BANK OF MAURITIUS ANNUAL DINNER WITH ECONOMIC STAKEHOLDERS

Address by Mr. R. Basant Roi, Governor of the Bank of Mauritius on 30 November 2001

Honourable Judges

Fellow Bankers

Distinguished Guests

Good Evening

I welcome you all to the Bank of Mauritius Annual Dinner.

I am delighted to address you once again on this occasion. Three years ago, on this same occasion, I had emphasised the importance of good corporate governance as a basis for best business practices and the supportive role that external auditors would be called upon to play in the promotion of a safe and sound banking industry. Those remarks and subsequent initiatives taken by the Bank of Mauritius were a clear shift from the rather passive system to an active system of supervising and regulating the banking industry in the country. That shift, as announced, I was later told, was marked by some fringes of arrogance. The distinction between 'the humility of central bankers' and 'the arrogance of central banking' is often less understood. Two years ago, again on this same occasion, I highlighted the urgency of the need for change - for re-structuring and consolidation at individual firms' level so as to enhance micro-economic efficiency. The address was unfamiliar and sour to the audience but they did reflect the potential threats of a difficult external economic environment likely to emerge in the years after. No one who is correctly informed of the past will take a morose or desponding view of the present. In December last year, I referred, *inter alia,* to the possibility of your having a lucky bite at the euro coin in your plum pudding. Some of you did have the lucky bite at the euro coin – and a few, through managerial ineptness, swallowed it and left no change behind!

I must say that my remarks have not been in vain. There has been an awakening, albeit slow, to the realities of the marketplace. In the last three years, enterprises and players in the domestic financial markets have been persuasively urged to review their treasury operations. Several enterprises responded. Some enterprises in the tourism sector as well as in the Export Processing Zone have indeed set up their own dealing rooms and have to quite an extent rationalised their treasury management. We have observed that the Mauritius Sugar Syndicate and some other institutions have been actively managing their exchange rate

exposures. The Bank of Mauritius views the initiatives taken by the Boards of Directors of these enterprises as a positive move towards improving efficiency in treasury management. The decision of the Bank of Mauritius to finance the re-structuring of the sugar industry has been variously interpreted. May I say that the decision was not simply a matter of cold calculation but an act of faith in the promotion of efficiency, reflecting the 'humility of central bankers'. In the medium and long-term interests of the economy, the Bank is often 'cruel only to be kind'.

The banking industry, in particular those incorporated locally, has initiated determined actions to restructure and upgrade their management and operations – thus moving away from traditional and deeply entrenched outdated styles to a modern approach of conducting banking business. Time is short. The demand for change is pressing. With the globalisation of financial markets, financial institutions around the world are exposed to a multiplicity of risks. Here in Mauritius we need to have good bankers to manage the risks and strong banks as well to effectively support the process of economic development. Within the banking industry we have to make a clear choice: either we do with the present quality of human capital in the industry and lag behind with all its undesirable consequences to the financial sector or we decisively and boldly take the right steps forward to strengthen our financial market and improve the interface between the domestic financial market and overseas financial markets. Most Boards of Directors and Chief Executives of banks have elected for change, restructuring and strengthening of their respective institutions despite pressures from their staff.

Why are central banks so concerned about the safety and soundness of banks? It is a question that is quite often set to me. I have no better answer than the classic one given by the Governor of the Bank of England several years ago. It goes as follows: financial bankruptcies can be quite different from industrial bankruptcies. When a shoemaker goes bankrupt, it does not necessarily follow that other manufacturers too can go bankrupt. Instead, other shoemakers would expect their business to expand. The story is different when a bank fails. Indeed, when a bank goes bankrupt, strong banks may benefit. But others may fall prey to suspicion. If the suspicion assumes a disproportionate dimension panic intensifies rapidly. The risk of contagion can throw the entire industry into jeopardy. The failure of a single bank, if not appropriately dealt with, could unleash immense centrifugal forces leading to widespread economic and financial crises. There could be no better reason for central bankers to be so concerned with the safety and soundness of not only banks but of the entire financial industry.

