

Regulating Financial Services in the Market Economy

Speech by Chairman, Financial Services Commission and Managing Director, Bank of Mauritius at the Association of Offshore Management Companies Conference, 25 April 2002

Chairman of the Association

Distinguished Guests

Your Excellencies from the Diplomatic Corps

Ladies and Gentlemen

Let me begin with the market economy. Few would disagree that there has hardly been any previous period of world economic history in which free market practices have been adopted on such a large scale as at present all over the world, specially during the past two decades. It is held that should this trend continue, there would be substantial positive spin offs in as much as benefits from greater openness of economies and more competition will raise the global average standard of living. This argument is not accepted across the board. There are objections against the ruthless pressure exerted by the forces of competition on the more vulnerable consumers living in less endowed economies.

A Changing Marketplace

I do not propose to go into this debate. As a practitioner on the market, however, I am bound to recognize and work together with new emerging features on global markets. What are they? The range of choice of operators and consumers has widened. Access to almost everything has become more universal. Technology has opened up larger markets than one could have contemplated. Only a quarter of a century past, a remotely located centre of production such as that of Mauritius could not have anticipated the international network of services it finds itself in today. This is a reality and we reckon much more needs to be done in that line. Costs of production are becoming more closely integrated globally. Information flows have acquired incredible speed and so has decision-making based on that flow of information.

This phase of economic development has been accompanied by profound transformations in the manner in which financial services are provided. Financial and technological innovations have, together with competition, occupied the driving seat in the field that is of interest to us. New players and more efficient distribution channels of financial services have come into play. Some of them survive. Others don't. In this environment, the dynamic operator is constantly on the lookout for reinventing his manner of doing business in

pursuit of greater efficiency, unfettered by what he perceives as unnecessary local regulatory constraints that presumably rival suppliers of service from other centres are not subjected to.

Role of the Regulator

These arguments no doubt carry weight. The fundamental question to ask in this context is: what business is the regulator engaged in if it is not to assist in the right development of business? To my mind, the regulator should satisfy at least three broad criteria to justify his role. First, he should fully know what he has set himself to achieve in terms of the objectives of regulation and these should be clearly stated and fully understood by those who are the subject of regulation. Second, he should be professionally competent and capable of implementing the highest standards of regulation in a consistent manner without damaging the business base. He should satisfy a third criterion, notably that his powers should be well defined and he should be capable of exercising them in a context of operational independence and public accountability. The regulator who meets these criteria can consider that he has licensed himself.

We have to bear in mind that when a bank is striking a foreign exchange deal with its overseas correspondent and that when we are incorporating a company with foreign beneficial owners, we are, in fact, exporting financial services to a substantially networked international financial market. There is growing international interest in cross-border transactions. The object of this interest is to address global concerns such as the stability of the international financial system, countering money laundering activities, cooperating in the elimination of economic crimes, tax evasion and, more recently, the financing of terrorism. The roles assumed in this context by international organisations such as the OECD, the FATF and the Financial Stability Forum, call for a coordinated response from the jurisdiction. There is little margin for error in this regard as damaging inroads could otherwise be made on the constructive fabric for providing financial services from our jurisdiction. However, my message is: We need not be on the defensive, but rather be engaged in adding on to the value chain.

This is one reason why there should be a credible standard setter in the jurisdiction, responsible for setting up a rigorous supervisory régime of international standing. To preserve the quality of business done from the Mauritius centre and to maintain the good perception it enjoys, the regulator is called upon to keep strengthening its market-friendly regulatory régime. To this end, the regulator and the operators should enhance their lines of communication and the Financial Services Commission should be seen to be doing business in transparency without for that matter, jeopardising the basic quest of clients to protect the fundamental privacy of their accounts and transactions as it is the case in all other jurisdictions.

Systemic Stability

Harmonization of regulatory rules at the international level is but one aspect of the matter. The more fundamental reason for adopting a rigorous regulatory approach has to do with **systemic stability**. In the financial sector, it is as difficult and painstaking a task to build up confidence and reputation, as it is easy to lose them. This situation was amply demonstrated by the East Asian crisis of 1997-98, when capital left the region swiftly, the banking system was thoroughly shaken up, exchange rates of currencies swung up and down and certain governments had to reintroduce exchange controls in an attempt to stem the tide. Even today, it is as yet unclear whether East Asia has got back to where it was before the crisis of 1997 and whether the region will rise to the occasion were the world economy to turn around in the near term.

Systemic stability refers to a situation in which market liquidity is well balanced and flows of liquidity are confidently sustained within the system to support what John Hicks referred to in 1974 as the "overdraft economy", that is, the one in which we live. Banks are at the heart of this system. The joint supply of deposits and loans by banks places them in a unique position to **provide liquidity on demand**. Failure to perform this essential function by banks will immediately set in motion a loss of confidence situation whereby the stability of the entire financial system will be gone together with the integrity of the country's payments system. As recently illustrated by the Asian crisis, this type of instability spreads from one bank to another through contagion effects and, in the case in point, it actually also spread from one country to another through the entire region. Economic growth snapped up and financial institutions, which were heretofore considered impregnable, went under. Stock markets plunged. There was complete uncertainty as to how and in which time frame the wide range of problems that surfaced up, would be resolved. No regulator can afford to take a risk on systemic failure of this sort and this is why banks have to be licensed and monitored closely due to their essential function as providers of liquidity on demand.

