Wholesale & Retail Trade and Other Social and Personal Service Activities* that performed relatively well. The challenging international conditions continued to weigh on business and consumer sentiment, keeping economic activity subdued. Final consumption expenditure grew by 2.8 per cent, with household consumption expanding by 2.8 per cent and government expenditure by 2.7 per cent. Investment grew by 10.4 per cent. According to forecasts made in June 2012 by Statistics Mauritius, the economy is projected to grow by 3.5 per cent in 2012.

Chart 3.1: Contribution of Major Sectors to Growth



** Forecast.*
Source: Statistics Mauritius.

3.1.1 External Vulnerabilities

Balance of Payments

The current account, inclusive of cross-border transactions of GBC1s, registered a slightly higher deficit of Rs4.3 billion in 2012Q1 compared to a deficit of Rs4.1 billion recorded in the corresponding quarter of last year. However, as a percentage of GDP at market prices, the current account deficit stood at 5.3 per cent in 2012Q1, lower than the 5.5 per cent recorded in 2011Q1.

The merchandise trade deficit deteriorated by 13.6 per cent, y-o-y, in 2012Q1 as a result of higher growth rate in imports, *f.o.b.* of 7.6 per cent compared to an expansion of only 2.6 per cent in exports. Provisional estimates for 2012Q1 indicated that export prices went up by 6.3 per cent, while import prices increased by 4.9 per cent, y-o-y, implying a fall in exports volume and a slight growth in imports volume.

The surplus in the balance of services went up by 15.6 per cent, y-o-y, largely driven by higher net travel receipts of Rs11.2 billion. The income account posted a higher surplus of Rs1.8 billion compared to Rs1.5 billion in 2011Q1. The surplus on the current transfers increased from Rs1.3 billion in 2011Q1 to Rs1.7 billion in 2012Q1, as a result of the larger net inflows on private transfers.

The capital and financial account posted higher net inflows of Rs5.6 billion. However, portfolio investment and other investment both displayed outflows. The overall balance of payments posted a deficit of Rs1.6 billion in 2012Q1.

Commodity Prices

With '*Food and Live Animals*' and '*Mineral Fuels*' imports accounting for around 40 per cent of the total goods import bill, the country is heavily exposed to surges in international commodity prices. Data from Statistics Mauritius show that '*Food and Live Animals*' imports increased by 7 per cent while imports of '*Mineral Fuels*' decreased by 4 per cent in 2012Q1. International commodity prices depicted a downward trend throughout 2012H1.

Adequacy of Reserves

The gross official international reserves of the country stood at Rs86.7 billion as at end-June 2012, representing 4.9 months of import cover. Following the IMF's recommendation, import cover is now calculated based on imports of goods, *f.o.b.* and non-factor services rather than only imports of goods, *c.i.f.* While the Bank has consistently been increasing its gross official reserves, imports have been growing at a much faster rate. Consequently, import cover has been moderating and the Bank deemed essential to build up its foreign exchange reserves. The Bank, thus, on 9 June 2012, embarked on the Operation Reserves Reconstitution (ORR) programme with the objective to eventually reach six months of import cover.

Chart 3.2: Financing of the Current Account

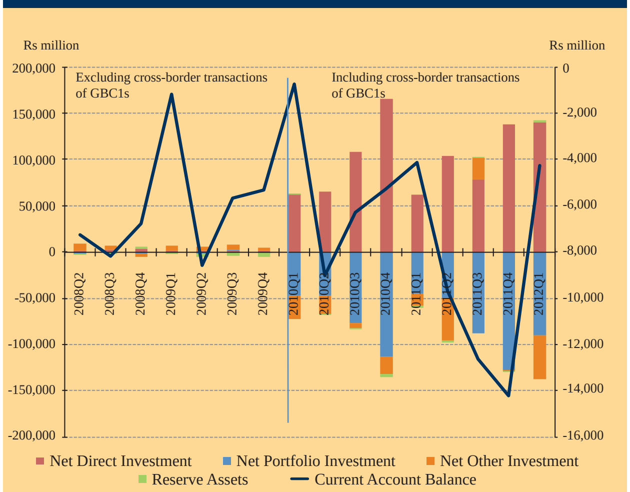
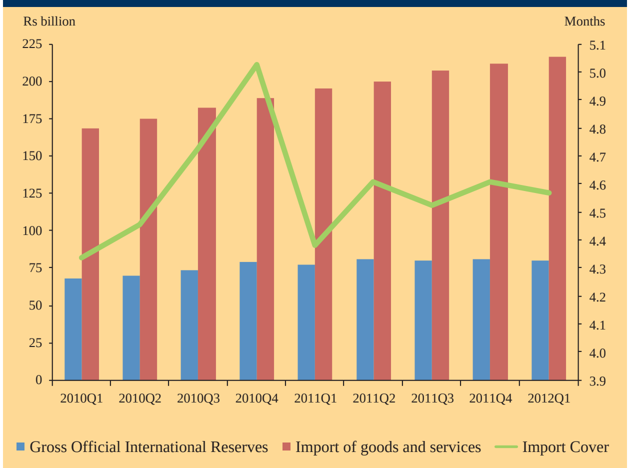


Chart 3.3: Gross Official International Reserves and Import Coverage



External Debt

The gross external debt, comprising general Government, public corporations, monetary authorities and private sector debt, rose by 9.9 per cent y-o-y to Rs44,749 million as at end-March 2012, driven mainly by an increase in central Government's and public enterprises' external debt. Gross external debt represented 13.6 per cent of GDP as at March 2012 compared to 13.3 per cent of GDP as at March 2011. Other solvency indicators with regard to gross external debt do not indicate any major cause for concern (see Box II).

External debt of central Government, which is the most important component of gross external debt, stood at 8.3 per cent of GDP as at end-December 2011 and end-March 2012. However, it is projected to grow steadily to reach 14.7 per cent of GDP, 16.2 per cent of GDP and 17.2 per cent of GDP, respectively, as at end-December 2012, 2013 and 2014. The majority of central government external debt is on floating interest rates (67.1 per cent), while fixed-interest rate and interest free external debt represent 27.9 per cent and 5.0 per cent, respectively. Active debt management with a view to lengthening the maturity profile of central government debt and reducing refinance risks was reflected in the redemption profile of external debt of central Government (Chart 3.4).

As at end-June 2012, central Government external debt was mainly denominated in US dollars and euros (Chart 3.5). The debt-service ratio for the country is forecast to remain contained and would hover in the range of 3.5 per cent to 4.0 per cent between 2012 and 2014.

Chart 3.4: Redemption Profile of Central Government External Debt-June 2012

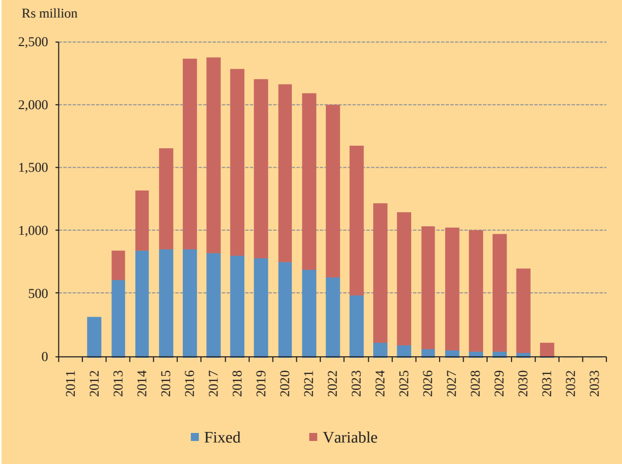
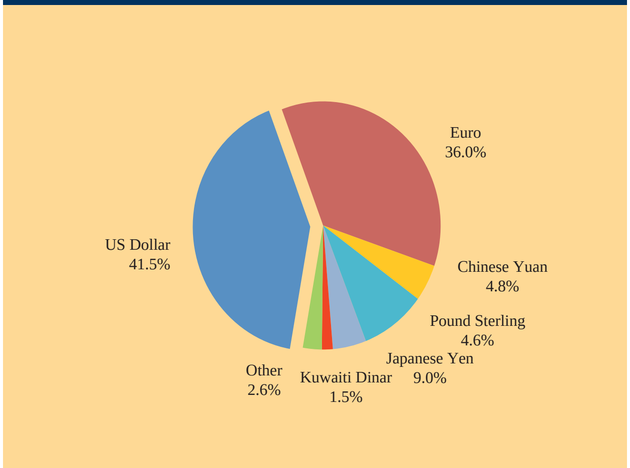


Chart 3.5: Currency Composition of Central Government External Debt-June 2012



Box II: External Indicators

		Mar-11	Mar-12
		Rs million	
Gross External Debt [1]	as at end	40,735	44,749
External Debt Service	year ended	7,525	9,404
Exports of Goods	year ended	72,774	76,372
Exports of Goods and Services	year ended	158,842	173,482
Imports of Goods and Services	year ended	195,983	216,774
Gross Official International Reserves [2]	as at end	77,497	80,821
GDP at market prices	year ended	305,802	328,284
Broad Money Liabilities	as at end	315,401	335,118
Indicators		*Per cent*	
I. Solvency			
Gross External Debt/GDP		13.3	13.6
Gross External Debt/Exports of Goods		56.0	58.6
Gross External Debt/Exports of Goods and Services		25.6	25.8
External Debt Service/Exports of Goods		10.3	12.3
External Debt Service/Exports of Goods and Services		4.7	5.4
II. Reserve Adequacy			
Reserves/Imports of Goods and Services		39.5	37.3
Reserves/ Broad Money Liabilities		24.6	24.1
Reserves/Gross External Debt		190.2	180.6

[1] *Gross external debt outstanding as at end of period comprises general Government, public corporations, monetary authorities and private sector.*

[2] *Gross Official International Reserves as at end of period comprises gross foreign assets of the Bank of Mauritius, reserve position in the IMF and the foreign assets of Government.*

3.1.2 Total Public Sector Debt

The budget deficit, which stood at 3.2 per cent of GDP in 2011, is expected to increase to 3.8 per cent in 2012, owing to higher net capital investment by government, before declining to 3.4 per cent in 2014. The primary balance was in deficit in 2011 and 2012, representing 0.2 per cent and 0.6 per cent of GDP, respectively, and is expected to fluctuate between -0.4 per cent and -0.8 per cent in the following two years.

Public sector debt, comprising debt of General Government and public enterprises, stood at 57.1 per cent of GDP as at end-March 2012. The debt to GDP ratio is expected to increase slightly to 57.7 per cent as at end-December 2012 before oscillating between 55.7 per cent and 56.3 per cent in the following two years.

As a result of the various measures taken to lengthen the maturity profile of Government debt and reduce the rollover risks and costs associated with debt management, long-term domestic debt (by original maturity) as a proportion of total domestic government debt increased from 42.6 per cent as at end-December 2011 to 43.8 per cent as at end-March 2012. Despite the increase in budget deficit, public sector debt can be viewed as being broadly sustainable. Moreover, Moody's commented positively on the debt dynamics in its upgrade of Mauritius sovereign ratings in June 2012.

Credit Rating

Moody's Investors Service placed Mauritius on watch for a possible upgrade on 16 March 2012 and concluded its rating action by eventually upgrading Mauritius's foreign and local currency government bond ratings to Baa1 from Baa2. Moody's also upgraded Mauritius's foreign currency ceilings for bonds and deposits to A2 from Baa1 and to Baa1 from Baa2, respectively. The country ceilings for local-currency debt and deposits were adjusted to A1 from Aa2 to better capture the default correlation between the government and other domestic entities through their joint dependence on the real economy which remains relatively small (Table 3.1). In its upgrade, Moody's made the following observations.

- *The main driver behind the decision to upgrade Mauritius' rating was the clear strengthening of the institutional framework, which is expected to permit the economy and public finances to circumvent a protracted negative impact from any shock emanating from Europe, the country's largest trading partner. The rating agency observed that aggressive countercyclical measures kept the economy growing even during the global recession in 2009. Buffers such as the National Resiliency Fund as well as precautionary multilateral lending programmes have been established that would allow renewed countercyclical spending as needed in coming years without leading to renewed fiscal deterioration.*

- *The second main driver behind the upgrade was the progress being made in diversifying the Mauritian economy, in part through the attraction of foreign direct investment from multiple sources.*

- *The third driver is the renewed positive trend in Mauritius's debt dynamics, after a temporary increase in debt was recorded during the global financial crisis.*

3.2 Financial Markets

3.2.1 The Money Market

Banks' excess reserves depicted a slight upward trend in 2012H1. The overall excess liquidity position in the banking system since end-December 2011 remained at a reasonable level, averaging Rs3.0 billion during 2012H1 compared to an average of Rs2.0 billion during 2011H2. After an issue of Bank of Mauritius Bills for Rs725 million in 2012Q1, the Bank did not issue any Bank of Mauritius Bills in 2012Q2. Sporadic shortages in rupee liquidity were observed in 2012H1. Consequently, the Bank kept open the option of buy-back of Bank of Mauritius Notes, but no transaction took place.

The slight uptrend in excess liquidity resulted into lower interest rates as well as lower volume of transactions on the interbank money market. Transactions in 2012H1 amounted to Rs102 billion, with rates ranging between 1.45 per cent and 3.20 per cent compared to an amount of Rs188 billion with interest rates varying between 1.65 per cent and 4.15 per cent in 2011H2. Overnight transactions constituted 97 per cent of total transactions. During 2012H1, no specific bank was only on the lending or only on the borrowing side implying that banks did not face any excessive funding pressure nor were banks enduring untenable levels of excessive liquidity. The interbank market, thus, appeared to have functioned smoothly.

The overnight interbank interest rate has ranged from 1.45 per cent to 2.75 per cent during 2012H1 while interest rates on short notice and term transactions hovered within a range of 1.55 per cent and 3.20 per cent. The weighted average interbank interest rate ranged between 1.59 per cent and 2.40 per cent compared to a range of 1.86 per cent to 3.48 per cent during 2011H2.

Chart 3.6: Banks' Average Excess Reserves

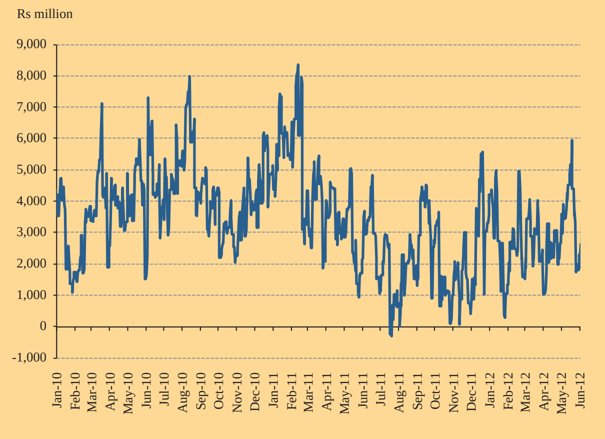


Table 3.1: Moody's Credit Rating for Mauritius

	January 2012		June 2012	
	Foreign Currency	Local Currency	Foreign Currency	Local Currency
Government Bond Rating	Baa2	Baa2	Baa1	Baa1
Country Ceiling	Baa1	Aa2	A2	A1
Bank Deposit Ceiling	Baa2	Aa2	Baa1	A1

Source: Moody's.