Why do banks fail? This is yet another question that is often asked in Mauritius and hence my decision to focus my remarks this evening on some of the causes of bank failures. Emphatically, I have to say that I do not have any particular bank operating in Mauritius in mind that fits the scenario I am about to outline. I believe, for the sake of transparency, you,

like many other citizens are entitled to know why central banks lay emphasis on prudential supervision and the implications of prudential norms not being followed by banks and other financial institutions.

Banks in financial distress follow typically the same course the world over until they collapse, if timely and adequate remedial action is not undertaken by both the supervisory authorities and the ailing banks. Characteristically, three distinct phases mark the life cycle of most ailing banks.

The seed of a bank in financial distress is sown in the first phase, which lasts for about two years. Obesity does not speak of good health; it sometimes leads to premature death. Driven by the desire to grow big and fast, any bank falling under this category adopts an aggressive lending policy regardless of the quality of loans and credit. The cardinal principle of credit diversification is totally disregarded. Over this two-year period, the bank's loans and credit grow inordinately at a rapid pace. To be able to further extend loans and credit, the bank mobilises resources that are essentially volatile. Another cardinal principle that a bank should not borrow short to lend long is also disregarded. The balance sheet of the bank swells to the point of obesity. The aggressive lending by the bank progressively intensifies the concentration of risks. Usually, such a bank has no business plan and if it has a plan it does not follow it. The bank has either weak internal controls or does not believe in having any internal controls at all. However, the bank is generating good earnings. Problems regarding bad debts are negligible. In short, the performance indicators of the bank are generally good. The bank does not quite reveal symptoms of serious weaknesses *per se*. But the supervisory authority concerned with the pace of expansion of the bank's business and being rightly suspicious of potential troubles in future, calls for prudence. In good times it is virtually impossible for supervisory authorities the world over to convince the management that its lending practices are unsound. The bank continues to soldier on as a financial intermediary. So far, so good.

But the bank has actually gone far enough in its fishing expedition. Risks of bad weather wrecking the enterprise are ever present. I need not mention that the ocean around us is never short of sharks. If not blessed by a stroke of good luck, which is rarely the case, the bank crosses the Plimsoll line to the second phase that lasts for another two years or so. The bank itself detects problems in its loans and credit portfolio; delinquent borrowers rear their heads to the surface. Annual profits of the bank show a peculiar trend that hits spectacularly in the eyes of the supervisor. However, through accounting gimmicks of concealing loan losses, the bank attempts to give a good make up to its balance sheet before publication. But make ups do not last long even when the heat in the kitchen is bearable. Eventually, the profitability and capital ratios of the bank decline and deteriorate. By that time the bank is already in dire difficulty finding funding resources.

The supervisory authority, mindful of the economic, financial and social consequences of a possible crash, brings the problems to the notice of the management of the bank. Some of the time the management is fully aware of the financial distress the bank is actually in and some of the time the management is ignorant of a potential threat of a collapse. The management simply repudiates the views of the supervisory authority and stubbornly maintains that the ailing bank is safe and sound. There is no such aspirin that can cure the management of its hallucinations. The senses and minds of the management cease to respond to moderate stimulation. To such a management truth is ultimately revealed rather than logically proved. The supervisory authority flexes its muscles. Injudiciously, the management of the bank often seeks and musters support against the stand of the supervisory authority. Whose authority prevails ultimately? I leave it to your judgement.

May I digress here a little to say that in this particular scenario, the external auditors should have been alerting management all along to the risks inherent in the bank’s policy approach and insisting on adequate accounting for loan losses. This is the critical point where the external auditors of the ailing bank have to take a definitive position. Quite often they do. Some of the time they do not. One does not murder a man who is committing suicide; one should rather take a calculated and determined stand to stop the suicide. The professionalism of the external auditors of the bank is ultimately tried and tested. In the event that the Board of Directors does not pay heed or refuses to take cognizance of the problems, the death warrant on the bank is signed, sealed and issued long before the bank actually collapses. The Board of Directors of banks often turns out to be a pain in the necks of external auditors.

Meanwhile, the bank continues to operate with its management hoping to be able to weather the impending crisis. But the stage is already set for the crisis phase. Heavy loan and credit losses are detected in the books of the bank. The bank’s own funds are inadequate to meet the exigencies of the strained financial situation. It ceases to have access to capital on markets as market confidence in the bank weakens. The supervisory authority has no alternative but to request the bank in trouble to submit a detailed plan of action to raise its capital and reserve ratios, reduce expenses and risks, cut dividends and submit reports, often on a daily basis, on its liquidity position. This phase lasts until the bank is either brought back on rail or an alternative solution is found out. Typically, the life cycle of an ailing bank lasts for about 5 years or so. However, unlike wounded elephants that take time to collapse, some banks do collapse overnight – mostly those banks in which massive frauds are suddenly detected.

