1. Executive Summary

Since 2008, the Bank of Mauritius has been publishing Financial Stability Reports (FSRs) that include assessments of key sectors, including payment systems infrastructure and institutions that are important for financial stability.

The current Report contains an assessment of the stability and resilience of the domestic financial system using available economic and financial data up to the end of December 2014 as per availability of data. The Report reviews the main developments in the global and domestic economies (Section 2), analyses the financial position of debtors and creditors (Sections 3, 4 and 5), sets out the domestic payment systems infrastructure (Section 6), and assesses the main risks to the financial sector (Section 7). Section 8 provides some concluding remarks.

Since the publication of the August 2014 FSR, the global economy has remained under stress, albeit with major differences between countries in terms of output growth and inflation. Except for the US, advanced economies are likely to perform below potential, although the fall in international oil prices may boost growth in consumption in the short-term. Inflation rates, which are below target levels, are a common concern among all central banks in advanced economies, especially the euro area. Leading emerging market economies also report differences in macroeconomic performance that are likely to result in different combinations of fiscal and monetary policies among them, depending on the macroeconomic policy priorities. Among the BRICS countries, Russia possibly faces the most difficult combination in terms of output growth and inflation outlook, due to the drop in oil revenue, a weak currency and economic sanctions.

The domestic economy showed macroeconomic resilience in 2014 and should further benefit from the slump in international oil prices, although the declining trend in private investment warrants monitoring. Output growth and inflation remained within recent trends: real GDP grew by 3.5 per cent, while inflation dropped to a low of 0.2 per cent by the end of December 2014 with a decline in food and energy inflation. For 2015, falling international prices, which are being passed-through to domestic consumers, should support growth in private consumption and consumption-related activities, such as trade and light manufacturing. Yet, the observed declining trend in the ratio of investment to GDP is reducing the economy's actual and potential growth. Sluggish private investment growth mirrors weak fundamentals of some leading corporations, which are highly leveraged by international standards and show declining ratios of profitability.

The weak external environment is likely to impair on Mauritius' external position, thus needing strong surveillance of financial flows which fund the current account deficits. External trade and current account deficits have been traditionally financed by income from tourism, from net inflows of foreign direct investment (FDI) and from portfolio investment. While most of the financial flows represent Global Business Companies (GBCs) resources and, therefore, are just in-transit to other jurisdictions, leads and lags between inflows and outflows appear to have provided resources to cover the current account deficit based on the balance of payments compilation and analysis. The net GBC inflows have compensated for net outflows by local banks. Against this background, strong policy coordination is, thus, critical between the Bank of Mauritius, as regulator of banking institutions, and the Financial Services Commission (FSC), as regulator of GBCs.

Household indebtedness and household debt service costs, both as a share of disposable income, are relatively low by international standards, but warrant monitoring, nonetheless. Macroprudential policies and credit limits are now in place on housing lending, thus providing standard conditions for banks in mortgage financing. Case-by-case analysis and monitoring of non-performing loans (NPL) is still needed to secure a proper implementation of the policy measures.

Corporate debt, as a share of GDP, is also relatively low by international standards in Mauritius. However, the high leverage ratio of some leading corporations in the economy remain a concern and may pose a risk to the soundness of banks. Leverage ratios in tourism, construction, real estate, traders and financial services are more than 100 per cent, which are multiples of the ratios found in comparator countries. Financial risks stemming from this situation depend on each sector's ability to reduce its indebtedness (deleveraging), accompanied by larger equity infusion or higher revenue growth, in a reasonably short period of time. Failure to do so carries a risk of reducing private investment and overall growth of the Mauritian economy.

Banks in Mauritius are adequately capitalised and have increased their loan loss provisions, but face risks stemming from the concentration of corporate credit, thus warranting monitoring and proactive action. Core capital ratios of domestic-owned banks are in line with prudential requirements, while those held by foreign branches and subsidiaries of foreign-owned banks are higher than the prudential requirements. Banks have also increased significantly their provisions against loan losses during last year. However, current trends suggest that capital ratios of a number of domestic-owned banks could be under stress, if credit concentration risks were to materialise due to a shock impairing the financial condition of corporations. Domestic-owned banks' exposure to highly leveraged corporations operating in the tourism, construction and real estate sectors, thus, warrant surveillance and proactive action. Initiatives in this regard may include timely re-structuring of corporates' bank debts to address their underlying cash flow problems, increases in banks' capital allocations, and the implementation of the April 2014 *Supervisory Framework for Measuring and Controlling Large Credit Exposures* that was issued by the Basel Committee on Banking Supervision (BCBS).

