

**Mauritius: Financial System Stability Assessment,
including Reports on the Observance of Standards and Codes on
the following topics: Banking Supervision, Payment Systems,
Monetary and Financial Policy Transparency,
and Anti-Money Laundering**

This Financial System Stability Assessment on **Mauritius** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **June 5, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Mauritius** or the Executive Board of the IMF.

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Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and African Departments

Approved by Stefan Ingves and Abdoulaye Bio-Tchané

June 5, 2003

- This Financial Sector Stability Assessment (FSSA) is based on the work of the joint IMF-World Bank mission that visited Mauritius from October 21–31, 2002 and December 3–17, 2002 in the context of the Financial Sector Assessment Program (FSAP). Extensive meetings were held with the Bank of Mauritius (BOM); the Ministries of Finance (MOF), Economic Development, Financial Services and Corporate Affairs (MEDFSCA) and Justice (MOJ); the Financial Services Commission (FSC); the Stock Exchange of Mauritius (SEM); the Chamber of Commerce and Industry, and the Joint Economic Council; associations of banks, credit unions, insurance companies, stockbrokers, and management companies; and several banks, insurance companies, pension funds, quasi-banking institutions, and investment and securities companies. Follow-up discussions were held with the authorities from March 12–19 in the context of the 2003 Article IV consultation.
- The teams included: Messrs. Abdessatar Ouanes (Mission Chief), Hemant Shah, Michael Andrews, Gamal El-Masry, Wim Fonteyne and Ms. Nancy Rawlings, and Ms. Delrene Alvis (Senior Administrative Assistant) [all IMF]; Ms. Ann Rennie (Deputy Mission Chief), Mr. Dimitri Vittas, Mr. Alain Damais, Mr. Juan Costain, Mr. Peter Kyle, and Ms. Leora Klapper [all World Bank]; Mr. David Wilton (IFC); Mr. Thomáš Hládek (Czech National Bank), Mr. Kee Meng Lee (Singapore Monetary Authority), and Ms. Diana Wong (Hong Kong Security Bureau, Government Secretariat).
- Mauritius has a deep financial sector dominated by a large domestic banking sector, with a significant expansion in the region. It also has a well-developed insurance and pension sectors, and a sizeable offshore financial services sector. The banking system is profitable, well-capitalized, and generally sound. However, it has not been fully tested in an economic downturn and will, therefore, face the medium-term challenges posed by the impending erosion of trade preferences in sugar and textile industries and the economic restructuring that will be required to maintain past high growth rates.
- The short-term stability risks facing the financial system in Mauritius are modest. The domestic banking system, while sound, is vulnerable to external economic shocks and to a downturn in economic activity. The vulnerability to these shocks is heightened by the underlying structure of the banking system (high concentration of players, with two banks dominating the system; a very high concentration of credit, with a handful of conglomerate borrowers; and a high sectoral loan concentration). There is also the risk arising from potential money laundering by some offshore funds or companies. Finally, the recent significant shortening in the maturity structure of government debt points to some roll-over risk.
- The reform strategy would need to focus on: (i) continuing the strengthening of banking supervision, and encouraging banks to improve internal audit and control systems; (ii) fostering the development of alternatives to bank lending to reduce portfolio concentration and increase competition; (iii) encouraging international risk diversification; (iv) strengthening provisioning levels so as to enhance the capacity of the system to weather a downturn; and (v) reducing the government's implicit contingent liability in the banking system.
- This report is divided into two parts. The first part provides a staff report on financial sector issues. The second part presents summary assessments of observance of standards and codes relating to banking supervision, payment system, transparency in monetary and financial policies, and anti-money laundering and combating the financing of terrorism.

The main authors of this FSSA are: Abdessatar Ouanes, Hemant Shah, and Wim Fonteyne.

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TABLE OF ACRONYMS

AGOA	U.S. African Growth and Opportunity Act
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BOM	Bank of Mauritius
BRP	Basic Retirement Pension
CAMELS	Capital Adequacy, Assets quality, Management soundness, Earnings, Liquidity, and Sensitivity
CAR	Capital Adequacy Ratio
CCU	Cooperative Credit Union
CDS	Central Depository Service
CEB	Central Electricity Board
CIS	Collective Investment Schemes
CPSS	Committee on Payment and Settlement Systems
DBM	Development Bank of Mauritius
DC	Defined Contribution
DMU	Debt Management Unit
DPP	Director of Public Prosecutions
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
EPZ	Export Promotion Zone
FATF	Financial Action Task Force on Money Laundering
FCB	First City Bank
FIAML Act	Financial Intelligence and Anti-Money Laundering Act 2002
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FSC	Financial Services Commission
FSD	Financial Services Development Act 2001
GBL	Global Business License
GOM	Government of Mauritius
IAIS	International Association of Insurance Supervisors
ICAC	Independent Commission Against Corruption
IOSCO	International Organization of Securities Commissions
MACSS	Mauritius Automated Clearing and Settlement System
MCB	Mauritius Commercial Bank
MEDFSCA	Ministry of Economic Development, Financial Services and Corporate Affairs
MHCL	Mauritius Housing Company Ltd
MOF	Ministry of Finance
MOJ	Ministry of Justice
MOU	Memorandum of Understanding
NAV	Net Asset Value
NBFI	Nonbank Financial Institutions
NCB	National Cooperative Bank
NCRC	National Coordination Review Committee

TABLE OF ACRONYMS

NPF	National Pension Fund
NPL	Nonperforming loans
OTC	Over-the counter
POSB	Post Office Savings Bank
ROSC	Report on Observance of Standards and Codes
SBM	State Bank of Mauritius
SEM	Stock Exchange of Mauritius
SEMDEX	Index of Leading Stocks on Mauritius Stock Exchange
SICOM	State Insurance Cooperation of Mauritius

I. PART I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

A. Overall Stability Assessment

1. Mauritius has been remarkably successful in achieving rapid economic growth, in diversifying its economy, and in developing a broad-based financial system. Mauritius has a deep financial sector, dominated by a large domestic banking sector, with assets equivalent to 100 percent of GDP and with a significant expansion in the region. It also has well-developed insurance and pension sectors and a sizeable offshore financial services sector. The banking system is profitable, well-capitalized, and generally sound. However, it has not been fully tested in an economic downturn and will, therefore, face the medium-term challenges posed by the impending erosion of trade preferences in sugar and textile industries and the economic restructuring that will be required to maintain past high growth rates.