Yield Curve of Government Securities

Following the 50 basis points cut in the KRR in March 2012, as well as aggressive bidding at auctions by market participants, the yields on Government securities, especially at the shorter end of the maturity spectrum, went down. The weighted yields on 91-Day and 182-Day Treasury Bills have declined from 4.03 per cent and 4.39 per cent, respectively, as at end-December 2011 to 3.04 per cent and 3.29 per cent, respectively, as at end-June 2012. Similarly, the weighted yields on the 273-Day Treasury Bill and 364-day Treasury Bill went down from 4.60 per cent and 4.73 per cent as at end-December 2011 to 3.39 per cent and 3.83 per cent, respectively, as at end-June 2012. Consequently, the yield curve shifted downwards as at end-June 2012 from end-December 2011, indicating lower borrowing costs for the government. The fall in borrowing costs at the lower end of the yield curve is, however, larger than that at the upper end, reflecting to a large extent the low interest rate environment (Chart 3.7).

3.2.2 The Stock Market

The SEMDEX, which is a weighted index of prices of all listed shares, posted a negative performance during 2012H1, falling by 6.0 per cent and hitting its lowest level since October 2010 (Chart 3.8). Comparatively, the SEM-7, which comprises the seven largest eligible shares of the SEM, as measured in terms of market capitalisation, fell by 2.9 per cent. The decline in share prices was largely driven by decreases in hotel stocks and the national airline stock. The shares of the three quoted hotel groups fell by 24.4 per cent, 23.9 per cent and 19.0 per cent, respectively, while those of the national airline company declined by 31.3 per cent. Banks as well as conglomerates traded within a narrow range.

The price-earnings (PE) ratio declined significantly from 11.29 at end-December 2011 to 10.63 at end-June 2012. Reductions were broad-based but companies in the 'Sugar' and 'Investments' categories registered the most significant declines.

Chart 3.7: Yield Curves of Government Securities

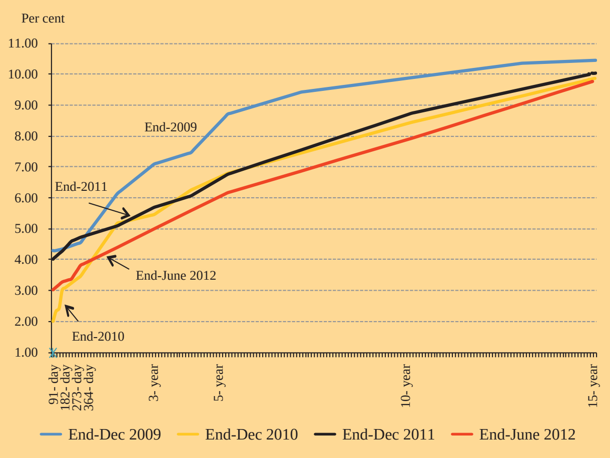
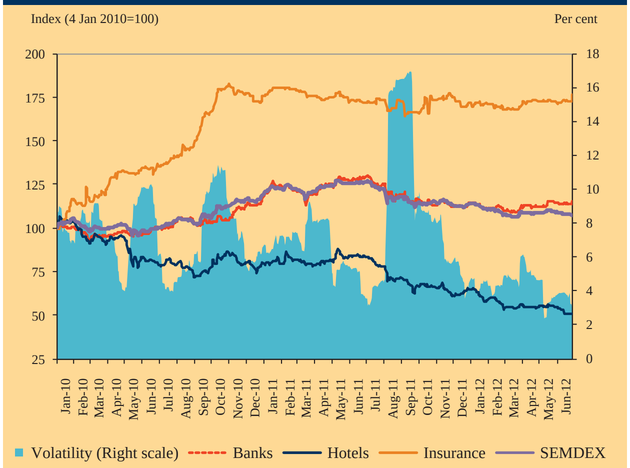
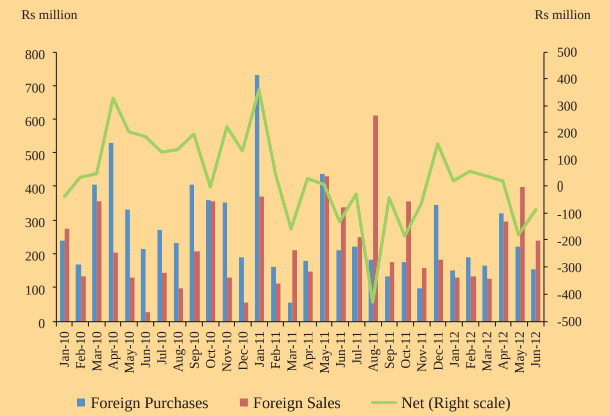


Chart 3.8: Share Price Indices of Banks, Hotels and Insurance and the SEMDEX



Source: Stock Exchange of Mauritius.

Chart 3.9: Foreign Investment on the SEM



Source: Stock Exchange of Mauritius.

Investment by foreign investors accounted for around 32.4 per cent of the total value traded on the stock market during the first half of 2012. In 2012H1, foreign investors' confidence was maintained although net outflows of Rs121.2 million were registered. Purchases and sales by foreign investors over that period amounted to Rs1,205.7 million and Rs1,326.9 million, respectively. The net outflows occurred mainly in the "Banking" sector (Chart 3.9).

3.2.3 The Foreign Exchange Market

During most of 2012H1, the rupee remained relatively stable in spite of significant volatility on the international market. The rupee depreciated against the US dollar in January 2012 as the latter strengthened on international markets on account of its safe haven status amid concern over the ongoing euro area crisis. Thereafter, the local currency recovered some of its losses but came under renewed pressure in early March 2012. Over the same period, the rupee appreciated against the euro on bearish sentiment towards the single currency.

The rupee depreciated against the Pound sterling as the latter demarked itself from the euro on the international foreign exchange market, benefiting to some extent from the troubles of the euro. But as releases of weak UK economic data weighed on the British currency, the rupee recouped some of its losses against the Pound sterling in May 2012. Movements of the rupee against the US dollar were, to a large extent, counterbalanced by its movements against the euro and Pound sterling such that MERI2 depicted a stable path between January and May 2012. Thereafter, the intensification of the euro crisis and the gloomy outlook of the world economy rekindled interest in the US dollar for its safe haven status. Reflecting these international trends, the rupee depreciated against the US dollar but appreciated vis-à-vis the Pound sterling and the euro.

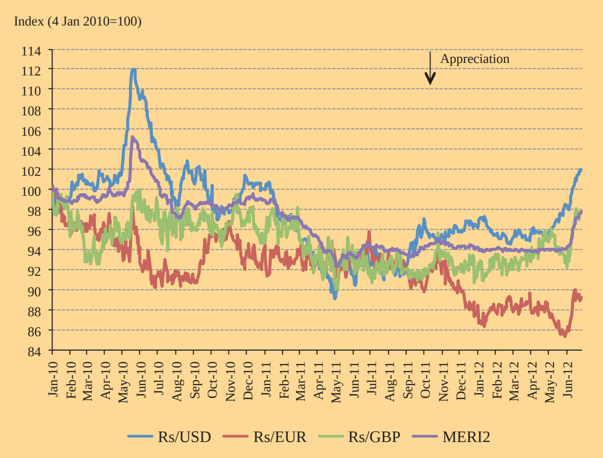
On 9 June 2012, the Bank of Mauritius announced its decision to intervene in the market to build its international reserves, noting that the rupee was misaligned with its fundamentals. Following the announcement, a correction was noted in the Rs/USD, Rs/EUR and Rs/GBP exchange rates as well as in MERI2 (Chart 3.10).

On a point-to-point basis, between 3 January 2012 and 29 June 2012, the consolidated indicative selling rate of the rupee depreciated against the US dollar (4.70 per cent), the euro (1.61 per cent) and the Pound sterling (5.05 per cent). Over the same period, the average rupee dealt selling rates, which are derived from transactions of US$30,000 and above or equivalent, depreciated by 5.47 per cent, 2.02 per cent and 6.58 per cent against the US dollar, euro and Pound sterling, respectively. In nominal effective terms, the trade-weighted value of the domestic currency, as measured by MERI1 and MERI2, registered depreciations of 2.05 per cent and 1.96 per cent, respectively, between January and June 2012.

Volatility in the domestic foreign exchange market in 2012H1 was mixed. While volatility in the Rs/USD rate remained low, revolving around 4 per cent, volatility in the Rs/EUR rate evolved in the range of 6.0-10.5 per cent, mirroring volatility in the EUR/USD rate. Nonetheless, volatility in the Rs/EUR rate was range-bound and had eased noticeably compared to 2011H2.

An analysis of the consolidated indicative bid-ask spreads of the rupee versus the major currencies showed relative stability in the Rs/EUR and Rs/GBP spreads over the period January to June 2012. The deepening of the euro crisis widened the spread in May 2012, but narrowed in early June on temporary moderation of the euro area crisis concerns. After the announcement of the Bank of Mauritius to build up its international reserves, the Rs/USD spread widened again, but rapidly narrowed as the market settled. The mean spread over the period January to June 2012 was Rs1.36 for Rs/USD, Rs1.77 for Rs/EUR and Rs2.16 for Rs/GBP.

Chart 3.10: Exchange Rate Movements



The daily average overbought foreign exchange position of banks in 2012H1 soared to US$20.6 million, from US$5.7 million in 2011H2. The Bank intervened to purchase an amount of US$250.4 million and EUR19.5 million from banks and foreign exchange dealers during 2012H1. Transactions on the interbank foreign exchange market rose to US$415.3 million during the period under review from US$312.8 million during 2011H2.

3.3 Credit Growth and Credit Risks

Credit risk is a major risk faced by banks in Mauritius as more than 60 per cent of their assets represent loans and advances. Growth in banking sector credit, on a y-o-y basis, stood at 13.5 per cent as at end-June 2012 compared to 10.9 per a year earlier (Chart 3.13). Y-o-y growth of credit granted in Mauritius, which accounted for 48 per cent of total credit in the sector, remained around 11 per cent from July to November 2011 but, thereafter, followed a declining trend, especially in the first months of 2012, to reach 8.2 per cent in April 2012. Subsequently, it picked up and attained 10.7 per cent in June 2012. Growth of credit granted outside Mauritius attained a peak of 25.6 per cent in January 2012, but decelerated to 16.2 per cent in June 2012.

Chart 3.11: Volatility of the Rupee

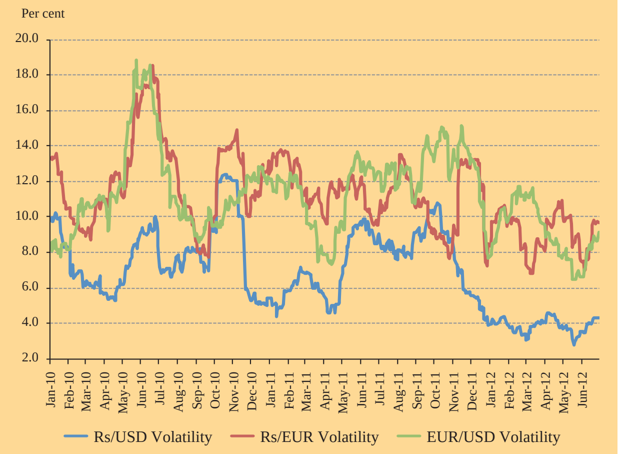


Chart 3.12: Bid-Ask Spread of the Rupee versus Major Currencies

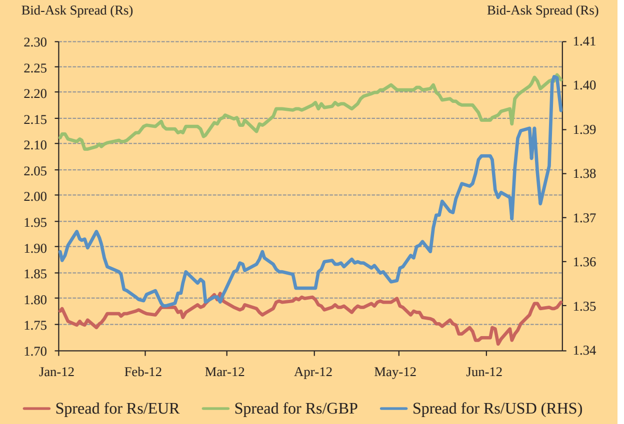
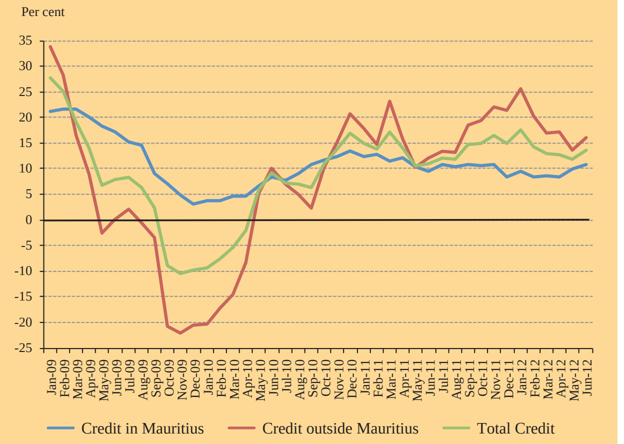


Chart 3.13: Y-o-y Growth of Total Credit



3.3.1 Household Sector

Household credit is granted mainly by domestically-owned banks and its evolution, therefore, has some implications for the banking sector given that domestic banks account for around 36 per cent of total banking sector assets and 72 per cent of total Segment A assets. Credit to households represented 18.2 per cent of GDP as at March 2012, up by 1.4 percentage points compared to the corresponding period of the previous year.

Household credit has for the past quarters maintained, on average, more than 20 per cent share in total credit to the private sector, thus indicating the importance of households in banks' credit portfolio. Credit to households is extended mainly as housing loans and consumption loans. Banks tend to favour mortgage loans due to the robust collaterals attached while consumption loans which are relatively more risky accounted for a lower share in total household credit. As at end-June 2012, mortgage loans accounted for 59.7 per cent of total household credit while the remainder was extended as consumption loans.

The y-o-y growth rate of household credit stood at 17.6 per cent as at end-June 2012 up from 15.6 per cent as at end-June 2011 (Table 3.2).