What about Non-Bank Activities?

Typically, the financial system is many layered. Banks are providers of liquidity on a lender of next-to-last resort basis to the entire hierarchy of financial institutions just below them. In this arrangement, the central bank, as the lender of the last resort, provides the ultimate insurance against the risk of systemic meltdown. This structure of risk management in the financial system has been one of the very foundations on which the market economy has prospered for centuries and will no doubt continue to do so.

Questions arise, however, as to why the non-banks should also be regulated since they do not directly pose as a risk to systemic stability in the manner banks do. Few would need to be convinced that there exist in this category of non-bank activities some of the most highly leveraged financial institutions. In fact, the process of financial liberalization has itself

been adding on heavily, by way of development of new instruments and institutions, to the non-bank component of financial services. The effect of global deregulation has been, indeed, to speed up financial flows and to shift funds in favour of and through these more fleet-footed non-bank vehicles which, being on the look-out for favourable berths, acknowledge no frontiers or well defined bounds of good governance since they owe little loyalty to other than the search for private advantage.

There is nothing wrong in doing so since maximization has been the quest of all transactors at all times and in all climes including those who dictate codes of conduct to others. We would only be shooting ourselves in the feet if, on the least unfounded suspicion of wrongdoing, the matter was blown out of proportions as if one had been proved guilty of misdeed already. There is a big risk, however, and it needs to be properly managed. A good jurisdiction cannot afford to get entangled in activities which could cast a cloud of ill-repute on its practices and, even less so, on its practitioners. Depending, however, on the degree of risk represented by distinct such activities, the level of scrutiny exercised by the regulator will pragmatically vary even though the regulator's objective is to adopt as far as possible a common risk based approach to both banks and non-banks, to avoid unnecessary regulatory arbitrage.

The global risk recently represented by Long Term Capital Management, LTCM, a highly leveraged American international hedge fund, and the disturbances that took place in 1998 after the Russian crisis are still fresh in our memory. There are also numerous examples of adverse financial market prices leading non-bank financial institutions into severe distress. Sometimes, banks have pulled the non-banks out of difficulties, acting as lenders of next-to-last resort. At other times, the banks have gone under, together with them. Clearly, systemic crises can originate outside the banking system and this is why supervision and regulation should be extended well beyond the boundaries of licensed banks.

If you were to compress in as few words as possible the nature of overall regulation required in the circumstances, that would boil down to KYC, a principle you are fully acquainted with and which is condensed in the form of the licence given to you. Far from being an impediment to financial innovation, the licence generates a formidable scope for business provided the regulatory authority is minded to thereby create a sound and responsible regulatory environment for industry to thrive. This matter is extremely important in as much as the management of risk aside, both the regulator and the person regulated need to exchange views continuously so as to overcome anticipated challenges and possible disruptions to business per se from rival centres or to attend to major global developments.

Conclusion

The FSC and the Bank of Mauritius have been working towards a common goal, that of growing the financial center through best practices, conscious of the fact that excessive

licensing restrictions give incentives to market participants to circumvent them. Our efforts are directed towards risk management. There is no conflict between this objective and fostering the right environment for the financial industry to thrive on a level playing field in the context of low compliance costs and the avoidance of distortions to private incentives. There is a significant amount of work to do in certain un- or under-regulated financial sector activities. This matter requires its own time but would be best achieved if the regulator and the regulated can freely put across their views without being bullied into accepting any one's views at face value. The overall aim is to catalyse the growth of the industry by being market-friendly, identifying our shortcomings and overcoming them in the search for consolidation in this highly competitive world. If this is well understood, the scope for developing a common strategy underlying the provision of a range of business from Mauritius will quickly materialize.

In concluding, I would like to stress that the opening up of markets should be seen as creating opportunities for the development of the financial centre of Mauritius. Being a service provider, the financial sector has to meet demand without unnecessary delay. In turn, the ability to do so rests on a full understanding by both the regulator and the persons regulated, of the full scope of accountabilities being called for and the reasons therefor. This is why we invite an improvement in the quality of dialogue between the two parties with a view to removing unnecessary impediments to business in an atmosphere of mutual understanding.

Which are the areas of business still beckoning us and for which we have to build up skills? They could be in any one of the following fields which is not an exhaustive list any way: trust business, treasury management, debt issuance, venture capital, insurance and reinsurance, equity and bond trading, investment and fund management, consultancy and advisory services, management contracting, investment and fund management, and so forth. There is a need to demonstrate that we have the legal, administrative and skill capabilities to undertake these businesses profitably from the Mauritius center. Failure to do so will narrow us down to the little scope offered by the domestic economy while missing out on the real opportunities coming our way from international financing business. To be a player effectively at this level, it is imperative for professionals and the regulator to bring to Mauritius the various intangibles that go in the making of a good market place. These intangibles include personal contacts, a hold on key market information, the respect and credibility which counter-parties attach to you as a jurisdiction, reputation for innovativeness and high skills and, not the least, the quality of the centre you are operating from. The Mauritius centre is a safe place to do business from and, as the establishment of the FSC has signaled, we intend to stick to high international standards of regulation and thrive as a financial centre untainted by the blemish which some find it so easy to cast upon others.

I thank you for your attention.