2. **The short-term stability risks facing the financial system in Mauritius are modest:**

- The domestic banking system, while sound, is vulnerable to external economic shocks and to a downturn in economic activity. The vulnerability to these shocks is increased by a highly concentrated structure of the banking system and the concentration of credit in the hands of few conglomerate borrowers and a few sectors. As a result, a prolonged downturn in economic activity in the key sectors (sugar, textiles, and tourism), where bank risk exposure is significant, will adversely affect the quality of bank portfolio and potentially threaten the stability of the system, as confirmed by stress tests.
- The banking system faces a relatively small market risk, inter-alia, because of banks' heavy reliance on variable rates on both the lending and deposit sides and of well-matched foreign exchange books.
- Insurance companies and pension funds do not pose a major system risk at present but are vulnerable to a persistent decline in interest rates because of the large duration mismatch of their assets and liabilities.
- While the offshore sector is vulnerable to a reputation risk related to potential money laundering activities, the ongoing strengthening of the AML/CFT regime is likely to mitigate this risk in the future. Further, even a major downturn in this sector is unlikely to have significant repercussions on the rest of the economy.

3. **The strategy for mitigating the potential risks facing the banking system in Mauritius requires a multifaceted approach.** This includes: (i) continuing the strengthening of banking supervision and encouraging banks to reinforce their internal controls; (ii) fostering the development of alternatives to bank lending to reduce portfolio concentrations and increase competition; (iii) encouraging sound international risk diversification;

(iv) strengthening provisioning levels so as to enhance the resilience of the system to a downturn in economic activity; and (v) reducing the government's implicit contingent liability in the banking system. The main FSAP recommendations are reported in Box 1.

4. **The assessment of standards and codes found a high level of compliance with internationally accepted norms and best practices.** The authorities have made substantial progress in this area and are upgrading key financial sector legislation and regulations. The implementation of the assessments' recommendations should help further strengthen the supervisory and regulatory framework and enhance the resilience of the financial system to shocks. These include: (i) making consolidated supervision more effective and improving the monitoring of group exposure; (ii) increasing supervisory focus on operational risk; and (iii) further strengthening the legal and institutional framework for anti-money laundering and combating the financing of terrorism.

II. MACROPRUDENTIAL CONTEXT

Background

5. **Mauritius has been remarkably successful in achieving rapid growth and a substantial diversification of a formerly mono-agricultural economy.** Over the past two decades, Mauritius has made impressive gains in macroeconomic and social areas: with per capita income more than doubled, income disparities significantly narrowed, and a stable and democratic political system developed. Mauritius enjoyed substantial resource transfers from very favorable trade preferences in the sugar sector, and to a lesser extent in the textile industry. Appropriate macroeconomic policies, supported by a dynamic and entrepreneurial private sector, permitted the country to diversify its export and productive bases from the previously mono-agricultural economy into one based on four pillars of development, namely sugar, textiles, tourism, and offshore financial services. Since the early 1990s, however, unemployment has risen steadily despite continued robust growth (Table 1).

6. **Maintaining the past high rates of growth will pose a major challenge as the economy is currently undergoing a major transformation.** With the impending erosion of trade preferences, the sugar industry is being forced to restructure. With the scheduled expiration of the Multifibre Arrangement at end-2004, and increased competition from low-cost textile producers,¹ the textile sector faces a downturn with potentially much larger impact on economic growth, employment, and foreign exchange earnings. Further, the prospects of the offshore financial sector are also threatened, as the key features of the double taxation avoidance treaties with Mauritius's most important offshore partners—India and

¹Although the U.S.-African Growth and Opportunity Act (AGOA) may provide some relief and new opportunities, this is unlikely to fully compensate for the fast eroding privileges.

Box 1. Summary of Main Recommendations

Banking and NBFIs

- Strengthen banking supervision, and enforce limits on large exposures and related party transactions. Ensure adequate levels of provisioning and conservative valuation of collateral. Encourage banks and NBFIs to upgrade their internal audit and control systems.
- Strengthen independence of the BOM through clearer mandate, full licensing and regulatory powers, longer apolitical appointments of key staff.
- Subject deposit-taking nonbanks (leasing companies, DBM, MHC) to appropriate bank-like regulation and supervision by BOM and review the government of Mauritius' long-term strategy concerning public sector depository institutions.
- Introduce a comprehensive credit information bureau and adopt appropriate regulation and nondiscriminatory taxation to foster the development of nondeposit taking firms in leasing, factoring and venture capital.

Financial sector regulation

- Pass amended BOM Act, Banking Act, Insurance Act, Securities Act, including a comprehensive legislation on CIS, Insolvency Act and prepare comprehensive new pension fund regulations.
- Upgrade FSC staffing through recruitment and training, and undertake a comprehensive program of on-site and off-site supervision for all licensed entities. Review the decision on integration of banking and nonbank supervision once both FSC and the BOM have brought their supervision closer to international standards.
- Improve exchange of information among domestic and foreign supervisory bodies.
- Implement recommendations of the anti-money laundering and combating the financing of terrorism (AML/CFT) assessment.

Public debt management

- Improve public debt management, distinguish monetary policy operations from fiscal financing operations, increase public debt maturity to reduce roll-over risk.

Insurance

- Adopt modern standards of corporate governance, internal controls, risk management, and capital adequacy, and promote consolidation through higher risk-based capital requirements. Develop early warning systems and require actuaries to undertake dynamic solvency testing to assess exposure to falling interest rates. Establish an insurance information bureau. Upgrade supervisory skills and strengthen insurance company supervision.

Pensions

- Adopt measures to contain costs of Basic Retirement Pension (BRP). Strengthen independence and investment management of National Pension Fund (NPF) and undertake external audit of its financial accounts and improve internal controls. Consider converting NPF to a more transparent defined contribution system. Strengthen regulation and supervision of occupational pension funds.

Financial markets

- Adopt measures to develop more efficient money, treasury-bill and foreign exchange markets, as well as a long-term government debt market. Remove tax distortions impeding the development of the non-government debt market.
- Improve corporate governance and disclosure, as well as market regulation, supervision and surveillance to ensure market integrity of SEM.