As at end-June 2012, the share of housing loans in total household loans increased to 59.7 per cent from 57.6 per cent a year earlier. Credit extended by banks for housing and consumption purposes grew by 21.9 per cent and 11.8 per cent y-o-y, respectively as at end-June 2012 compared to 21.5 per cent and 7.7 per cent, in the corresponding period a year earlier (Chart 3.15). Credit card facilities, which are typically unsecured, are also consumption loans and have a potentially higher default rate. However, they account for only around 3 per cent of total household credit currently and, thus, do not presently raise any potential financial stability concerns.

Chart 3.14: Credit to Households as a percentage of GDP

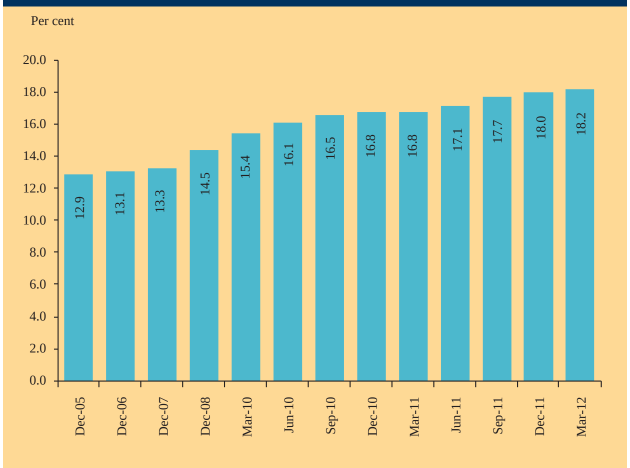


Chart 3.15: Y-o-y Growth of Credit to Households

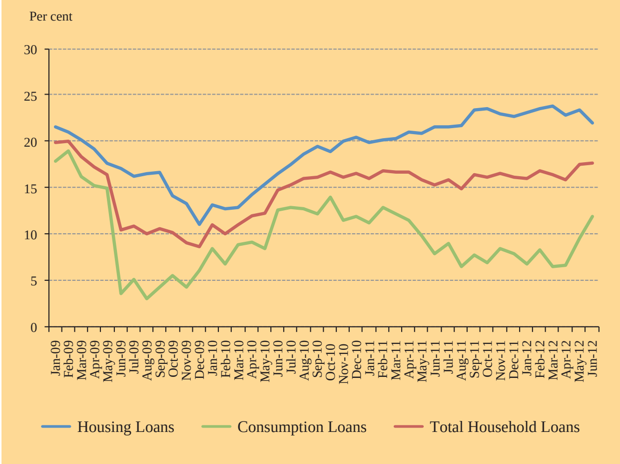


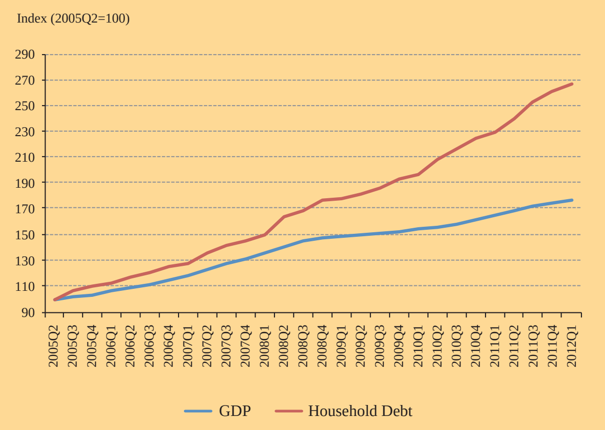
Table 3.2: Household Credit

	Jun-07	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12
Share in Total Credit (per cent)	23.0	23.6	22.2	23.5	24.7	26.3
Y-o-y Growth Rate (per cent)	15.7	21.3	10.3	14.6	15.3	17.6

Growth of Household Credit and GDP

The relative growth rate of household credit and nominal GDP is a commonly used indicator for monitoring household vulnerabilities. Analysis shows that since the break-out of the crisis in 2008, the gap between household credit growth and nominal GDP growth has continuously widened (Chart 3.16). Generally, the widening of the gap would point to vulnerabilities in the household sector as it might indicate potential debt service difficulties. However, since household credit is driven by housing loans which typically carry low risk of default compared to consumption loans, the widening gap may not necessarily point to increasing household vulnerabilities.

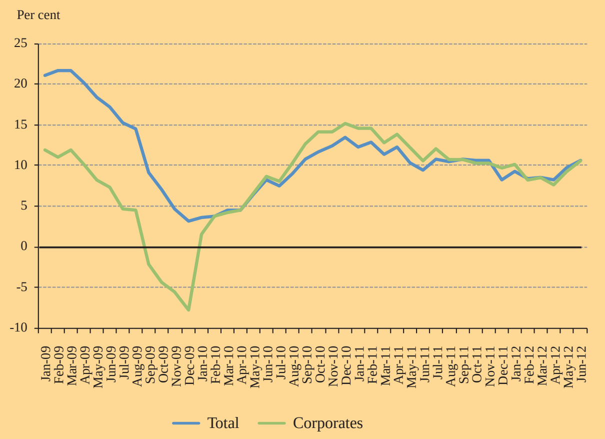
Chart 3.16: Household Credit and GDP



3.3.2 Corporate Sector

The recently issued ranking of the Top 100 companies in Mauritius shows that most of them have achieved growth in 2011, with a combined increase of 16.6 per cent in turnover. Three companies registered more than Rs15 billion turnover each and more than 75 companies achieved Rs1.0 billion turnover each. The Top 100 companies altogether registered an increase of 37.2 per cent in profits with 7 companies each recording more than Rs1.0 billion profits in 2011.

Chart 3.17: Y-o-y Growth of Credit in Mauritius



Corporate credit represented 71.5 per cent of total bank credit to the private sector as at end-June 2012, marginally lower compared to 71.6 per cent registered a year earlier. Corporate credit growth maintained a declining trend as from December 2010 and through to April 2012 but increased in June 2012 (Chart 3.17). As at end-June 2012, corporate credit grew by 10.5 per cent y-o-y, unchanged from a year earlier.

Corporate sector credit is channelled to all the key economic sectors with credit to five main sectors accounting for 58.5 per cent of total private sector credit. The tourism sector has the highest share of corporate credit, with its borrowings making up 25.3 per cent of total corporate sector credit, while credit to traders, financial and business services and construction represented 16.7 per cent, 14.6 per cent and 14.2 per cent of corporate credit, respectively, as at end-June 2012. As a percentage of total private sector credit, credit to the tourism, traders, financial and business services and construction sectors individually represented 18.1 per cent, 12.0 per cent, 10.4 per cent and 10.1 per cent, respectively (Chart 3.18).

The y-o-y credit growth to the tourism and, financial and business services sectors decelerated sharply from 19.5 per cent each at end-June 2011 to 2.7 per cent and 2.0 per cent, respectively, at end June 2012. The manufacturing sector which includes the export sector registered a credit growth rate of 4.4 per cent as at end-June 2012 compared to 2.9 per cent as at end-June 2011, while the credit growth to the construction sector, excluding housing loans, increased considerably from 4.6 per cent to 28.7 per cent, over that same period mainly as a result of major infrastructural and real estate projects. Growth in credit to traders rose from 12.6 per cent as at end-June 2011 to 13.9 per cent as at end-June 2012 (Chart 3.19).

Credit in foreign currency also constitutes an important form of funding to the corporate sector as a large number of companies relies on foreign currency credit for import of raw materials and consumption goods. As at end-June 2012, the tourism sector borrowed 31.2 per cent of its loans in foreign currencies while the manufacturing sector borrowed 24.6 per cent, traders 10.9 per cent and financial and business services 11.3 per cent.

With private sector investment forecast to remain weak in 2012, corporate credit is expected to maintain the current trend in the coming months. The Bank introduced on 9 June 2012 a foreign currency line of credit to assist enterprises mitigate foreign exchange risks. This policy initiative aims to help refinance the stock of outstanding debt in rupees of export operators that face currency mismatches with their income streams.

Overall, the corporate sector credit does not currently pose any cause for financial stability concern.

Chart 3.18: Sectorwise Distribution of Credit-June 2012

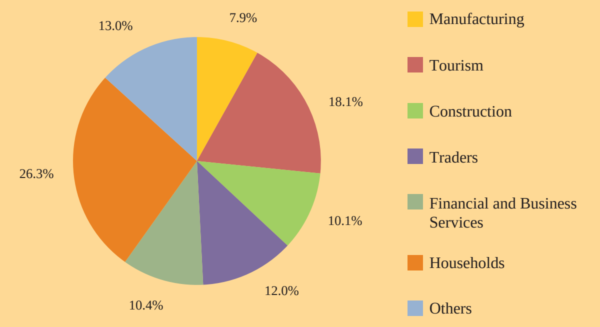
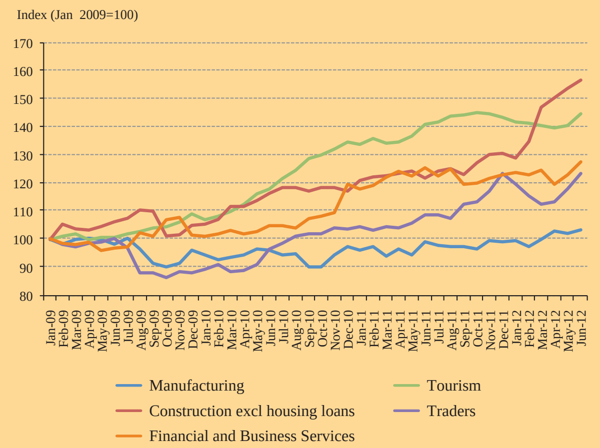


Chart 3.19: Evolution of Corporate Credit



3.4 Banking Sector Performance

Banking sector activities continued to expand at a relatively reasonable pace despite global and domestic economic concerns. Aggregate banking sector assets, which at end-June 2012 constituted of 39.3 per cent and 60.7 per cent of Segment A and Segment B assets, respectively, grew by 4.0 per cent in the year to June 2012 following a growth rate of 3.8 per cent in the preceding year ended June 2011. This was largely driven by growth in domestic banking activities and to a lesser extent by growth in global banking business. Consequently, Segment A assets posted a y-o-y increase of 6.4 per cent as at end-June 2012 against 10.4 per cent a year earlier while Segment B assets registered a growth rate of 2.6 per cent at end-June 2012 compared to virtually no growth at end-June 2011. (Chart 3.20).

Banks continue to favour advances and cash and balances with banks as the two major components of their assets (Chart 3.21). The share of advances in total assets increased to 65.5 per cent as at end-June 2012 from 59.4 per cent a year earlier while the share of cash and balances with banks in total banking sector assets decreased from 27.1 per cent to 20.4 per cent over the same period.

Asset Diversification

The asset diversification matrix for the banking sector for 2012Q1 indicates that banks have maintained a general preference for assets bearing 100 per cent risk-weight followed by those bearing 20 per cent and zero per cent. Between end-March 2011 and end-March 2012, the share of assets held in the 100 risk-weight

Chart 3.20: Growth of Assets in the Banking Sector

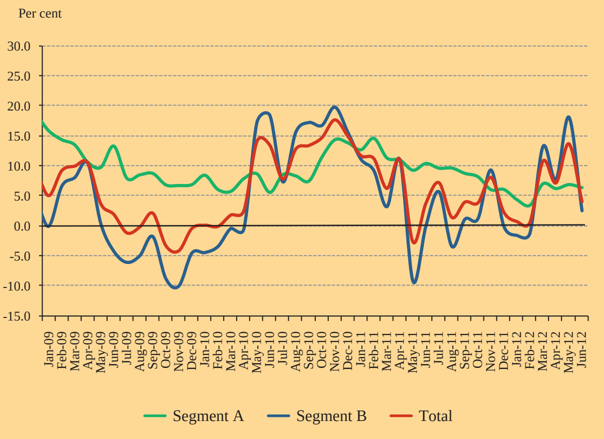


Chart 3.22: Risk Diversification Matrix for the Banking Sector

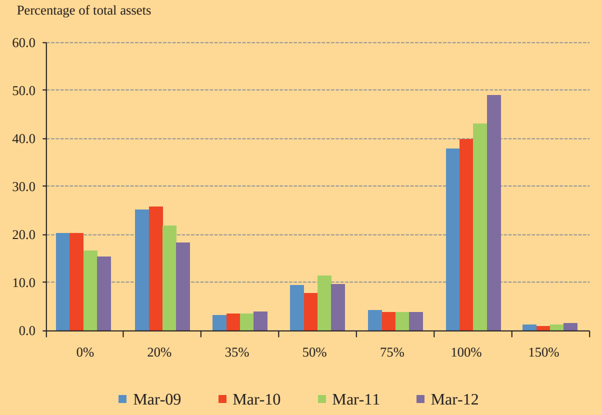
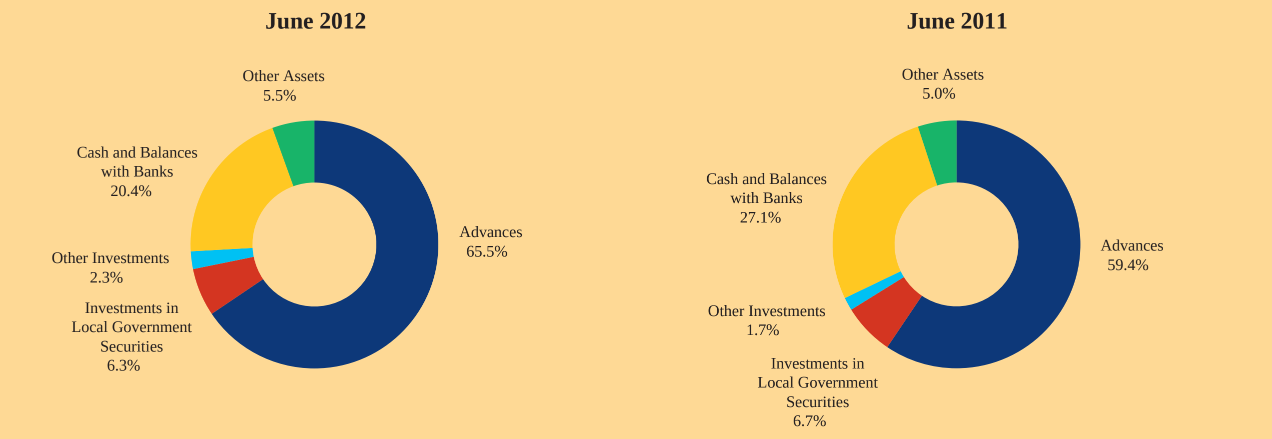


Chart 3.21: Components of Banks' Total Assets



Figures may not add up due to rounding.

category increased noticeably, from 42.7 per cent to 48.8 per cent while the share of assets held in the zero and 20 per cent risk weights fell from 16.5 per cent and 21.5 per cent to 15.2 per cent and 18.0 per cent respectively. Changes in the share of assets in the other risk weights were not significant over these two periods (Chart 3.22).