Having said that let me bring the attitude and approach of the management of such a bank into sharp focus. As I stated earlier, the process of deterioration of most banks worldwide begins with poor lending practices and inadequate risk management policies. Supervisors refer to it as technical mismanagement. Once the problem of growing loan losses is recognised, one would ordinarily expect the Board of Directors to initiate immediate actions to

review the management and operation of the bank with the goal of setting it back on rail. Instead, the management culture of the bank deteriorates in most cases. Bad management permeates from the top to lower layers of the bank. The bank attempts to cover up the losses by having recourse to what supervisors call cosmetic management. Net profits of the bank are fudged through ever-greening operations. The desperate banker attempts to revive his enterprise from its comatose state. Rather than administering intensive care, the banker usually transforms into a gambler. The striped suit of the once flamboyant banker loses its gloss. Short of liquidity, the bank offers interest rates on deposits higher than market rates. Habitual delinquent borrowers default and walk away expecting to make a kill should the bank go bust. Eventually, when the supervisory authority steps in it may also discover that from desperate management the bank is deeply involved in outright fraudulent activities. This is quite a rare case of reckless bank management. Rescuing such a bank is a misfortune; letting it collapse is a calamity.

The time it takes an ailing bank to move from the first to the last phase depends on the rate at which the bank's problems build up over time and on the management's as well as the supervisory authority's perception of an effective risk of collapse. It is incumbent upon supervisory authorities to rescue those banks, but only those banks with fairly sound financial standing. Merger, acquisitions and various other options are available to the supervisory authority. The bank in trouble is offered a new deal, a fair deal, but before the deal is negotiated, the supervisory authority cuts the cards in the best interests of all those concerned. The three principal players – the management of the bank, the external auditors of the bank and the supervisory authority - have a decisive role to play in this endeavour.

Banking, as we are all aware, is a business of risk taking. The very nature and character of the business impose constraints on the liberties of the Board of Directors of banks, the management of banks and of their external auditors. Weaknesses at any one of the first two levels do severely undermine the effectiveness of the supervisory authority. There is no substitute to good management by the banks themselves. Self-supervision is best supervision. No matter how effective the supervisor is, he cannot subsume the role of the management. You will certainly appreciate that the supervisor cannot be permanently sitting over the shoulders of the bank management and watching the daily moves it make. What the Bank of Mauritius does, as the supervisory authority, is to seek assurances that the principal players in a bank do recognise their roles and responsibilities and put in place adequate systems and controls to ensure the bank's continuing safety and soundness. The Bank of Mauritius relies, to a very large extent, on the integrity, honesty and competence of the management of the bank.

In the last three years, the Bank of Mauritius has set up a new infrastructure for banking supervision. A new manual, supplemented by various guides, for the staff has been implemented for use in on-site inspections and off-site monitoring as well. Each and every

bank is now inspected once a year – a major improvement over past practice. The Bank of Mauritius has also issued several guidelines to the banking industry – guidelines on risk concentration, guidelines on non-performing loans and provisioning, guidelines on liquidity and guidelines on corporate governance. These guidelines are not obituary notices to be simply read and cast aside, but principles and prudential norms that should be adhered to. Several more guidelines are in the pipeline. We expect to release a guideline on related party transactions and self-dealing. Another important guideline will deal with transparency and public disclosure of information by banks. The Bank of Mauritius has itself set the pace already. You must have noticed the extent of disclosure of information in the financial statements of the Bank of Mauritius, published in the Annual Report for the year ended June 2001.

There are three critical players in corporate governance of a bank: the Board of Directors, Executive Management and External Auditors. I leave my reflections on the first two players for some other occasion. Let me say that corporate governance demands a very active and alert external auditor. The Bank of Mauritius guideline on corporate governance underlines the fundamental importance of his role. Let me explain.