Table 1. Mauritius: Selected Macroeconomic Indicators, 1997/98-2002/03 1/

Total population (thousands, mid-2002)	1,210					
GDP per capita (US\$, 1999/2000)	3,640					
	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03 Proj.
Real Sector (in percent, unless otherwise indicated)						
Real GDP growth 2/	6.0	5.4	2.7	7.0	4.0	3.3
GDP at market prices (in millions of rupees)	94,167	106,079	112,685	125,123	137,312	149,101
GDP deflator (change in percent) 2/	6.0	6.9	3.4	3.8	5.5	5.2
Consumer price index (change in period average)	5.4	7.9	5.3	4.4	6.4	5.1
Unemployment rate	6.6	7.1	8.1	8.9	9.4	9.8
Monetary and credit data (annual change in percent)						
Money (M1)	14.4	7.4	1.5	14.9	19.0	13.4
Broad money (M2)	17.4	13.2	10.9	9.9	13.0	11.0
Domestic credit	24.9	13.6	13.7	5.3	8.1	7.3
Yield on 91-day treasury bills 3/	8.81	11.14	11.87	9.66	9.18	8.46
Yield on 728-day treasury bills 3/ 4/	-	12.23	12.62	12.33	11.52	10.75
Prime lending rate of commercial banks 3/ 5/	...	10.00-13.00	10.00-13.00	10.00-12.25	10.00-11.50	9.00-11.25
Interest rate (one-year term deposits, in percent) 6/	10.0	12.0	10.8	11.4	11.80	11.8
Stock market index (percent change, end of period)	19.6	-10.2	-0.5	-4.9	-7.3	...
Public finances (in percent of GDP at market prices)						
Central government overall balance (including grants)	-3.8	-3.3	-3.8	-5.7	-5.9	-5.9
Domestic debt	34.2	34.8	37.0	42.4	48.6	50.7
External debt	11.4	9.5	8.8	5.4	6.2	7.0
External sector (levels in millions of U.S. dollars, unless otherwise indicated)						
Rupees per U.S. dollar (end of period)	24.28	25.24	26.09	29.24	29.96	28.63
Trade balance	-410.4	-365.5	-483.9	-252.9	-219.2	-266.4
Current account balance	-115.8	-65.3	-68.7	154.3	238.2	234.8
Current account balance (in percent of GDP)	-2.8	-1.5	-1.6	3.4	5.2	4.6
Foreign direct investment (net)	44.8	18.8	12.7	197.3	48.4	22.5
Portfolio investment (net)	-28.1	28.8	-23.1	-139.0	-19.9	-6.8
Net international reserves of the Bank of Mauritius	622.0	625.4	688.0	789.3	1017.0	1328.3
in months of prospective imports, c.i.f.	3.7	3.5	4.1	5.0	6.0	7.3
Net international reserves of the banking system	879.6	893.7	966.0	1085.9	1352.9	1611.3
in months of prospective imports, c.i.f.	4.8	5.0	5.7	6.9	7.9	8.9
Public sector external debt	1,223	1,207	1,103	960	989	1087
Banking sector external debt	1,060	1,067	977	850	850	823
Debt-service ratio (in percent of exports of goods and services)	7.0	7.6	7.9	9.8	8.5	7.3
Central bank foreign liabilities	1.1	0.7	0.4	0.4	0.8	...
External interest payments (in percent of exports of goods and services)	2.3	2.1	2.1	1.8	1.4	1.5
Foreign currency long-term debt rating by Moody's	Baa2	Baa2	Baa2	Baa2	Baa2	Baa2

Sources: Mauritian authorities, staff estimates.

1/ Fiscal year from July to June.

2/ Sugar crops and milling included in fiscal year harvested; otherwise, averages of calendar-year data.

3/ 2002/03 figure refers to the period July 2002–February 2003.

4/ 728-day treasury bills were introduced in July 1998.

5/ Minimum and maximum observed.

6/ Remaining maturities of one year or less.

South Africa—are either under legal challenge (India) or threatened by changes in tax laws (South Africa). Finally, the tourism sector, which still has growth potential, remains vulnerable to adverse developments in international terrorism and weather.

7. **The success of the authorities' strategy to transform the economy will hinge on how well they manage the transition while maintaining social cohesion and macroeconomic stability.** To sustain a high level of economic growth, the authorities recognize the need for restructuring the economy and have already embarked on strategic plans in all affected industries. They are also focusing attention on, and investing heavily in, education so as to realign the labor force with the requirements of the new engines of growth, as the prospect for a jump in unemployment in the early phase of the restructuring is likely to be high. On the fiscal front, Mauritius has declining but still large budget deficits and its domestic public debt is moderately large. While the authorities have recognized the need to reduce the deficit over the medium-term, their success is premised on robust economic growth and continued fiscal discipline. In addition, the authorities face potentially large contingent liabilities emanating from, inter-alia, the unfunded civil service pension.

8. **Overall the long-term growth prospects are subject to significant down-side risks, which could pose a threat to financial stability.** However, Mauritius is well positioned to properly manage the transformation process, since there is a strong recognition among social partners of the challenges ahead and the urgency for early action. At the same time, there appears to be a strong consensus on the key measures that need to be taken to facilitate the transformation process. Nevertheless, mitigating the impact on the economy and the financial sector of the restructuring ahead would require managing the transformation process in a way that would ensure macroeconomic stability, preserve international competitiveness, and foster social cohesion.

Overview of the financial system

9. **Mauritius has a well-developed and relatively large domestic financial system and a growing offshore sector.** The domestic financial system consists of (i) a large banking sector with assets of some US\$ 4.3 billion, equivalent to about 100 percent of GDP; (ii) a sizable insurance and pension sector with assets equivalent to 41 percent of GDP; (iii) a number of nonbank financial institutions including 11 leasing companies (with assets close to 3.5 percent of GDP); and (iv) a stock market with 44 securities under two categories of listing and a market capitalization of 19 percent of GDP (Table 2). Payment, securities trading, and settlement systems are modern and efficient. The informal sector is relatively small and access to credit is well developed. Access to banking services is extremely high, with 1.6 million commercial bank accounts, 150 branches, and some 750,000 credit/debit cards, for a population of 1.2 million.

Table 2. Mauritius: Financial System Structure, 1997-2002

	December 2001				June 2002			
	Number	Assets (MUR mln)	% of Total Assets	% of GDP	Number 2/	Assets (MUR mln)	% of Total Assets	% of GDP
Banks—Domestic	10	126,801	61.8	91.9	10	134,675	94.8	97.6
Private	10	126,801	61.8	91.9	9	129,267	91.0	93.7
Domestic	3	91,673	44.7	66.4	3	97,550	68.7	70.7
Foreign	7	35,128	17.1	25.5	6	31,717	22.3	23.0
State-owned	-	-	-	-	1	5,408	3.8	3.9
Institutional investors	1,031	62,671	30.6	45.4	1,117	N/A		
Insurance companies	24	23,971	11.7	17.4	22	N/A		
Pension funds	1,007	38,700	18.9	28.0	1,095	N/A		
Mutual funds			-	-			-	-
Other nonbank	275	15,644	7.6	11.3	265	7,324	5.2	5.3
Development Bank of Mauritius 1/	1	4,409	2.1	3.2	1	N/A		
Post Office Savings Bank	1	943	0.5	0.7	1	1,032	0.7	0.7
Leasing companies	10	4,500	2.2	3.3	N/A	N/A		
Finance companies	N/A	N/A			N/A	N/A		
Securities firms	N/A	N/A			N/A	N/A		
Mauritius Housing Company 1/	1	5,792	2.8	4.2	1	6,292	4.4	4.6
Cooperative credits	178	N/A			178	N/A		
Credit unions	80	N/A			80	N/A		
Cooperative thrift institutions	4	N/A			4	N/A		
Total onshore financial system	1,316	205,116	100.0	148.7	1,392	141,999	100.0	102.9
Banks—Offshore	12	112,040	100.0	81.2	12	129,205	100.0	93.6
Insurance companies—offshore			-	-			-	-
Other offshore NBFIs			-	-			-	-
Total offshore financial system	12	112,040	100.0	81.2	12	129,205	100.0	93.6
Total financial system	1,328	317,156		229.9	1,404	271,204		196.6

Sources: Mauritian authorities and IMF/World Bank staff estimates.