3.4.1 CAMEL Rating

The Bank has been publishing the CAMEL ratings of banks in Mauritius since March 2011 based on their financial conditions, with a view to improving transparency and market disclosure, and also to improve the overall efficiency and stability of the financial system.

In June 2012, the Bank published the CAMEL ratings of banks based on their financial conditions as at end-December 2011. The evaluation shows that 14 banks held a 'satisfactory' rating (2+ or 2-) and 6 banks were assigned a 'fair' rating (3+ or 3-). On a comparative basis, most banks retained the same composite rating

Chart 3.23: Risk Diversification Matrix by Bank Type (March 2012)

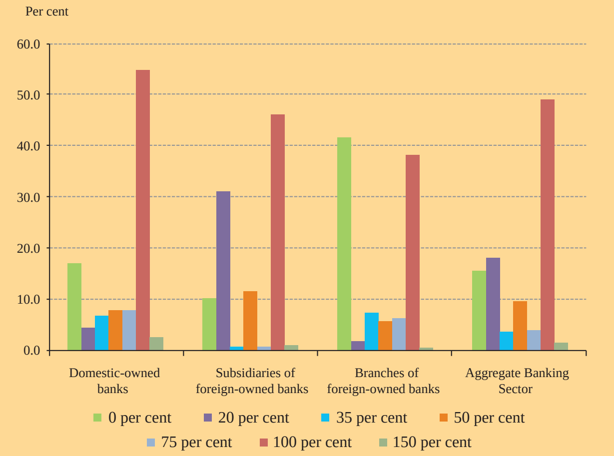


Table 3.3: CAMEL Ratings as at end-December 2011

CAMEL Ratings	Jun-11	Dec-11
ABC Banking Corporation Ltd	3+	3+
AfrAsia Bank Limited	2+	2+
Bank of Baroda	2+	2+
Bank One Limited	2-	2+
Banque des Mascareignes Ltée	3+	3+
Barclays Bank PLC	2+	2-
Bramer Banking Corporation Ltd	3+	3+
Century Banking Corporation Ltd*	N/A	3+
Deutsche Bank (Mauritius) Limited	2+	2+
Habib Bank Limited	2-	2-
HSBC Bank (Mauritius) Limited	2+	2+
Investec Bank (Mauritius) Limited	2+	2+
Mauritius Post and Cooperative Bank Ltd	3+	3+
P.T Bank Internasional Indonesia	2+	2-
SBI (Mauritius) Ltd	2-	3+
Standard Bank (Mauritius) Limited	2+	2+
Standard Chartered Bank (Mauritius) Limited	2-	2+
State Bank of Mauritius Ltd	2+	2+
The Hongkong and Shanghai Banking Corporation Limited	2+	2+
The Mauritius Commercial Bank Ltd	2+	2+

** The CAMEL rating for Century Banking Corporation Ltd was not disclosed for the quarter June 2011 as it started operations as from 31 March 2011.*

as that assigned six months earlier, except for one bank whose composite rating was revised from 'satisfactory' to 'fair'. On an overall basis, the assessment of banks' CAMEL ratings indicates that the banking sector has maintained its stability and soundness as at end-December 2011. Table 3.3 provides the individual composite ratings of banks in Mauritius.

3.4.2 Market Concentration

The domestic banking sector recorded a slight deterioration in the market concentration for assets and deposits as at end-March 2012 compared to end-December 2011. At end-March 2012, the Herfindahl-Hirschman Index (HHI) for banking sector loans, deposits and assets stood respectively at 1,142, 1,409 and 1,179 and thus remained in the 'moderate concentration' band.

On a disaggregated basis, the four biggest banks accounted for 60.7 per cent of total banking sector assets at end-March 2012 and each held assets in excess of 10 per cent of total banking sector assets. The remaining 16 banks held individual market share ranging from 0.03 per cent to 9.9 per cent.

From a segmental point of view, the Segment A assets of 3 largest banks accounted for 69.6 per cent of total Segment A assets and the HHI for Segment A assets thus stood at 2109, which tends to point to high concentration in this Segment and could give rise to potential systemic risk concerns.

3.4.3 Regulatory Capital

The banking system has been resilient, with adequate capital to withstand adverse economic shocks. The capital adequacy ratio has been comfortably maintained above the minimum requirement of 10 per cent. Banks' capital adequacy ratio increased to 16.0 per cent of risk-weighted assets as at end-March 2012. As at that date, the capital adequacy ratio of the banking sector (excluding the branches of foreign-owned banks operating in Mauritius) could absorb losses of more than 20.0 per cent of the prevailing level of activities.

Tier 1 Capital

The capital adequacy of banks assessed on the basis of tier 1 capital as a ratio of risk-weighted assets indicated that, excluding branches of foreign-owned banks operating in Mauritius, banks' tier 1 capital ratio hovered around 13.5 per cent over the year to end-March 2012. Tier 1 capital increased by 16.3 per cent over this period, with around 87.9 per cent originating from retained earnings.

Tier 1 capital across most banks is composed mainly of common equity, which is the component of capital having the highest loss-absorbing capacity. The dispersion of total resources by tier 1 capital shows that around 57.6 per cent of total assets were held by banks having tier 1 capital ratios of more 11.0 per cent as at end-March 2012 compared to 55.0 per cent a year earlier (Chart 3.24).

Chart 3.24: Dispersion of Total Assets by Tier 1 Capital

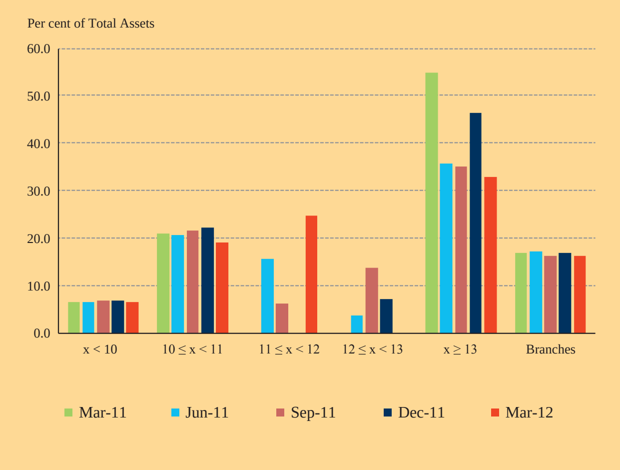


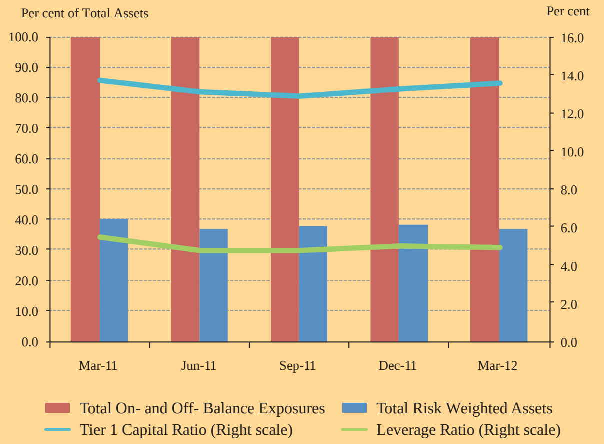
Table 3.4: Herfindahl-Hirschman Index

	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Mar-12
Loans	1,521	1,372	1,268	1,263	1,259	1,293	1,245	1,142
Deposits	1,717	1,199	1,327	1,297	1,207	1,168	1,265	1,409
Assets	1,443	1,143	1,159	1,172	1,067	1,047	1,109	1,179

Leverage

The leverage ratio of the banking sector (excluding branches of foreign-owned banks operating in Mauritius), which measures banks' total assets to tier 1 capital, has decreased slightly by 50 basis points over the past twelve months to 5.0 per cent as at end-March 2012 due to the increase in total assets (Chart 3.25). Over the same period, banks maintained a relatively equitable balance between leverage and tier 1 capital ratios commensurate with the growth in total on- and off-balance sheet assets and their equivalent in terms of total risk-weighted assets.

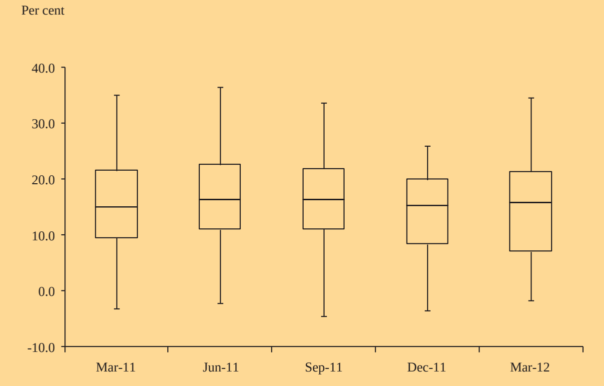
Chart 3.25: Leverage Ratio



3.4.4 Financial Performance

Banks continued to record robust profits despite the prevailing challenging economic conditions. Quarterly reports have indicated that the annualised pre-tax profits of banks – which constitute the sum of pre-tax profits for the four last quarters reached Rs16.9 billion at the end of March 2012 compared to Rs14.3 billion at the end of March 2011. The increase in profits was due in part to the exceptional gains recorded by a few banks and the lower bad and doubtful debt charges. However, even when those exceptional gains are excluded, the level of profits in the sector stood well above pre-crisis level.

Chart 3.26: Distribution of Return on Equity

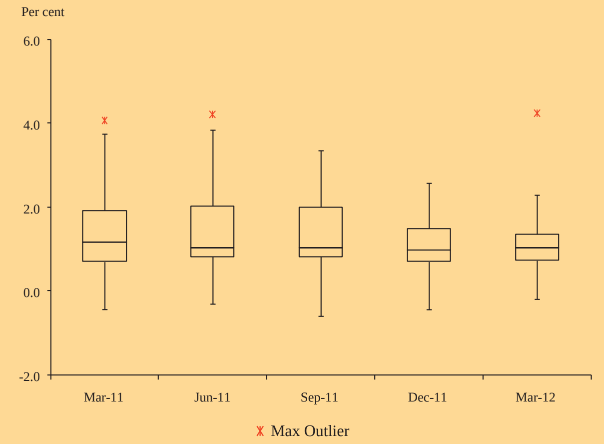


The performance of local banks, which accounted for 57.5 per cent of total pre-tax profits, was better compared with a year earlier. Their profitability was underpinned by relatively elevated net interest income and fees and commission income representing, respectively, 58.1 per cent and 21.1 per cent of their total operating income as at end-March 2012.

Return on Equity and Return on Assets

The annualised return on equity (ROE), as measured as the ratio of pre-tax profit to average equity, increased from 19.3 per cent as at end-March 2011 to 20.3 per cent as at end-March 2012 due to a higher increase in the level of pre-tax profits relative to the increase in average total assets during the period under review (Chart 3.26).

Chart 3.27: Distribution of Return on Assets



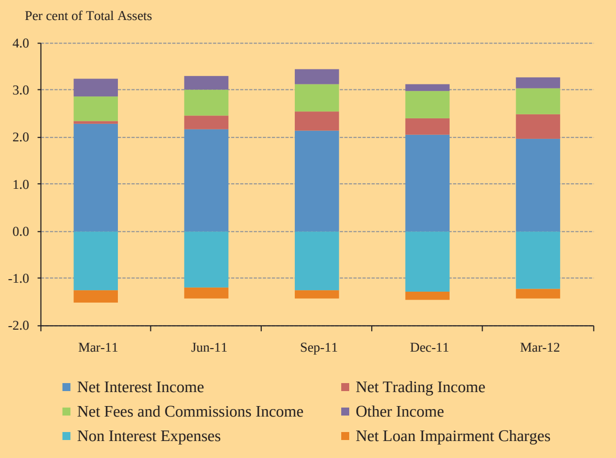
An alternative measure of profitability, the annualised return on assets (ROA), followed broadly the same trend with a slight increase from 1.4 per cent as at end-March 2011 to 1.5 per cent as at end-March 2012 due to higher increase in pre-tax profits relative to the increase in average equity (Chart 3.27).

Revenue and Expenses

Net interest income remains the dominant source of revenue for the banking sector (Chart 3.28). As a percentage of total assets, it decreased from 2.3 per cent as at end-March 2011 to 2.0 per cent as at end-March 2012. However, net fees and commission income increased to 0.6 per cent of total assets as at end-March 2012, from 0.5 per cent a year earlier. Trading income remained volatile, reflecting shifts in market conditions, but was higher as at end-March 2012. Net trading income as a percentage of total assets increased from 0.1 per cent as at end-March 2011 to 0.5 per cent as at end-March 2012.

The other components of income decreased slightly to 0.2 per cent of total assets as at end-March 2012 compared to 0.4 per cent recorded a year earlier.

Chart 3.28: Components of Revenue and Expense



Consequently, total operating income, expressed as a percentage of total assets, increased from 3.2 per cent as at end-March 2011 to 3.3 per cent as at end-March 2012.

Banks' non-interest expense as a ratio to total assets decreased by 0.1 percentage point to 1.2 per cent, while the ratio of net loan impairment charges hovered around its long-term average of 0.2 per cent as at end-March 2012. As a result, the sector's cost-to-income ratio contracted from 39.8 per cent as at end-March 2011 to 38.0 per cent as at end-March 2012, representing an improvement compared to the preceding year.

Stress Testing

As at end-March 2012, the distribution of credit exposure in key sectors was generally concentrated among banks with capital adequacy ratio (CAR) of above 12 per cent. A stress test was conducted to assess the ability of banks to absorb possible shocks on their credit portfolio in the event of a general weakening in economic activities causing 30 per cent of the loan portfolio in key sectors and 15 per cent of the loan portfolio in the remaining sectors to become impaired as at end-March 2012. The size of the impact of the shock varied among banks, depending on the composition and quality of their portfolio and the amount of capital they have to withstand the shock. Results concluded that banks (excluding branches of foreign owned banks) would generally be resilient to a range of adverse shocks affecting key sectors, with banks' capital adequacy ratio dropping from 15.1 per cent to 11.8 per cent (Charts 3.29 and 3.30). Overall, the banking sector is assessed to withstand to the impact of the specified shock.