The legislators of Mauritius envision a much wider role for the external auditor of a bank than what is traditionally known for financial bankruptcies can be quite different from industrial bankruptcies. It is true that their attestation of a bank's financial statements does not unequivocally mean a clean bill of health of the bank. This is so because the financial statements represent the state of health of the bank at a point in time and deal largely with historical information on the operations of a bank. But let me be clear that the auditor of a bank has a much larger and forward-looking role. Under the Bank of Mauritius Guidance note of 1994, the auditor must express an opinion on the adequacy and effective maintenance of internal controls in a bank to manage its key risks. This is a significant role and the onus it places on the auditor must not be underestimated. With economic and financial liberalisation, banks and non-bank financial institutions are today more exposed to risks – indeed a wide spectrum of risks - than before. Supervisory authorities the world over are focusing greater attention to risk management. Not surprisingly, a few economists have recently been awarded the Nobel Prize for their discoveries in optimal risk management and asymmetric information in markets.

Let me mention another dimension to the auditors' role. Normally, I do not quote legislations to make a point. But here I have to. Section 25 of the Banking Act places a critical demand on the external auditor. Should he discover in the course of his audit that the bank has been in a serious breach of the provisions of the Act, regulations and guidelines, he must immediately report the matter to the Bank of Mauritius. Since the thrust of the legislative framework of Mauritius is prudential management of a bank, I would assign this responsibility of the auditor for reporting on the well being of the bank with a forward-looking dimension and appreciation.

With the proclamation of the Financial Services and Development Act, the scope of the work of external auditors would be further enhanced.

Indeed, the audit profession has very delicate and difficult duties. We have in Mauritius auditors of international standard, capable, competent and compliant to the rules of the profession. I have, in my day-to-day discharge of my duties over the years, come across honest and highly capable auditors willing to give their best shots. It does not mean that if external auditors tell the truths the Board of Directors should show them the exit door. Independence from their clients at all times and complete fidelity to public trust is nevertheless required of auditors. The complexity of the duties of external auditors is evident. One does not have to run complex simultaneous equations models to find the unknowns.

In fact, there are complementarities between the responsibilities of the supervisory authority and those of the auditor. The Bank of Mauritius supervisors rely on external auditors' work to quite an extent in order to avoid wasteful duplication of work. The Bank, as the supervisory authority, is the auditors' ally in ensuring the safety and soundness of banks. Our responsibilities are inextricably intertwined. We intend to come up with a protocol for the sharing of information between the Bank and external auditors of individual banks.

Ladies and gentlemen, I highlighted the organic or rather the institutional problems leading to bank failures. However, bank failures are not always due to mismanagement only. Macro-economic causes are many. Experiences world-wide have demonstrated that overvalued exchange rates over a protracted period of time followed by sharp devaluations, unexpected severe downturn in economic activities, highly expansionary policies, high rates of inflation and substantially high interest rates could also lead to bank failures. Viewed from this angle, it is virtually impossible to extricate monetary policy making from the stability of financial systems. While appropriately designed macro-economic policies and consistency in the prosecution of the policies constitute a vital element in the promotion and preservation of a sound and efficient financial industry, ethical behaviour of those at the helm of affairs in the financial sector remains a pre-eminently decisive factor. You know it as much as I do that borders do no longer exist in the world of finance. The border between honesty and dishonesty also seems to be slimming down the world over. Things do not always turn out the way we want them to.

This reminds me of a story. A very busy auditor was invited to the inauguration of a prosperous bank branch that had moved to a new location in town. The auditor was late for the inaugural ceremony. He purchased a bouquet from a florist shop in a hurry and rushed to the bank's new location. Upon arrival he offered the bouquet to the branch manager of the bank. Mistakenly the bouquet carried the inscription 'Rest in Peace'. Embarrassed and upset, the auditor went to the florist on his way back home and protested vehemently. Cool and composed, the florist replied, 'Cool down gentleman. Think of the person, who passed away

in town and was buried today with a bouquet carrying the inscription, ‘Good Luck In Your New Location’.

Yes, however good the intentions are things do not always turn out the way we want them to.

May I, Ladies and Gentlemen, on behalf of the Board of Directors, the staff of the Bank of Mauritius and on my own behalf, wish you and your families a merry Xmas and a Happy New Year.

May God bless you.

30 November 2001