1/ Balance sheet data refer to June 30 of the relevant year.

2/ One onshore and two offshore banks commenced operations after June 2002.

Structure of the banking system

10. **Mauritius' banking system consists of two subsystems: an onshore and an offshore banking sector.** As of end-2002, the onshore sector comprises 11 banks² having a Category 1 license, which permits them to operate a normal range of banking activities, in domestic as well as foreign currencies. The offshore sector consists of 14 banks having a Category 2 license, which requires them to be majority-owned by nonresidents and restricts their activities to operations in foreign currency. In return, they benefit from a number of tax, duty and other advantages. In contrast to offshore banks in many other countries, Category 2 banks are allowed to deal with residents, as long as such dealings are undertaken in foreign currency.

11. **The onshore banking system accounts for about two-thirds of the assets of the total onshore financial sector.** The system comprises two large domestically-owned banks MCB and SBM, which hold 70 percent of the assets of the system; three local operations of large international banks accounting for 20 percent of the system;³ and six small banks that represent the remaining 10 percent.⁴ Overall, six onshore banks in the system are foreign owned and account for 26 percent of the assets in the system.

12. **MCB and SBM dominate the onshore banking system.** The MCB accounts for 54 percent of the system's loans, 45 percent of deposits, and 46 percent of assets. The MCB and SBM together account for 77 percent of loans, 68 percent of deposits, and 70 percent of assets.

13. **These two largest banks also have significant interests in other components of the financial sector.** The MCB has subsidiaries/affiliates in leasing, stock brokerage, and fund management in Mauritius and abroad, in addition to having links to some of the most important businesses in Mauritius. The SBM has subsidiaries/affiliates in financial services, leasing, information technology (IT) and asset management, and is expanding internationally. The SBM owns a 20 percent share of the largest insurance company, State Insurance Company of Mauritius (SICOM). Further, the shareholdings of the MCB and SBM in turn establish linkages with a number of Mauritian businesses. MCB is owned primarily by a diverse group of Mauritian businesses and individuals, and has traditionally had close links to the sugar industry.⁵ The majority of SBM's shares, by contrast, is held by just a few large

²One onshore and two offshore banks began operations after June 2002.

³The Hong Kong and Shanghai Banking Corporation Ltd. (HSBC), and Barclays Bank. Barclays Bank took over the Mauritian operations of the third international bank (BNPI) in 2002, merging it with its own local operations in November 2002.

⁴Of these six banks, two are government-controlled domestic banks.

⁵As of June 30, 2002, only two shareholders held more than 5 percent of its equity: Lloyds TSB Bank Plc of the United Kingdom (9.97 percent) and Fincorp Investment Ltd. (6.63 percent).

shareholders, namely Nedbank of South Africa (holding almost 20 percent), the government of Mauritius, and various public sector entities (holding directly and indirectly 38 percent).

14. **Several Mauritian banks are seeking regional diversification.** The MCB and SBM are expanding activities in the Indian Ocean and southeast Africa, both through subsidiaries and other operations such as international project finance. The MCB and SBM between them have a major presence in Africa, including in Reunion, the Seychelles, Mayotte, Madagascar, Mozambique, and Malawi (Box 2).

Performance and soundness of the onshore banking system

15. **The strong economic performance over the past decade has spurred the development and growth of a highly profitable banking system.** The sustained economic growth of recent years has enabled the banking system to grow at an average of 13 percent per year over the past five years. Return on assets has consistently been above 2 percent, and return on equity over 20 percent during the past five years, thanks to solid interest margins and low operating expenses (Figure 1). However, the growth prospects of the banking sector will be constrained by the capacity of the economy to sustain past high levels of growth and the ability of the largest two banks to continue to expand regionally in a sound manner.

16. **The banking system is well capitalized, liquid and generally sound (Table 3).** The average capital adequacy ratio, at 13.1 percent, comfortably exceeds the regulatory minimum of 10 percent and the Basel norm of 8 percent. In comparison to countries in the African region and similar income levels, the overall quality of assets is relatively good, with the ratio of nonperforming loans (NPLs) to total advances around 8 percent during the last five years. To guard against a deterioration in the quality of their portfolios, banks have been reducing their exposure to the private sector, with the largest reduction affecting the riskiest portfolio, especially in textiles. This shift is also reflected in the jump in commercial banks' holding of government securities. These nearly doubled in the two-year period ended in 2002. Provisioning is relatively low, in part because banks have historically achieved significant recoveries from collateral. Finally, the system is rather liquid, with liquid assets covering 63 percent of short-term liabilities.

Box 2. Regional Presence of Mauritian Banks

The two largest Mauritian banks (MCB and SBM) are committed to a regional expansion strategy. Their good profitability and efficiency in the local market provides a sound base to venture abroad, and both have already publicized plans to invest in further regional expansion. The attractiveness of regional expansion is two-fold. It may be easier to achieve growth in less developed countries in the region than in the mature domestic market, and perhaps more important, operations abroad provide a potential for diversification away from the risks inherent in the small and highly concentrated home market. There are, however, risks and limitations to the Mauritian banks' international expansion strategy.

As MCB and SBM look beyond Mauritius, their small size limits expansion options. Global operations are clearly beyond their scope, but selected regional investments can be attractive. SBM currently has three branches in India (Mumbai, Chennai, and Hyderabad) and a license for a fourth branch (Bangalore). In January 1998, SBM established a wholly owned subsidiary in Madagascar (Banque SBM Madagascar), selling a 20 percent stake to Nedcor of South Africa in November 1999. In another joint venture, SBM Nedcor Holdings, together with Banque National de Paris, has acquired a 75 percent stake in the Finance Corporation of Malawi. MCB has an 89 percent stake in Banque Francaise Commerciale Ocean Indien (BFCOI), which has operations in Reunion (nine branches), the Seychelles (four branches), Mayotte (three branches), and Paris. MCB also has a 77 percent ownership share of Union Commercial Bank of Madagascar, with Standard Bank Investment Corporation Ltd and local investors each holding 10 percent. Finally, MCB owns 76 percent of Union Commercial Bank of Mozambique.