Chart 3.29: Sectorwise Distribution of Credit Exposure by CAR at end-March 2012

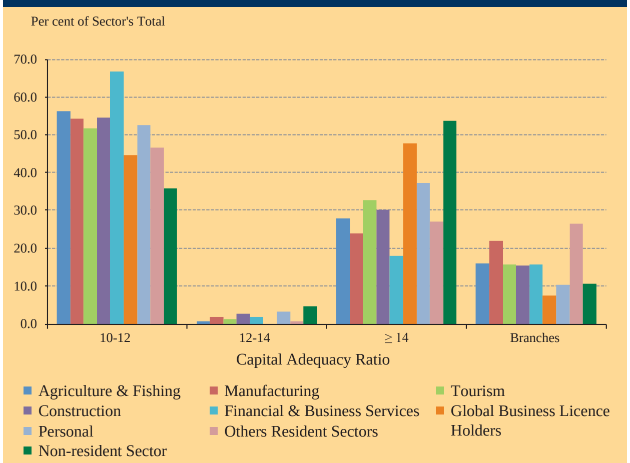
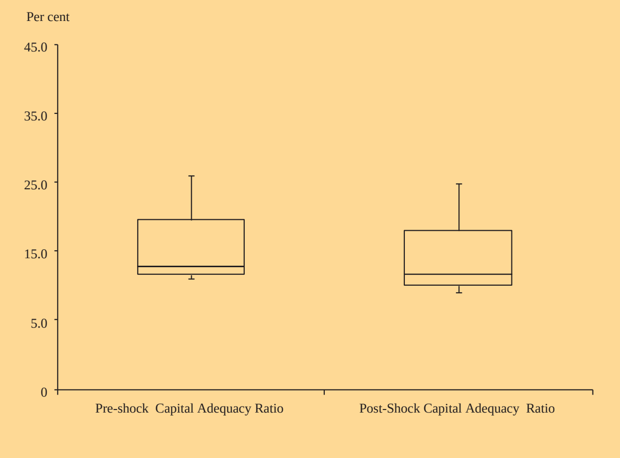


Chart 3.30: Box Plot Stress Testing Result



3.4.5 Concentration of Credit

Large exposures in the banking sector fell by 2.7 per cent in 2012Q1 compared to the preceding quarter. However, over the year ended March 2012, large exposure has expanded by 26.2 per cent driven by additional exposure to related customers by three banks. Local banks held large exposure ratios in the range of 180-333 per cent with the exception of a new entrant bank, while foreign banks' large exposure ratios were in the range of 52 per cent to 456 per cent.

The overall credit concentration in the banking sector measured by the ratio of aggregate large exposures to the sector's capital base has expanded from 200 per cent to 232 per cent over the year ended March 2012. Credit concentration risk in the sector is considered as limited, since banks are operating well below the aggregate prudential limit of 800 per cent.

Table 3.5: Credit Concentration Ratio

	Percentage of aggregate large exposures to capital base (per cent)	Percentage of aggregate large exposures to total credit facilities (per cent)
Mar-10	209	26
Jun-10	197	23
Sep-10	197	25
Dec-10	221	26
Mar-11	200	23
Jun-11	228	28
Sep-11	250	30
Dec-11	246	29
Mar-12	232	29

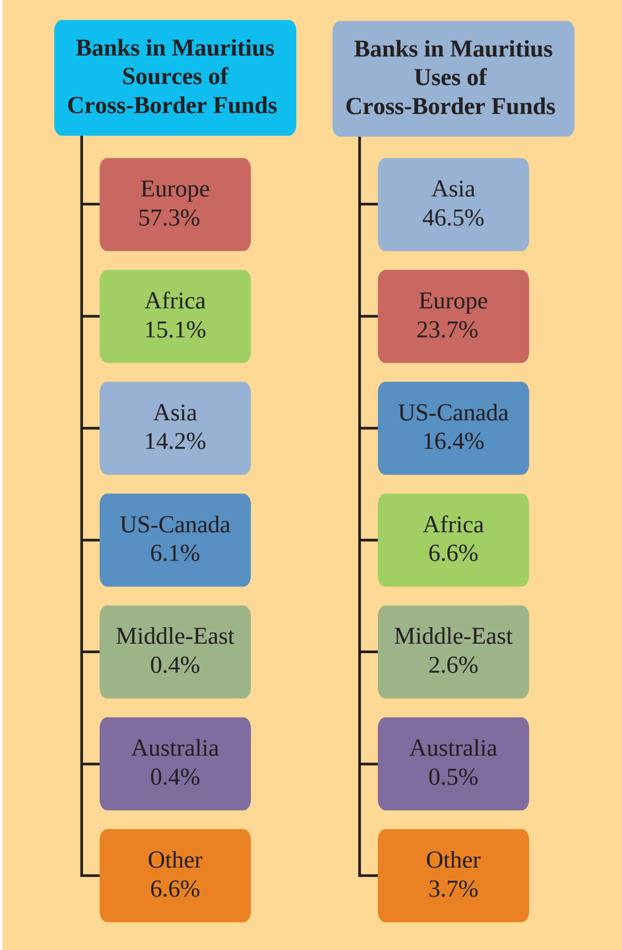
3.4.6 Cross-Border Banking Activities

The banking sector derives a large part of its foreign currency funds from abroad and mainly in the form of deposits and borrowings. As at end-March 2012, out of total cross border funds flowing into the banking system, borrowings constituted 48.9 per cent and deposits accounted for 34.5 per cent. Europe and Africa are the two main regions from where foreign currency deposits are sourced.

Foreign currency funds are mainly extended as loans, placements and investments to customers abroad. At end-March 2012, 86.0 per cent of the bulk of cross border funds was extended as loans and placements abroad. Placements constitute a secure activity for most foreign banks especially in the current global economic context, thus explaining the high share of that component. Asia and Europe are the two main regions to which cross border funds are channelled and at end-March 2012, 70.2 per cent of total cross border funds was extended to these two regions. Table 3.6 provides details on banks' country-wise sources and uses of funds at end-March 2012.

Credit risks associated with cross-border banking activities may be assessed by the amount of loans granted to customers outside Mauritius and the level of impairment arising from these exposures. The share of cross-border loans in total banking sector loans increased to 50.6 per cent as at end-March 2012

Table 3.6: Cross-Border Sources and Uses of Funds as at end-March 2012



Figures may not add up due to rounding.

compared to 48.9 per cent in the corresponding period of 2011. At end-March 2012, total cross border loans amounted to Rs254,664 million representing an increase of 18.1 per cent compared to end-March 2011. Of these, around 64 per cent and 13 per cent were channelled to Asia and Europe at end-March 2012, almost unchanged from end-March 2011. The level of impairment arising from cross border loans to Asia and Europe was relatively small and stood at less than one per cent at end-March 2012 (Table 3.7). Cross border loans are, thus, not likely to raise financial stability concerns for the time being. On-going monitoring of banks' cross border activities will be maintained in light of developments in the euro area.

3.4.7 Non-Performing Loans

The asset quality of the banking sector as a whole remained relatively good in the first six months of 2012 despite domestic and international economic uncertainties. At end-March 2012, the ratio of non-performing loans (NPLs) to total loans stood at 2.6 per cent compared to 2.4 per cent at end-March 2011. Effectively, at end-March 2012, NPLs arising on credit extended in Mauritius edged up to 4.6 per cent, from 4.5 per cent in the previous quarter while NPLs recorded on credit granted outside Mauritius also went up from 0.6 per cent in 2011Q4 to 1.0 per cent in 2012Q1.

Table 3.7: Banks' Cross-Border 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
Region	**March 2010**		**March 2011**		**March 2012**	
Africa	6.60	6.15	9.61	2.02	10.96	1.43
Asia	66.00	0.10	66.14	0.00	64.72	0.56
Australia	0.30	0.13	0.46	0.11	0.39	0.07
Europe	12.50	1.65	10.70	1.39	12.44	0.99
Middle East	3.90	-	3.94	0.42	4.06	0.00
USA and Canada	0.70	1.73	1.03	0.31	0.62	0.04
Others	10.10	0.12	8.12	4.43	6.80	8.68

Table 3.8: Non-Performing Loans

	NPLs as a percentage of credit in Mauritius	NPLs as a percentage of credit outside Mauritius	Total NPLs as a percentage of total credit
Mar-08	4.7	0.1	2.2
Mar-09	4.0	0.9	2.4
Mar-10	4.3	0.6	2.3
Mar-11	4.5	0.6	2.4
Jun-11	4.3	0.6	2.3
Sep-11	4.3	0.7	2.3
Dec-11	4.5	0.6	2.3
Mar-12	4.6	1.0	2.6

On a y-o-y basis, broad based increases in the NPLs on credit pertaining to most key economic sectors were recorded. Consequently, loan losses on credit extended in Mauritius have been increasing since June 2011 as indicated in Table 3.8.

The *construction, manufacturing, traders and personal* sectors are the four main sectors that accounted for around 71 per cent in the total NPLs of the banking sector. At end-March 2012, non-performing loans on credit to the *construction and traders* sectors registered y-o-y increases of 15.3 per cent and 22.2 per cent respectively, while NPLs on credit to the *manufacturing* sector contracted by 6.1 per cent. The personal sector, which alone accounted for 18.7 per cent in total NPLs, also registered a contraction over that period. The amount of NPLs arising from credit to export enterprises experienced a y-o-y increase of 42.3 per cent at end-March 2012 while the amount of NPLs arising from credit to the *tourism* sector worsened by 53.0 per cent y-o-y, at the end of 2012Q1. However, the share of NPLs on credit to these two sectors represented around 8.9 per cent in total NPLs as at that date. Chart 3.31 shows the share of non-performing loans in total NPLs and Chart 3.32 depicts the share of NPLs in credit to the respective sectors.

Coverage Ratio

Rising non-performing loans are generally accompanied by specific provisions and the latter depend largely on the realisable value of collaterals. Consequently, higher levels of NPLs may not necessarily require a proportionate increase in specific provisions made which are mitigated by the value of the collaterals. Non-performing loans pertaining to credit extended in Mauritius increased by 12.2 per cent between March 2011 and March 2012, while specific provisions contracted by 1.3 per cent during that period. This resulted in a fall in the coverage ratio from 54.2 per cent to 47.7 per cent (Chart 3.33). However, the coverage ratio is considered as an adequate buffer against future losses that might arise in the event non-performing loans materialise.

Chart 3.31: Share of Major Sectors' NPLs in Total NPLs

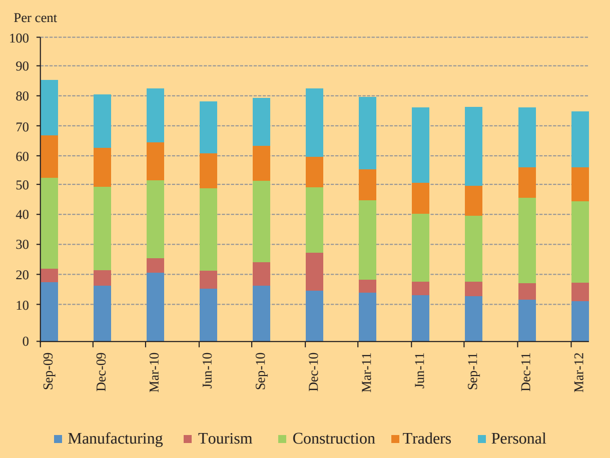


Chart 3.32: Sectoral NPLs as a percentage of Credit to Respective Sectors

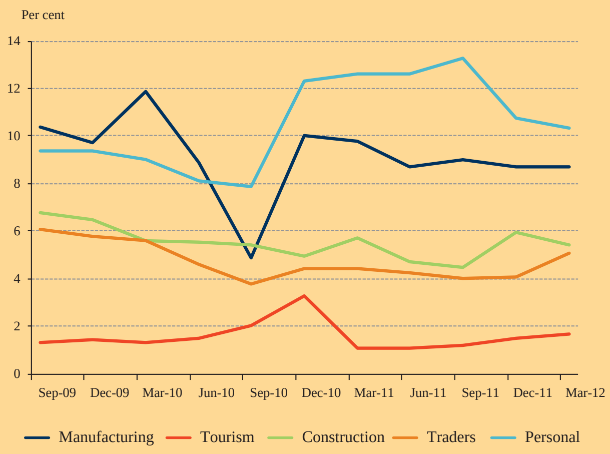
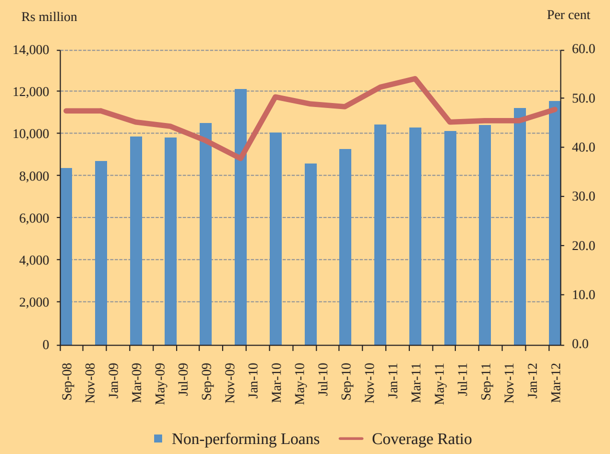


Chart 3.33: Non-Performing Loans and Coverage Ratio

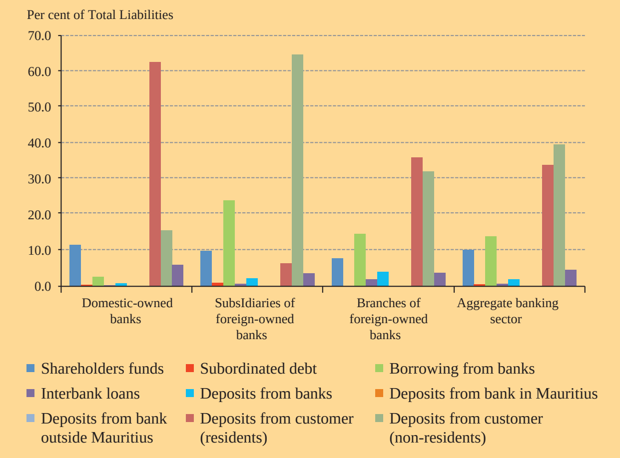


3.4.8 Funding and Liquidity Risks

Overall, banks in Mauritius have operated in a favourable funding environment for most of 2012Q1. Funding risk has been low since most banks do not rely on short-term wholesale funding to finance their core lending business but, instead, make greater use of deposits, which are a stable source of funding.

Deposits from customers (including deposits from residents and non-residents) have been the largest component of banks' funding, representing 69.2 per cent of total liabilities of the sector as at end-March 2012 compared to 70.5 per cent a year earlier. Deposits and borrowings from banks, which are the main components of wholesale funding in Mauritius, made up 14.6 per cent of banks' total liabilities as at end-March 2012 compared to 13.1 per cent a year earlier. Shareholders' fund, which is a permanent source of funding, accounted for 8.4 per cent of total liabilities of banks as at end-March 2012 compared to 8.7 per cent a year earlier (Chart 3.34).