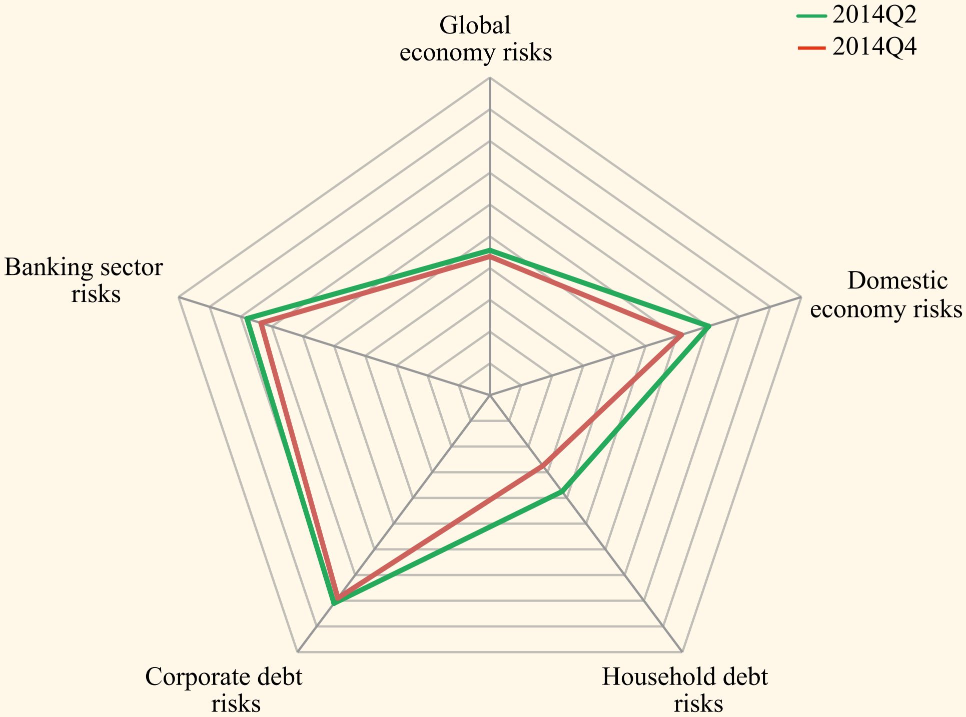
There are also risks stemming from banks' sizeable foreign claims on frontier African markets and from the slow growth of the domestic economy. Credit and possible exchange rate risks exist in terms of the sizeable amount and currency denomination of banks' foreign claims (loans and other type of assets) on frontier markets in Africa and in India. This has come at a time when there has been a slowdown in growth of credit extended to households while credit extended to corporations contracted. A prolonged decline in the ratio of corporate credit to GDP is particularly worrisome as this may adversely affect future economic growth.

Risks stemming from non-bank financial intermediaries remain broadly contained. Non-bank deposit-taking institutions (NBDTIs) remain well capitalised and their balance sheets are relatively small for the size of the economy. Insurance companies hold sizeable deposits and equity in domestic banks. While these funds could potentially experience volatility, this has historically not been the case.

Payment systems infrastructure is being upgraded and continues to operate with high levels of availability. Potential risks from failures in payment systems infrastructure have not materialised and have limited probability to happen going forward. However, it is important that the Bank of Mauritius' current projects should be rapidly implemented for high- and low-value payments in the system, including retail and debit payments.

Financial Stability Map

Between 2014Q2 and 2014Q4, there were improvements in risks stemming from the global and domestic economies, as well as those from households and the domestic banking sector, while corporate debt risks remained high and unchanged. Improvements in global economic risks reflect the recovery of the US economy, the impact of falling international oil prices and diminished volatility in global equity markets. Domestic economy risks also declined due to improvements in international terms of trade, low inflation and sustained economic growth that more than offset the impact from stagnant domestic private investment and savings. Risks stemming from the household sector debt have moderated as a result of a fall in the ratio of household bank credit to disposable income, while household indebtedness and debt service ratios remained below those recorded in comparator countries. Banking sector risks have improved marginally on account of limited growth of banks' exposures to frontier markets abroad, while other financial indicators remain challenging, particularly large exposures. Corporate debt risks have remained significant due to high leverage ratios and low returns on equity affecting the performance of leading enterprises in the economy.



Note 1: Lower vulnerability closer to the center.

Note 2: For further information on the methodology used in the financial stability map, see Financial Stability Report February 2014.