About one-third of MCB's assets and earnings are attributable to its activities outside Mauritius (table below). SBM has less than 10 percent of its assets outside Mauritius, but the percentage of non-interest income earned abroad is 16.4 percent, reflecting the focus on trade finance, foreign exchange and treasury services of SBM's international business. SBM does very little retail banking outside Mauritius. By contrast, BFCOI, which accounts for around 30 percent of MCB group business (close to 90 percent of all international activity), has a significant retail banking presence in Mayotte, Reunion and the Seychelles.

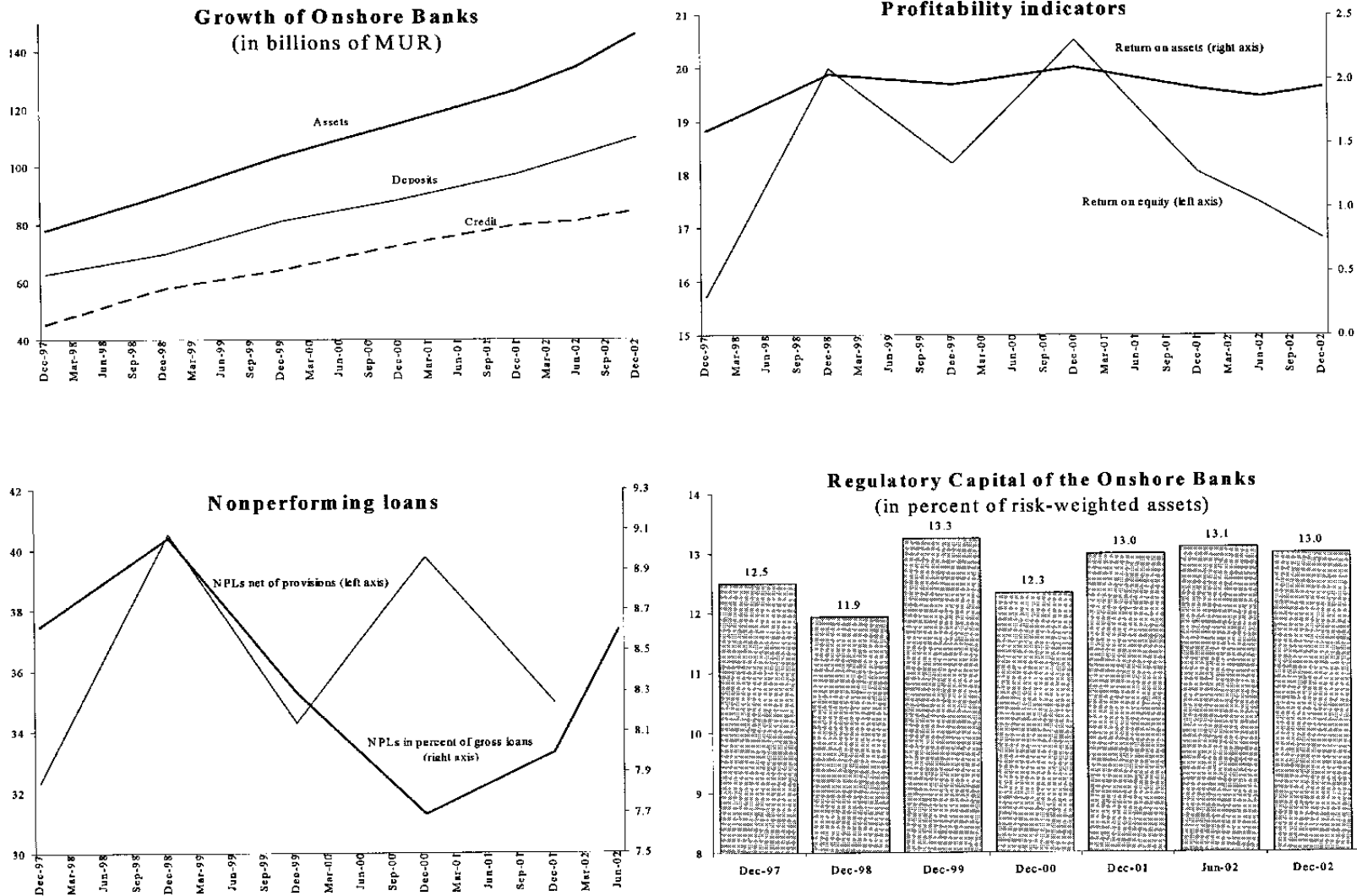
MCB and SBM Groups Domestic and International Segments, 2002
(Percent of total)

	MCB		SBM	
	Domestic	International	Domestic	International
Interest income	74.4	25.6	89.7	10.3
Non-interest income	62.3	37.7	83.6	16.4
Total assets	67.4	32.6	90.8	9.2

While foreign expansion offers the benefit of risk diversification, it also brings additional exposures. Credit risk management in international operations is complicated by country risk exposure, as demonstrated when both MCB and SBM had to increase provisions due to unrest in Madagascar. Perhaps more importantly, when venturing abroad Mauritian management loses one of the benefits of operating in small and highly concentrated markets, an innate knowledge of their clients and local economy. While MCB enjoys this same advantage in the small islands where BFCOI operates, it is unlikely to be replicated in other international ventures at this initial stage. Even with the best technical credit analysis, the Mauritian banks may have difficulty—in the short run—matching the credit quality of their domestic operations. A further consideration is that losses on nonperforming loans in Mauritius have been mitigated by generally favorable, if slow, recoveries on collateral. When venturing into jurisdictions with a less well developed rule of law, the Mauritian banks may find that recoveries on collateral are less able to compensate for errors in credit analysis.

Sources: Moody's Investor Services, *Mauritius Banking System Outlook*, August 2002; MCB and SBM 2002 annual reports.

Figure 1. Mauritius :Selected Indicators of the Onshore Banking System



Source: Bank of Mauritius.