Chart 3.34: Components of Total Liabilities as at end-March 2012

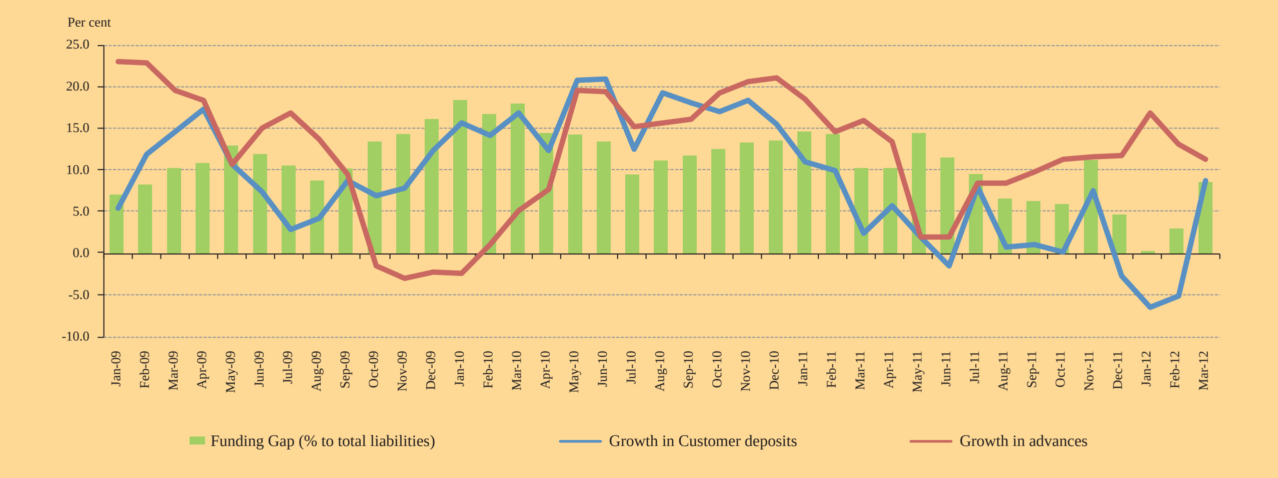


Interbank loans accounted for only 0.7 per cent of total liabilities of banks as at end-March 2012 compared to 0.4 per cent as at end-March 2011, as most domestic-owned banks could mobilise sufficient deposits to finance their lending activities.

Domestic-owned banks source the largest share of their funding from deposits from residents to finance their activities although the size of deposits from the non-residents is also important. Customer deposits from residents represented 62.6 per cent of the total liabilities of domestic-owned banks as at end-March 2012 compared to 64.0 per cent as at end-March 2011. Aggregate borrowings from banks, which represented only 2.7 per cent of the total liabilities of domestic owned banks as at end-March 2012, comprised mainly relatively cheaper funding raised abroad to finance lending in foreign currency to non-residents.

Notwithstanding the challenging international funding environment, foreign-owned banks operating in Mauritius had satisfactory access to deposits from non-residents to fund their operations. As at end-March 2012, deposits from non-residents accounted for 55.1 per cent of banks' total liabilities compared to 52.1 per cent as at end-March 2011. In order to manage maturity and currency mismatches, some foreign-owned banks have continued to place a significant proportion of their non-residents' deposits with their

Chart 3.35: Y-o-y Growth in Advances and Deposits from Customers



parent/sister banks, while having recourse to intragroup funding to finance their core lending business. The aggregate borrowings from banks mainly from parent banks abroad, subsidiaries and branches of foreign-owned banks operating in Mauritius, respectively, accounted for 24.0 per cent and 14.6 per cent of their total liabilities as at end-March 2012 compared to 20.4 per cent and 5.3 per cent, respectively, as at end-March 2011.

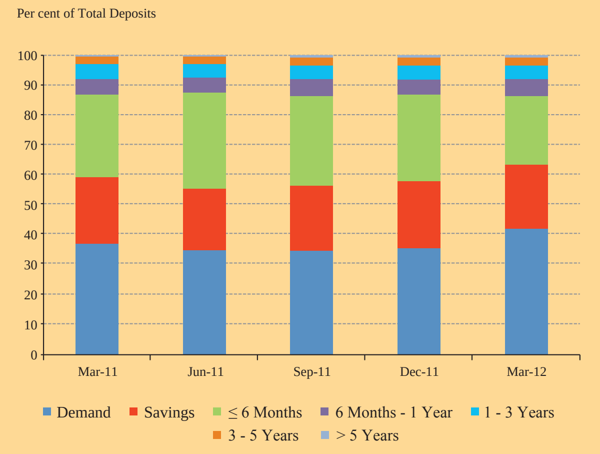
Growth in deposits from customers in the banking sector remained stable. The difference between deposits from customers (including deposits from residents and non-residents) and advances – a measure of the funding gap that needs to be filled in from wholesale and other sources – shows that the banking sector has been operating with surplus funds representing 8.5 per cent of total liabilities as at end-March 2012 compared to 10.1 per cent as at end-March 2011. The reduction was largely due to the fact that the growth in advances, which was at 11.3 per cent, has continued to outweigh the growth in customer deposits, which stood at 8.8 per cent as at end-March 2012.

Banks continued to expand their cross-border activities, recording a mild increase in the share of foreign currency deposits to total deposits from 62.2 per cent as at end-March 2011 to 62.9 per cent as at end-March 2012. However, banks have been managing their funding and liquidity risks across currencies cautiously by matching, to a large extent, most of their liabilities with assets in the same foreign currency and maturity.

As at end-March 2012, demand and savings deposits accounted for 63.6 per cent of total deposits of banks while time deposits, which represent more stable long-term source of funding, accounted for the remaining 36.4 per cent of total deposits. The maturity pattern of time deposits has remained rather unchanged over the years even though customers have a broad preference for shorter maturities, typically six months or less (Chart 3.36).

Since demand and savings deposits have no contractual maturity and customers can withdraw funds on request, there is a risk that a significant portion of such deposits may be withdrawn within a short period of time in reaction to any adverse developments affecting banks. Hence, in order to meet their obligations, banks in Mauritius hold a

Chart 3.36: Components of Total Deposits



reasonable proportion of liquid assets to manage liquidity risk. As at end-March 2012, the ratio of liquid assets to total deposits stood at 45.8 per cent, up by 1.9 percentage points compared to end-March 2011. The three main components of liquid assets consisted of government securities (19.9 per cent), placements with banks abroad (71.0 per cent) and balances with the Bank of Mauritius (7.8 per cent).

A reverse stress test conducted on data as at end-March 2012 indicated that most banks would, on average, be able to sustain a drawdown in demand and savings deposits of more than 15 per cent without infringing the minimum statutory cash ratio requirement and without having recourse to repo transactions or any other liquidity-injecting operations by the Bank of Mauritius. Moreover, system-wide risk arising from interbank contagion would be limited by the relatively small amount of interbank loans. Overall, with higher capital levels and a strong liquidity and funding position, the banking system would be able to cope with periods of market stress.

Box III: Selected Financial Stability Indicators

Core Set of Financial Soundness Indicators	**Sep-10**	**Dec-10**	**Mar-11**	**Jun-11**	**Sep-11**	**Dec-11**	**Mar-12**
Capital-based							
Regulatory capital to risk-weighted assets	15.9%	15.8%	17.2%	16.3%	15.8%	15.7%	16.0%
Regulatory Tier 1 capital to risk-weighted assets	13.6%	13.6%	15.0%	14.1%	13.8%	13.9%	14.5%
Non-performing loans net of provisions to capital	8.6%	9.1%	8.2%	9.6%	9.6%	10.8%	10.7%
Asset Quality							
Non-performing loans to total gross loans	2.5%	2.8%	2.8%	2.6%	2.6%	2.8%	3.0%
Sectoral distribution of loans to total loans							
Interbank loans	*0.3%*	*0.3%*	*0.3%*	*0.3%*	*0.6%*	*0.5%*	*0.3%*
Central bank	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
General Government	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Other financial corporations	*1.2%*	*1.1%*	*1.4%*	*1.3%*	*1.2%*	*1.1%*	*1.3%*
Non-financial corporations	*33.9%*	*33.7%*	*34.2%*	*33.3%*	*33.0%*	*32.6%*	*32.9%*
Other domestic sectors	*15.9%*	*16.1%*	*15.3%*	*15.0%*	*14.7%*	*14.3%*	*15.0%*
Non-residents	*48.8%*	*48.8%*	*48.9%*	*50.0%*	*50.6%*	*51.5%*	*50.5%*
Earnings and Profitability							
Return on assets	1.2%	1.4%	1.4%	1.6%	1.6%	1.3%	1.5%
Return on equity	16.7%	20.0%	19.3%	21.5%	22.1%	17.9%	20.3%
Interest margin to gross income	70.5%	67.1%	70.0%	65.4%	62.4%	65.4%	59.7%
Non-interest expenses to gross income	43.0%	38.9%	39.3%	36.7%	36.8%	41.2%	38.0%
Liquidity							
Liquid assets to total assets	23.6%	23.4%	19.8%	21.2%	18.2%	17.7%	19.1%
Liquid assets to short-term liabilities	31.2%	31.9%	28.1%	29.9%	26.7%	26.0%	28.8%
Sensitivity to Market Risk							
Net open position in foreign exchange to capital	4.3%	7.0%	2.6%	2.0%	1.7%	2.2%	3.3%

Box III (Continued): Selected Financial Stability Indicators

Encouraged Set of Financial Soundness Indicators	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Capital to assets	7.0%	7.3%	7.5%	7.3%	7.3%	7.2%	7.1%
Value of large exposures to capital	217.0%	222.5%	197.4%	228.2%	250.2%	247.0%	232.7%
Customer deposits to total (non-interbank) loans	148.8%	149.6%	140.3%	142.7%	131.4%	124.9%	134.9%
Residential real estate loans to total loans	6.9%	6.8%	6.9%	5.9%	5.7%	6.8%	7.2%
Commercial real estate loans to total loans	3.2%	5.6%	6.2%	5.3%	5.2%	6.6%	7.6%
Trading income to total income	11.4%	7.8%	2.1%	8.5%	11.3%	11.2%	15.9%
Personnel expenses to non-interest expenses	50.9%	52.8%	54.5%	54.7%	54.5%	52.5%	53.9%

Macroeconomic Indicators	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Headline Inflation	2.0%	2.9%	4.0%	5.1%	6.2%	6.5%	5.9%
Year-on-Year Inflation	2.5%	6.1%	7.2%	6.6%	6.3%	4.8%	3.8%
Key Repo Rate (end of period)	4.75%	4.75%	5.25%	5.50%	5.50%	5.40%	4.90%
Total Public Sector Debt/GDP (end of period)	58.6%	57.4%	56.4%	55.6%	55.5%	57.3%	57.1%
Total External Public Sector Debt/GDP (end of period)	10.0%	10.4%	10.8%	10.5%	10.9%	11.8%	11.6%
Import Coverage of GOIR (No. of months)*	4.7	5.0	4.4	4.6	4.5	4.6	4.6
Deposit/Broad Money Liabilities**	84.5%	83.8%	84.1%	84.2%	83.4%	83.1%	83.1%
Household Debt/GDP (end of period)***	16.5%	16.8%	16.8%	17.1%	17.7%	18.0%	18.2%
Corporate Debt/GDP (end of period)***	49.0%	50.1%	49.1%	49.6%	50.0%	50.7%	49.7%

	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1
Real GDP Growth****	6.0%	5.1%	5.1%	5.1%	3.7%	1.9%	2.8%
Unemployment Rate	7.6%	7.2%	8.3%	8.0%	7.9%	7.5%	7.6%
Current Account Deficit/GDP	11.4%	10.6%	5.5%	12.4%	15.9%	15.8%	5.3%

** In line with the recommendation of the IMF Article IV Mission of January 2012, import cover is no longer computed on imports of goods, cif but based on imports of goods, fob and non-factor services.*

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

**** Debts contracted with banks only.*

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

Note:

1. FSIs are calculated on a domestic consolidation basis using the Financial Soundness Indicators Compilation Guide of the IMF. Figures may be slightly differerent from other parts of this Report.

2. Total loans include advances to non-residents.

3. Figures may not add up due to rounding.

3.5 Non-Bank Deposit-Taking Institutions

The Non-Bank Deposit-Taking (NBDT) sector is relatively small, representing around 5.6 per cent of banking sector assets at end-March 2012 compared to 5.7 per cent a year earlier. Total assets in that sector represented 16.8 per cent of GDP. The main activities of Non-Bank Deposit-Taking Institutions (NBDTIs) comprise raising deposits and extending leasing and loan facilities. Congruent to trends in the banking sector, activity of NBDTIs slowed down in the first months of 2012 partly as a result of subdued economic conditions.

Chart 3.37: Y-o-y Growth of Total Assets, Deposits, Total Loans, Total Leases and Liquid Assets

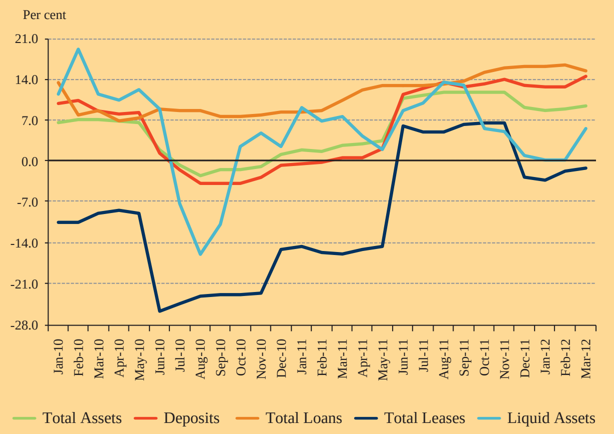
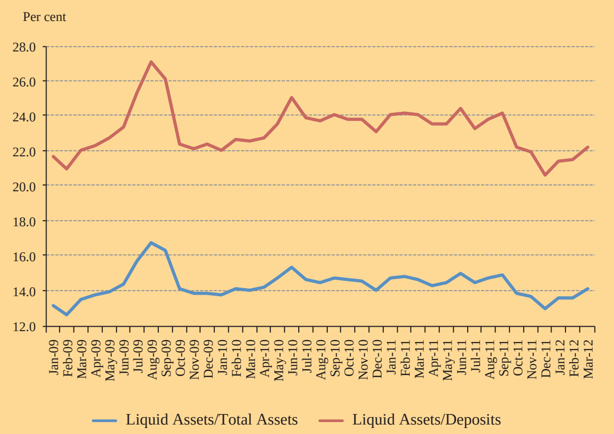


Chart 3.38: Liquidity Indicators of NBDTIs



Balance Sheet Structure

Leases and loans accounted for 70.1 per cent of total assets of NBDTIs as at end-March 2012. As at that date, the y-o-y growth of assets of NBDTIs stood at 9.4 per cent compared to 2.7 per cent as at end-March 2011. It must be noted that from March to September 2011, the sector recorded increasing y-o-y growth rate in assets to reach 11.9 per cent in September 2011. Subsequently, growth of activities of NBDTIs decelerated through to January 2012 but picked up in February and March 2012. This was, to a large extent, driven by contraction in leasing facilities while loans continued to grow and registered above 15 per cent growth rate in the first quarter of 2012. On the liabilities side, deposits which accounted for 63.6 per cent of total liabilities posted a growth rate of 14.6 per cent at end-March 2012 compared to a growth of 0.7 per cent in the corresponding period of 2011.

Liquidity

The NBDT sector remained relatively liquid in early 2012 with a liquidity ratio above the statutory minimum of 10 per cent. As at end-March 2012, the liquid assets to total assets ratio and the liquid assets to total deposits ratio stood at 14.1 per cent and 22.2 per cent, respectively, down by 0.5 percentage point and 1.9 percentage points, respectively, compared to the corresponding period of 2011. Chart 3.37 shows the y-o-y growth of total assets, deposits, total loans, total leases and liquid assets of NBDTIs while Chart 3.38 shows the evolution of liquidity indicators of NBDTIs.

Profitability

Despite the domestic economic conditions, the performance indicators based on the financial results for the year 2011 revealed that the sector demonstrated resilience and continued to be profitable. Net profit for the year registered an increase of 22.4 per cent compared to a growth of 35.0 per cent recorded in 2010. Return on Assets (ROA) increased to 2.9 per cent in 2011 compared to 2.5 per cent in 2010, while Return on Equity (ROE) also improved from 14.7 per cent in 2010 to 17.1 per cent in 2011. The evolution of ROA and ROE over the past five years is depicted in Chart 3.39.

The revenue of NBDTIs is mainly based on interest income arising from loans and leases while expense arises from interest paid on deposits. Notwithstanding the low interest rate environment that prevailed, interest income grew by 3.5 per cent in 2011 against a contraction of 1.2 per cent in 2010. This can be explained by the fact that in 2011, total leases and loans grew at 10.4 per cent while they contracted by 0.03 per cent in 2010.

Interest expense, on the other hand, contracted again in 2011 but lower than the decline recorded in 2010. Cost of deposits, which accounted for 84 per cent of total interest expense, had contracted by around 10 per cent in 2010. In addition, cost incurred on deposits of and borrowings from financial institutions which held about 9 per cent share in total interest expense remained rather unchanged. However, in 2011, cost of deposits went up by 2.7 per cent while costs incurred on deposits of and borrowings from financial institutions contracted by 21.4 per cent. Consequently, growth of net interest income in 2011 was slightly higher than that registered in 2010 (Chart 3.40).

Capital Adequacy

NBDTIs have maintained preference for assets bearing 50 per cent and 100 per cent risk-weight given that a large share of their assets continued to be parked in those risk buckets. At end-March 2012, NBDTIs invested around 67 per cent in the 50 per cent and 100 per cent risk-weight assets collectively compared to 64 per cent at end-March 2011. The NBDTI sector is considered as sound as NBDTIs are well-capitalised and maintained a capital adequacy ratio of 21.8 per cent as at end-March 2012 compared to 22.5 per cent as at end-March 2011 (Chart 3.41).

Sectoral Credit

NBDTIs complement banks' supply of rupee-denominated credit to the private sector with the largest share channelled to the *construction and personal* sectors. At end-March 2012, credit by NBDTIs represented 18.1 per cent of banking sector rupee advances. Credit to the *personal and construction* sectors accounted for 78.4 per cent of total credit at the end of the first quarter of 2012 while credit to the *manufacturing, traders and financial and business services* sectors collectively accounted for around 10 per cent in total NBDTI credit. Credit to the *personal* sector which is mostly geared towards consumption

Chart 3.39: Return on Assets and Return on Equity of NBDTIs

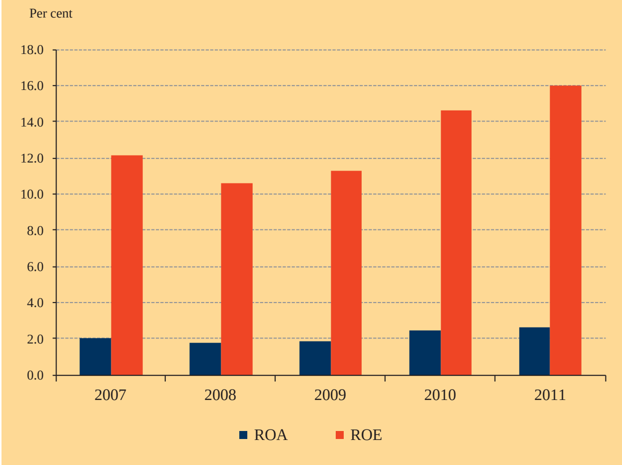


Chart 3.40: Revenue and Expense of Non-Bank Deposit-Taking Institutions

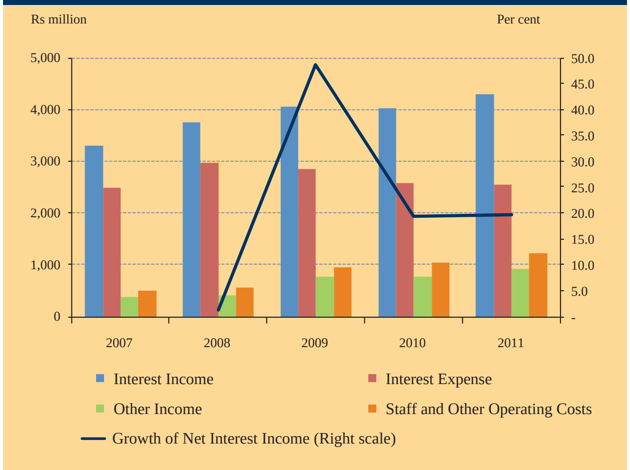
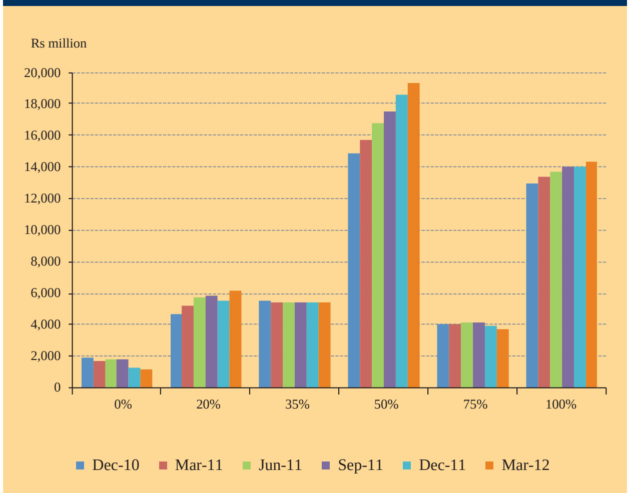


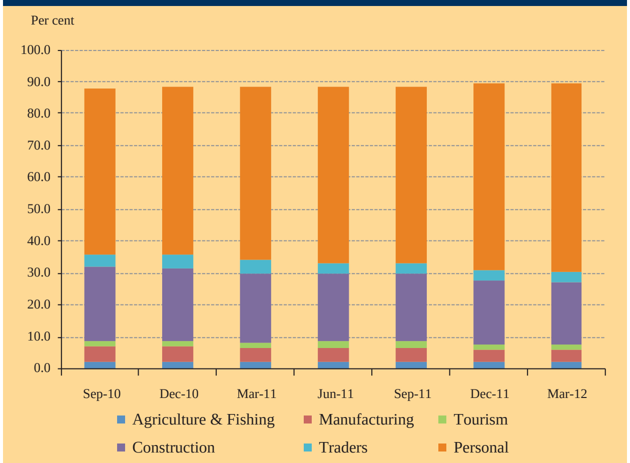
Chart 3.41: Risk Diversification Matrix of NBDTIs



purposes accounted for around 60 per cent of total credit at end-March 2012 and grew at a higher rate of 20.1 per cent at end-March 2012 compared to 15.9 per cent a year earlier. Credit extended to the *construction* sector fell by 2.1 per cent as at end-March 2012, lower than the 4.9 per cent contraction in the corresponding period of 2011 while credit to the *manufacturing* sector also declined by 6.3 per cent at end-March 2012 compared to a contraction of 8.2 at end-March 2011 (Chart 3.42).

Asset quality in the NBDTI sector deteriorated in 2012Q1 with NPL ratio standing at 7.2 per cent compared to an average of 6.5 per cent registered in the last three quarters of 2011. However, it must be noted that the NPL ratio in the NBDT sector was higher at end-March 2011 when it stood at 7.5 per cent.

Chart 3.42: Distribution of Credit by NBDTIs to Key Sectors



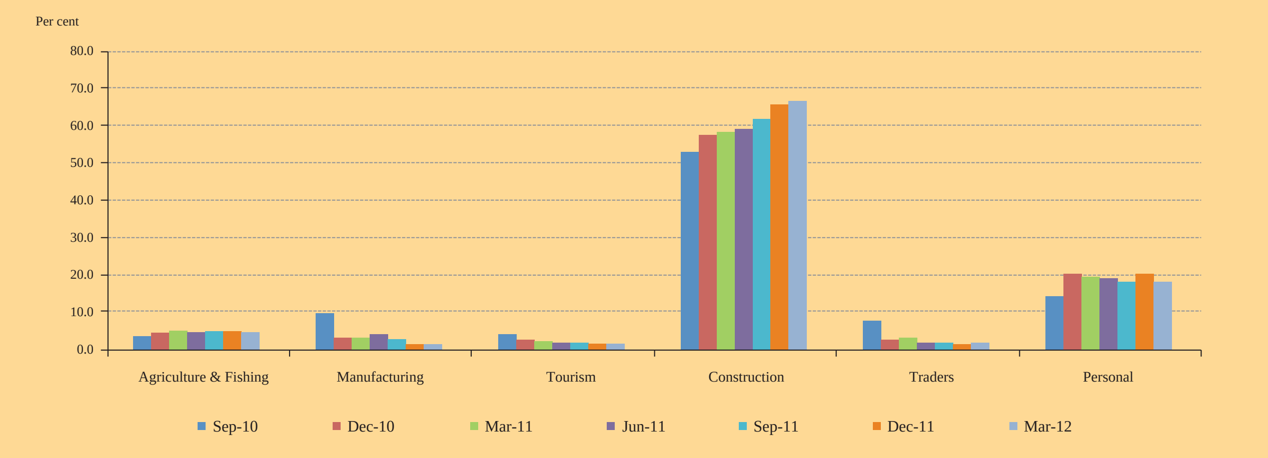
On a sectoral basis, credit to the *construction* sector which accounted for 19.2 per cent of total credit at end-March 2012 registered non-performing loans equivalent to 66.3 per cent of total NPLs as at that same date. In addition, 24.9 per cent of loans granted to that sector turned non-performing at end-March 2012 compared to 20.0 per cent at end-March 2011.

Credit to the *personal* sector, though accounting for a relatively higher share of credit, registered lower impairment level and at end-March 2012, NPLs hovered around 17.8 per cent compared to 19.2 per cent a year earlier (Chart 3.43). The ability of NBDTIs to absorb losses arising from NPLs is considered as adequate as in terms of specific provisioning, the coverage ratio increased to 38.5 per cent as at end-March 2012 from 36.5 per cent in the same period of 2011.

3.6 Insurance Sector

According to a report released by the International Association of Insurance Supervisors (IAIS) in February 2012, the insurance business model has, in general, enabled the majority of insurers to withstand the financial crisis better than other financial institutions and traditional reinsurance is unlikely to cause, or amplify systemic risk. However, the IAIS also noted that insurance groups and conglomerates that engage in non-traditional or non-insurance activities (i.e. credit default swap transactions for non-hedging purposes or leveraging assets to enhance investment returns) are more vulnerable to financial market development and more likely to amplify, or contribute to, systemic risk.

Chart 3.43: NPLs in Key Sectors as a Ratio of Total NPLs



3.6.1 Solvency

In Mauritius, the insurance sector has maintained its resilience in the first six months of 2012 in spite of the adverse global economic environment and weak economic conditions locally. General insurance companies have a minimum solvency requirement of 100 per cent and are required to meet a target ratio of 150 per cent while long term insurers have to meet a minimum requirement of 100 per cent. Latest available data indicate that both the general and long term insurers were solvent with the average solvency ratio[1] of the general insurance industry amounting to 258 per cent in 2011. Actuarial valuation reports indicated that the long term insurance industry's solvency average[2] amounted to 145 per cent in 2011. The solvency averages thus demonstrate that the insurance sector is well capitalised and has adequate buffer to withstand shocks that might affect its soundness. Nevertheless, insurance companies that operate with weak solvency margins are being closely monitored.

3.6.2 Growth of Activities

Activities of domestic insurers expanded by 8 per cent in 2011 with total assets of the long term insurers growing by 12 per cent while those of general insurers registered a contraction of 11 per cent in their total assets. Total gross premium of insurers in the domestic market grew by 9 per cent in 2011 resulting from the 12 per cent and 8 per cent increases in the gross premium of the general insurers and long-term insurers respectively. Growth of claims of general insurers stood at 27 per cent in 2011, largely outpacing the growth of gross premium in that sector.

3.6.3 Exposure to Global Conditions

The difficulties in the euro area are not expected to pose any significant threat for the insurance industry as its exposure to foreign securities is small. In 2011, only 6.2 per cent of long-term insurance assets were in foreign equities. Insurers are restricted by regulation from investing more than 50 per cent of technical provisions outside Mauritius. However, developments in the global reinsurance market may result in upwards pricing pressure for Mauritian general insurers, which rely significantly on reinsurance. As a whole, the general insurance sector reinsured 37 per cent of its gross premium written. In the property segment, 74 per cent of premiums were reinsured.

3.6.4 Concentration

The FSC has recently approved the amalgamation of CIM Insurance Ltd with Swan Insurance Company Limited ("Swan") and the amalgamation of CIM Life Ltd with the Anglo-Mauritius Assurance Society Limited ("AMAS"). Currently, there is a high concentration in the gross premium of long term business. In 2011, the three largest long-term insurers held 88.5 per cent of the market's total gross premium. With the amalgamation, the three largest long-term insurers are expected to hold 90.7 per cent of the market's total gross premium. Prior to the amalgamation exercise, the Herfindahl-Hirschman (HHI) index for the life segment stood at 5113 thereby confirming this very high concentration. With the amalgamation, concentration in that segment is likely to increase further and the HHI is estimated to go slightly up to 5127.