Table 3. Mauritius: Financial Soundness Indicators for the Banking Sector, 1997–2001
(In percent, unless otherwise indicated)

	Dec. 1997	Dec. 1998	Dec. 1999	Dec. 2000	Dec. 2001	Dec. 2002
Capital adequacy						
Regulatory capital to risk-weighted assets 1/ *	12.5	11.9	13.3	12.3	13.0	13.0
Regulatory Tier I capital to risk-weighted assets 2/ *	12.1	11.8	12.6	12.5	12.7	13.7
Total (regulatory) capital to total assets	7.2	7.1	8.1	7.8	8.4	9.0
Asset composition and quality						
Share of loans (exposures) per risk weight (RW) category						
RW=0%	4.2	4.5	5.6	6.3	6.3	7.8
RW=20%	2.9	5.0	2.5	4.2	1.2	1.9
RW=50%	8.8	10.0	10.0	8.9	8.2	6.8
RW=100%	84.1	80.5	82.0	80.5	84.3	83.5
Total exposures/total assets	49.8	53.9	54.3	56.5	58.9	61.8
Sectoral distribution of loans to total loans 3/						
Agriculture	8.6	7.8	6.7	8.6	8.3	9.8
<i>of which: sugar</i>	7.1	6.7	5.8	7.7	6.5	7.9
Manufacturing	23.9	22.8	20.1	19.6	18.2	16.1
<i>of which: export enterprise certificate holders</i>	13.8	13.2	10.9	10.7	10.8	8.6
Traders	19.3	19.9	18.6	15.8	14.1	14.3
Personal and professional	13.7	13.1	13.3	12.3	9.5	9.1
Construction	16.0	17.7	18.7	16.9	14.2	13.7
<i>of which: housing</i>	10.3	12.2	12.8	11.6	8.7	8.5
Tourism/hotels 4/	4.0	4.4	7.3	8.3	14.1	17.2
Other	14.5	14.4	15.3	18.5	21.6	19.8
FX loans to total loans	8.3	12.6	10.1	12.7	13.9	14.1
NPLs to gross loans—excluding accrued/unpaid interest 5/	8.6	9.1	8.3	7.7	8.0	8.6
NPLs net of provisions to capital*	32.3	40.5	34.3	39.8	35.0	...
Large exposures to capital*	143.2	212.4	248.6	197.8	256.6	251.4
Earnings and profitability 6/						
ROA(pre-tax net income/average assets)*	2.0	2.4	2.2	2.3	2.2	2.3
ROE(pre-tax net income/average equity)*	19.9	23.9	20.7	22.1	20.6	22.0
Interest margin to gross income*	29.7	28.3	27.4	27.2	30.6	33.3
Noninterest expenses to gross income*	23.5	22.3	20.8	20.6	21.2	23.2
Expenses/revenues	11.1	10.5	10.3	9.9	10.5	10.8
Earnings/employee—in Rs 000s	...	1,371	1,401	1,718	1,752	1,828
Liquidity						
Liquid assets to total assets*	36.8	28.4	31.2	28.5	29.2	32.7
Liquid assets to total short-term liabilities*	85.1	63.1	73.2	67.0	60.2	65.3
Funding volatility ratio	7.0	16.4	11.6	14.1	21.1	16.4
Demand deposits / Total liabilities	7.0	6.5	6.0	6.1	10.9	10.3
FX deposits to total deposits	8.5	9.6	11.3	12.1	12.1	11.7
Sensitivity to market risk						
Net open positions in FX to capital*	5.8	3.6	9.2	5.0	3.2	7.5

Source: Mauritian authorities and IMF/WB staff estimates.

1/ Total of Tier 1 and Tier 2 capital, less investments in subsidiaries and associated companies.

2/ Does not reflect deductions for investments in subsidiaries and associated companies.

3/ The sectoral classification was changed in 2001. An attempt has been made to make a time-consistent series, but the numbers from 2001 onwards may not refer to the exact same industries as those from before that date.

4/ Refers to hotels and hotel management certificate companies only up to 2000, entire tourism industry after that date.

5/ 2002 data refer to June-2002.

6/ 2002 data refer to the January-June 2002 period.

* Part of the core set of financial soundness indicators.

III. VULNERABILITIES FACING THE FINANCIAL SYSTEM

17. **The analysis of the financial system in Mauritius reveals three main sources of potential risks and vulnerabilities.** The most important is the vulnerability of the banking system to external economic shocks and a downturn in economic activity. The second (much smaller) risk arises from any tarnishing of Mauritius' reputation as an offshore center from possible money laundering or criminal activities by some offshore funds or companies, or adverse developments in tax treaties. However, given that the offshore financial sector's contribution to Mauritius' GDP is small, even a major downturn in this sector is unlikely to have significant repercussions for the rest of the economy. The third vulnerability emanates from the roll-over risk due to the relatively short maturity structure of government debt.

18. **Insurance companies and pension funds currently do not present major systemic risks.** The tradition of prudent management and adherence to internationally accepted accounting and actuarial standards, at least by the larger institutions, has compensated for a generally weak supervision historically. Insurance supervision has been strengthened since the creation of the Financial Services Commission. Both insurance companies and pension funds suffer from a large duration mismatch of their assets and liabilities and could be vulnerable to a large and persistent decline in interest rates.

A. Vulnerabilities in the Domestic Banking Sector

19. **The key sources of vulnerability emanate from the underlying structure of the banking system, namely:** (i) a highly concentrated structure, with two domestically owned banks dominating the system; (ii) a very high concentration of credit, with a handful of conglomerate borrowers having the potential to exhaust the capital base of the banking system; and (iii) a relatively high sectoral concentration of credit, with sugar, textile, and tourism accounting for some 40 percent of loans. As a result, a prolonged downturn in economic activity in the key sectors (sugar, textiles, and tourism) where the bank risk exposure is important is likely to weaken the quality of the banks' portfolio and potentially threaten the stability of the system.

20. **Thus, credit risk is by far the most important risk facing the banking system, as also confirmed by the stress test results (Box 3).** Banks' vulnerability to credit risk is exacerbated by the extent of their lending to highly-leveraged firms, and by the low level of provisioning. Total bank lending to highly-leveraged firms is estimated (with a debt-to-equity ratio of greater than two) to represent over half of the total bank credit to the private sector. In addition, over 75 percent of bank debt in these firms is of the short-term variety, which suggests considerable vulnerability of these borrowers to a downturn in economic activity or

Box 3. Stress Testing

The FSAP mission conducted stress tests to investigate the soundness of the onshore banks in Mauritius. The tests encompassed standard tests for liquidity risk, interest rate risk, and exchange rate risk, as well as a detailed analysis of credit risk and brief tests of margin risk and equity price risk. Liquidity risk was modeled as a run on deposits, affecting different types of deposits differently. The test for interest rate risk was limited to changes in the value of the banks' portfolios of fixed-rate securities. The tests for foreign exchange risk covered both Mauritius-specific exchange rate shocks, in which the value of the rupee changes vis-à-vis the world's other currencies, and cross-exchange rate shocks in the euro/U.S. dollar rate. For credit risk, the analysis included both overall portfolio shocks and sector-specific shocks, each of which was modeled to have up to four components: an increase in nonperforming loans, the application of a transformation matrix to the classification of the loan portfolios, a change in the value of collateral, and a change in provisioning rates. The test for equity price risk was limited to a percentage reduction in the book value of equity held as assets, while the one for margin risk estimated the effect of a change in the banks' interest spreads on their profitability indicators. Combination scenarios were made of those shocks that result in a charge to capital, and liquidity shocks were included in some of those scenarios on the basis of assumptions regarding their likely impact on interest rates.

The tests indicated that credit risk is the main risk facing the Mauritian banking system, although the high levels of capital and profits of the system, provide a comfortable buffer against high-probability shocks. Nevertheless, the system is vulnerable to more severe admittedly lower-probability shocks to the loan portfolios arising from sector- or economy-wide downturns and to (concomitant) reduction in the value of collateral that could be brought about by such a shock or by the ensuing large-scale liquidation of collateral. The smaller banks are naturally more susceptible to credit risks. The tests also showed that, among the major sectors of the economy, manufacturing is the one that presents the highest risks to the financial system and to individual banks, substantially more so than tourism and agriculture.

Mauritius—Stress Tests for Credit Risk

<i>Increase in NPLs (%)</i>	<i>Decrease in the value of collateral (in %)</i>			
	0	20	40	60
0	13.4	12.8	12.1	11.5
100	12.0	10.7	9.3	7.9
200	10.7	8.6	6.5	4.3
300	9.4	6.7	3.7	0.6

Source: IMF staff calculations on the basis of BOM data for June-2002.

The table shows the post-shock CAR of the onshore banking system as a function of the changes in the value of collateral and increases in NPLs.

While the banks could, in principle, be vulnerable to a run on their deposits, liquidity risk is in practice curtailed by the low level of demand deposits, by the banks' substantial holdings of liquid assets, and by the observed stability of deposits in Mauritius. As of June 2002, banks did not seem to be directly exposed to foreign exchange risk, although they could be indirectly affected by changes in the euro/U.S. dollar exchange rate. Direct interest rate risk is limited, but the banks are indirectly exposed to a rise in interest rates, through the impact such a rise could have on the cash flows of their borrowers. Mauritian banks are somewhat vulnerable to a reduction in their interest margin and, to an almost negligible degree, to equity price risk.

an unexpected increase in interest rates (Box 4).⁶ Nevertheless, the stress test results showed that it would require a very substantial increase in nonperforming loans for the capital adequacy ratio of the major banks to fall below critical levels.

Box 4. Corporate Leverage

An analysis conducted by the FSAP team on the basis of statistics on some 7,125 non-financial firms obtained from the Registrar of companies indicates:

- **The overall corporate leverage in Mauritius does not appear to be very high by international standards.** The average debt-to-asset ratio of corporations was 0.55, including shareholder loans as debt, and excluding them it was 0.45.
- **Over 2/5 of the firms are found to be highly leveraged with debt-to-asset ratio of 0.66 (i.e., a debt/equity ratio, or leverage, of over 2).** Firms with higher leverage include medium-sized firms (with turnover of between MUR 10-80 million) and manufacturing, services, and trade firms.
- **Commercial banks have significant exposure to the highly leveraged firms.** About MUR 40 billion, or over half of bank loans, are extended to highly leveraged firms. As is typical of bank loans, 75 percent of bank lending to these firms is also short term, which may accentuate the vulnerability of these firms to a decline in revenue or a rise in interest rates.

21. **By comparison, banks face relatively small direct exchange rate and interest rate risks due to sound regulation of foreign exchange exposure, well-matched currency books and largely variable interest rates on lending and deposit-taking.** The interest rate risk they face is related to exposure to the public sector, with investments in government securities accounting at end-June for 17 percent of the banking system's total assets and rapidly rising.⁷ The banks face only moderate and manageable liquidity and equity price risks, and moderate indirect credit risks as a result of their borrowers' exposure to exchange rate movements and increasing interest rates. This exchange rate exposure is partially a result of borrowing in foreign exchange, but also and primarily of the mismatch in the economy between an exchange rate (and cost base) that broadly follows the U.S. dollar and export markets that are primarily euro-based. While precise information on corporate foreign exchange hedging practices is unavailable, banks and foreign exchange borrowers appear to be aware of the need for borrowers to hedge their currency risks through export revenues.

⁶Over 3,000 firms (out of a total of 7,125) report a debt-to-assets ratio of over 0.66. The total debt of these firms amounts to MUR 57 billion, with about MUR 45 billion of this estimated to be bank loans.

⁷The share of government securities in total assets of the banking system has increased to close to 20 percent at end-2002 from about 14 percent at end-2001.

Finally, the revelation in February 2003 that a senior staff member of the MCB was able to embezzle MUR 600 million in deposits of the National Pension Fund over a period of more than five years, indicates that operational risks in Mauritius can be significant.⁸

22. Mitigating these risks to the banking system would require action on several fronts within a well-designed policy framework. The pursuit of appropriate macroeconomic and financial policies is the best safeguard for the soundness of the financial system. Beyond that, the strategy requires a multifaceted approach, including: (i) continuing the strengthening of banking supervision; and encouraging banks to strengthen internal audit and control systems; (ii) fostering the development of alternatives to bank lending to reduce portfolio concentrations and increase competition; (iii) encouraging international risk diversification (iv) strengthening provisioning levels so as to enhance the capacity of the system to weather a downturn; and (v) reducing the government's implicit contingent liability in the banking system.

Strengthening banking sector regulation and supervision

23. The government has adopted a prudent and phased approach to putting in place an appropriate regulatory and supervisory framework for Mauritius. The first phase of regulatory reform was the creation of a unified regulator for the nonbank financial sector. It was decided at the time of the creation of the FSC that a review would be conducted in three years to determine whether to merge the Bank of Mauritius and FSC into a single unified regulatory authority for the financial services sector in Mauritius, in light of both domestic and international developments. The FSC currently faces a significant organizational challenge in integrating the former insurance and securities commissions, and the offshore business, and, while a great deal has been achieved in its first year of operation, much remains to be done to bring the supervision of the nonbank and the global business in line with international standards. The mission welcomes the government's decision to review the decision on further integration once the authorities are satisfied that both the BOM and FSC have brought their supervision closer to international standards and achieved a high level of credibility in the market place. In the interim, the two institutions need to focus their attention on the challenges they face in strengthening their staff and improving oversight over the financial system. In making a final decision on the supervisory regime for the financial sector, it is important, among other considerations, to ensure that the effectiveness of banking supervision is not undermined in any way and the BOM is neither distracted nor handicapped in conducting monetary and exchange rate policy and in implementing its mandate of maintaining price stability.