3.6.5 Performance

Financial performance in the insurance sector is rather heterogeneous as evidenced by the relatively wide dispersion on return on assets and return on equity for both the general insurance segment and the long term insurance segment of the sector. The general insurance industry posted improved performance in 2011 with an average return on assets of 9 per cent compared to 7 per cent in 2010. In contrast, the long term insurance industry posted a slight deterioration in its performance in 2011, with most profitability indicators on the downtrend, as a result of increased claims.

In 2011, the general insurance segment had better underwriting results than in the previous ten years (Chart 3.44). The combined ratio, expressed as a proportion of total revenue over net earned premium, stood at 87 per cent compared to a range of 98 per cent to 115 per cent in the previous ten years. It may be noted that a combined ratio of over 100 per cent indicates that insurers need to increase reliance on investment income to cover underwriting losses.

On the other hand, the performance of the long term insurance segment recorded a sharp rise in claims ratio leading to a significant increase in the expense ratio. The claims ratio and expense ratio are,

[1] *Weighted average using gross premium market share of insurers.*
[2] *Weighted average using gross premium market share of insurers, excluding three life insurers which are in run-off.*

respectively, defined as claims as a percentage of net earned premium and as total expenses as a percentage of net earned premium. In 2011, the expense ratio increased to 95 per cent, from 79 per cent in 2010 (Chart 3.45).

Overall, the insurance sector is considered to have relatively performed well in 2011 and has remained stable and sound. In spite of the projected lower economic growth for 2012, the insurance sector is expected to continue display resilience and stability.

Chart 3.44: General Insurance Combined Ratio

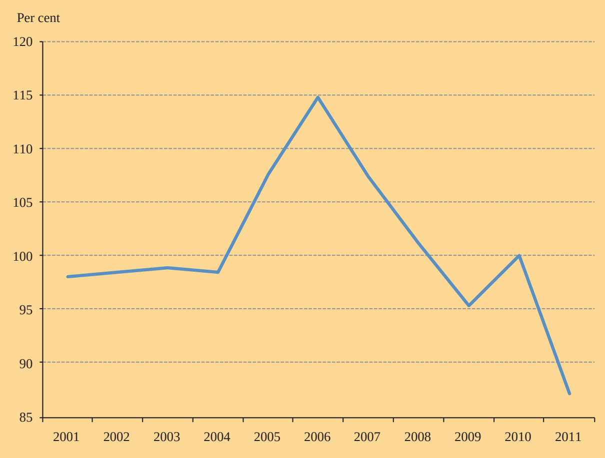
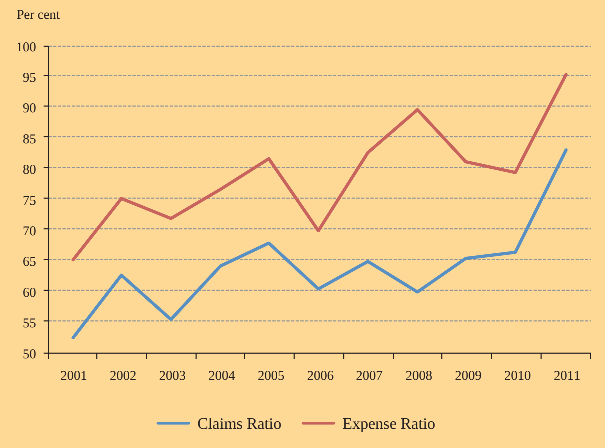


Chart 3.45: Life Insurance Claims and Expense Ratios



4 Financial System Infrastructure

Following the launch of the Bulk Clearing System (BCS) in September 2011, clearing of low value payments as well as image-based cheques were undertaken through that platform. In April 2012, the Bank introduced the Depository system for Treasury Bills and Bonds that provides for a strict deliver-versus-payment (DVP) mechanism for the issue of Government and Bank of Mauritius securities. Securities are automatically settled on the Mauritius Automated Clearing and Settlement System (MACSS), while the account of the holder is credited with the securities. This mechanism eliminates risks relating to settlement procedures and is in line with the BIS recommendations for securities settlement. These developments have further modernised the financial system infrastructure in Mauritius.

4.1 The Bulk Clearing System

The BCS is a clearing system for electronic and cheque payments. The system was initially launched with four clearing cycles per day-two for cheques and two for electronic payments. This time schedule posed several practical problems and prevented an additional agenda for payments received late in the afternoon. This was eventually resolved as from 5 July 2012 when cheques as well as electronic payments started being settled indiscriminately during any of the four cycles.

The main objective of the BCS is to remove bulk low payments from the MACSS, the Real Time Gross Settlement System (RTGS) of the country, so as to contribute to its overall efficiency. Since its introduction, 4.2 million cheques and 2.1 million low value payments have been processed on the BCS, indicating that the BCS has rapidly integrated the payment infrastructure of the country and has effectively enhanced MACSS's efficiency. Between January and June 2012, the BCS cleared 2.5 million cheques and 1.1 million low value payments. (Table 4.1)

With a view to expanding the usage of the BCS, one non-bank financial institution was admitted as a direct participant to carry out its own mass payments without requiring the services of a bank. The successful outcome of the experiment means that this procedure can be extended to other large payers in the market. It is envisaged that, by the end of this year, Government salaries and mass payments will be routed through the BCS to ensure same day credit of payments.

Table 4.1: Volume and Value of Transactions on BCS

	Cheque Clearance		Electronic Transfers	
	Number of Cheques	Amount (Rs' 000)	Number of ETs	Amount (Rs' 000)
2012				
January	411,557	20,402,574	203,109	4,761,764
February	401,302	20,239,873	66,008	1,514,551
March	432,715	21,349,071	204,026	4,587,152
April	436,837	21,910,904	205,543	4,807,918
May	470,150	22,379,207	231,469	5,298,239
June	423,483	21,139,261	211,611	4,884,707
January-June 2012	2,576,044	127,420,890	1,121,766	25,854,331
January-June 2011*	2,656,028	128,390,394	-	-

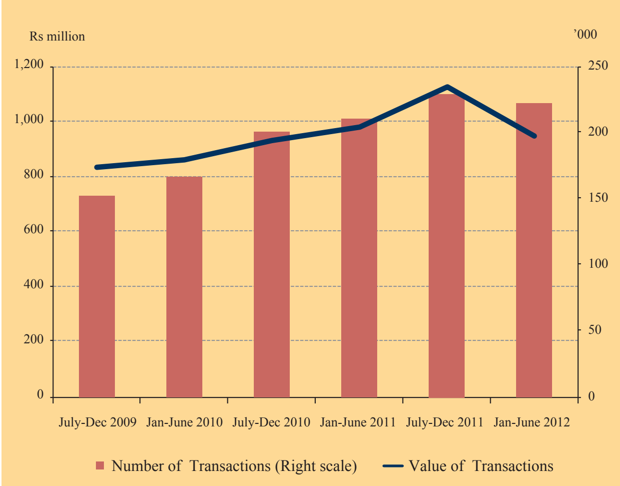
** BCS was launched on 6 September 2011.*

Efficiency and Resilience of MACSS

During 2012H1, 221,589 transactions were settled on MACSS for a total value of Rs948 billion. (Chart 4.1) All transactions were settled without delay and no transactions were rejected or lost due to system fault. Moreover, the impact of the introduction of the BCS on the throughput was remarkable. MACSS processed 5 per cent more transactions during the period January to June 2012 compared to the corresponding period in 2011, but 3 per cent less in terms of value of transactions since Rs25 billion worth of transfers were routed through the BCS platform. Consequently, high value time-sensitive transfers can now benefit from a much more efficient MACSS platform.

MACSS operated without any major downtime during 2012H1. In fact, the availability of MACSS over this period was close to 100 per cent with a single downtime of 30 minutes on one day due to network outage. The contingency procedures in place ensured that all transactions were settled without any loss or critical delay.

Chart 4.1: Transactions on MACSS



Box IV: Mobile Payments

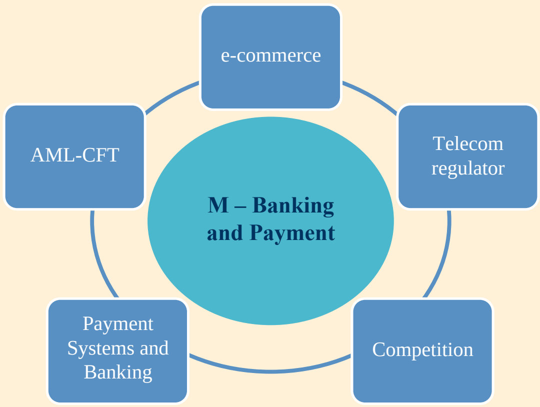
Mobile payments refer to the transfer of funds, such as a bill payment, from a payer to a payee, using devices such as mobile phones. Mobile banking is a subset of e-banking where customers access a range of banking products, such as fund transfer, via electronic channels of hand-held devices. Mobile banking requires the customer to hold a deposit account from which payments or transfers will be made.

Mobile payments have grown at a remarkable pace in countries where landline telecommunication networks are poor and banking services outreach is limited. Risks associated with mobile payments include breach of confidentiality of customer information, security of data transmission, fraud, identity theft, security of mobile device and non-compliance with laws and regulation, among others.

The amorphous nature of the mobile phone, which is a conglomeration of several functionalities, poses a real challenge to regulators of mobile payment in terms of supervision, oversight and customer protection. Mobile payments and mobile banking involve the interactions of several regulatory bodies namely banking, telecom, payment system supervisors and anti-money laundering agencies. The overlap substantially raises the risk of coordination failure, where legislation or regulatory approaches might be inconsistent or contradictory and where regulatory objectives might not coincide.

This complexity raises a number of issues for each regulator which are summarised below:

Regulator	Issues
Telecom	Licensing requirements and insolvency
Financial	Consumer protection Financial stability and payment systems oversight Deposit taking and money supply Is airtime a new form of currency'?
Competition	Risks of anti-competitive lock-in
AML-CFT	Enforcement of AML/CFT regulations



While regulators in developed countries consider that mobile payments are still at an early stage of development to address these issues, in many developing countries, mobile payments, through private initiatives, are being used with little or no proper regulation. Regulators are, however, increasing emphasis on this new form of payments and closely monitoring developments to assess risks over time.

Although Mauritius has more than 1.2 million mobile subscribers with a mobidensity of 92.8 per 100 inhabitants in 2010, mobile banking and payments services are still at a nascent stage. Currently, five banks provide mobile banking facilities limited to account balance checking and airtime top-up using Short Message Service (SMS). One non-bank financial institution is also providing retail payments with the use of mobile. Recently, the utility bill payment facility was introduced between a mobile operator and a bank as the first mobile payment service. There are indications that other products and services will follow shortly.

Mobile payments could pose financial stability risks if the amount transacted becomes significant. But currently, these fall under the category of low value retail payments and have not so far created any financial stability concern. In Mauritius, the mass services are yet to be developed and the volume of mobile payment transactions is also very low. Thus, mobile payment activities do not currently represent any risks to the financial stability of the country.

5 Risks and Outlook

Global economic conditions weakened in 2012H1 and are poised to remain subdued in 2012H2. The euro area crisis looks unlikely to be resolved soon, causing global uncertainty to persist. Advanced economies are projected to register dismal growth in 2012, while emerging economies' growth is expected to moderate. Global financial markets are expected to remain driven principally by developments in the euro area, with occasional bouts of excessive volatility. In their efforts to revamp growth, major central banks may be required to implement further non-standard measures as interest rates are already very low.

The outlook for the international banking sector remains beset with uncertainty as developments in the European banking sector and regulatory reforms continue. Faced with fragile recovery in the banking sector, accelerating reforms initiated post the global financial crisis of 2008 remains a key priority worldwide to strengthen the sector and enhance stakeholders' confidence. Various initiatives, principally led by the Bank for International Settlements (BIS), have been undertaken to review practices, and regulatory and supervisory frameworks worldwide. The new wave of reforms has several cost and revenue implications for the international banking sector. Nonetheless, it is hoped that these new regulations and standards will make the banking business more prudent and, thus, avert the severity of crises. Consequently, and amid subdued global economic conditions, the international banking sector revenues are expected to grow moderately in 2012.

According to forecasts made by Statistics Mauritius in June 2012, the domestic economy is expected to grow by 3.5 per cent in 2012. Further worsening of the euro crisis will most likely weigh on the export-led sectors, but the relatively diversified nature of the economy, encouraging growth prospects in emerging sectors, like the ICT and seafood, and diversification into regional markets, are expected to support growth. Final consumption expenditure is seen to continue to grow at a subdued rate. With global uncertainty persisting, it is expected that business and consumer sentiment will remain low and impact on private investment.

Government's prudent approach to fiscal stimulus is expected to continue to support the positive trend in public sector debt dynamics, as noted by Moody's. The budget deficit is expected to remain below 4 per cent this year and public sector debt, comprising debt of General Government and public enterprises, will most likely be contained below the 60 per cent threshold. The downward shift of the yield curve for Government securities, indicating lower borrowing costs for Government.

The Bank has embarked on Operation Reserves Reconstitution (ORR) to build additional reserves buffer. The Bank also introduced a Special Foreign Currency Line of Credit to help export-led enterprises mitigate foreign exchange risks. Moreover, the country remains in a comfortable position to withstand potential external shocks. Gross international reserves stood at Rs86.7 billion as at end-June 2012, representing 4.9 months of import cover. The debt-service ratio for the country is forecast to remain contained within a range of 3.5 per cent to 4.0 per cent between 2012 and 2014.

The banking sector is expected to continue to expand despite challenging global and domestic economic conditions. Non-performing loans in and outside Mauritius are at relatively low levels and are seen to hover around these levels in the medium term. Capital adequacy ratios of banks are well-above the minimum requirement of 10 per cent and provide enough cushions to absorb potential shocks. A stress test carried out on the scenario of weakening economic activity indicated that banks would comfortably withstand such shocks. Exposure of banks' balance sheets to the euro area was quite limited, implying that the deepening of the euro area crisis would have small impact on banks' portfolio. Financial soundness indicators of banks were also at comfortable levels, pointing to a sound banking system. Overall, financial stability risks in the banking sector are considered to be moderate.

The Bank has undertaken a number of initiatives to increase transparency and improve financial literacy in the country to enhance further financial soundness in the banking sector.

The financial infrastructure remains in a process of continuous upgrade and enhancement and the Bank is vigilant in ensuring the smooth functioning of the payments system. The Bank further modernised the financial infrastructure of the country, introducing the Bulk Clearing System and Depository System for Government and its own securities thereby enhancing efficiency in settlement of transactions and reducing settlement risks.

Overall, financial stability risks are assessed to be broadly contained.

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