⁸In a press release, MCB estimated the loss at about 9 percent of its capital and 60 percent of its estimated FY2003 profits.

24. **Great strides have been made in strengthening banking sector regulation and supervision, but further progress is required.** This is especially the case in strengthening the legal framework, developing needed regulations, and further enhancing implementation (Box 5).

Fostering the development of alternatives to bank lending

25. **Developing alternatives to bank intermediation is necessary both to promote stability, and to foster competition and innovation.** The availability of diversified sources of funding allows financial intermediation to be maintained during periods of stress. In countries where banks dominate financial intermediation (e.g., Japan and Thailand), recent banking crises have had much more pronounced and longer-term repercussions on economic activity than in countries which have more diversified financial systems (e.g., the United States and Sweden). While Mauritius has developed a sizeable contractual savings industry, the securities markets are surprisingly underdeveloped. Development of an active government and corporate debt market, in particular, is needed. In this regard, tax disincentives to the development of the corporate bond market should be removed. A corporate debt market would provide companies with an important alternative to bank finance; offer leasing and other nonbank financial institutions an important alternative to deposit-based funding, and would provide institutional investors with much needed longer-term investment instruments.

Encouraging international risk diversification

26. **An increased market share of strong foreign banks would help mitigate the risks.** Currently, foreign banks account for 28 percent of total deposits, and there is evidence of their appetite for enhanced market share. Since the introduction of the credit concentration limits in May 2000, the two large domestic banks are increasingly constrained and competition among banks has increased as the large foreign banks have gained market share. Larger and stronger borrowers that can hedge foreign exchange exposure, and which represent very large exposures for the domestic banks, should also consider looking overseas to meet some of their borrowing requirements.

27. **The two largest domestic banks in Mauritius, aware of their limited prospects for growth in the domestic economy, have branched out in the region, thus contributing to risk diversification, and increasing their potential to become significant regional players.** In order to ensure that this international expansion leads to a welcome and sound diversification of risks that would indeed reduce the overall risk profile of banks, close monitoring by the BOM of this expansion is required (Box 2 above).

Box 5. Banking Regulation and Supervision

The quality of banking supervision in Mauritius has significantly improved over the past several years and is of a generally higher standard than in most African countries. Prudential guidelines reflecting international best practices have been introduced, and the capacity of the BOM to enforce the guidelines has improved with the development of knowledge and skills within the banking supervision department. However, the banking and central bank legislation are dated and in need of revision, resulting in a number of deficiencies in the legal framework for banking supervision. Also, further improvements are needed in the regulation and practice of banking supervision.

Legislation: In the legal area, priority should be accorded to amending the Bank of Mauritius Act and the Banking Act to:¹ (i) enhance the independence of the BOM; (ii) provide a clearer legal basis for regulations or guidelines; (iii) provide additional powers to the BOM to deal with problem banks; (iii) focus the objective of the BOM; (iv) strengthen transparency; and (v) clarify provisions regarding information sharing.

Regulation: Over the past two years, the BOM has introduced a number of welcome regulations and guidelines. It should build on the strong foundation provided by the guidelines already in force by promulgating additional prudential guidelines, including on country and market risk and credit policy.

Practice of supervision: The practice of banking supervision, while already of a good standard, should be enhanced. Areas in need of strengthening include: (i) consolidated supervision; (ii) on-site and off-site examinations; (iii) enforcement of prudential rules and guidelines; (iv) problem bank resolution; and (v) the supervision of operational risk management.

- **Introduce effective consolidated supervision:** On the domestic level, there is a need to build on the recent Memorandum of Understanding (MOU) between the BOM and FSC to establish formal and working level information exchange between them, agreement on lead supervisory roles, division of responsibilities, and coordination mechanisms. Internationally, the BOM needs to further enhance its contacts with foreign supervisors in countries where Mauritian banks have establishments.
- **Strengthen on-site examinations** through more forceful recommendations and follow-up.
- **Enhance off-site analysis**, including implementation of a systematic risk assessment using the CAMELS methodology or a similar framework.
- **Expand on internal guidelines and procedures** to assist in training and development of junior staff and ensure consistency in application.
- **Strengthen human resources** by filling vacant senior positions.
- **Improve problem bank resolution.** While it is to the credit of the BOM that insolvent banks have been addressed, the authorities should seek to ensure orderly exit for weak banks rather than preserve them, thus laying the foundation for future problems. Deposit insurance to protect the majority of small depositors could assist in reaching resolutions such as asset sales or orderly wind-ups as alternatives to bail-outs, ultimately contributing to a more efficient and competitive banking sector.
- **Strengthening the supervision of operational risk management.** The MCB/ National Pension Fund scandal underscores the need for the BOM to closely monitor operational risk management by banks.

1/ Most legal deficiencies would be addressed if the current drafts of the new Banking Bill and Bank of Mauritius Act were adopted.

28. **Banks should also explore alternative means of portfolio diversification, such as securitized asset sales and credit derivatives.** These instruments could be used both domestically and possibly internationally, and would provide an additional, less costly, means for banks to lay off risk and reduce sectoral and loan concentrations. While most domestic financing is too small to be of interest to international banks or investors, there might be a market for securitized, pooled risks. However, this will also require building up BOM's capacity to effectively supervise these types of activities.

Strengthening of provisioning

29. **The level of provisioning, while adequate by historical standards, might be insufficient to deal with a severe or prolonged economic slowdown.** Most of the banks report a capital adequacy ratio (CAR) in excess of the minimum, with a system-wide average CAR of 13.1 percent. Some banks hold significantly higher capital in recognition of the risks they are underwriting. At the same time, however, system-wide specific provisions to total NPLs amounted to less than 25 percent. This very low level is the direct result of allowing a full deduction of collateral. While this practice has not posed a risk to the system so far, as evidenced by a lack of direct charge-offs, the mission is concerned about the level of provisions in the system, especially in the context of a possible slowdown in the economy. Stress test results point clearly to the vulnerability of the system to credit risk in the context of a downturn in economic activity. It also reveals that given the size of the banking system's risk portfolio, a plausible erosion in the value of collateral could have significant adverse effects on the capital base, although banks report that they overcollateralize their loans.⁹ A number of measures can be considered in this area, including: (i) ensuring that collateral valuations are current and reasonable; (ii) ensuring that safety margins are built in for the valuation of different classes of collateral; (iii) raising the general provision gradually from the current level of 1 percent; and (iv) reviewing the tax treatment of provisions to eliminate any disincentives.

Reducing government's contingent liability

30. **Mauritius has no deposit insurance, but there is a general perception, based on past government behavior, that there is an implicit blanket guarantee for depositors.** In view of the large size of the deposit base compared to GDP (72 percent of GDP), this implicit contingent liability is quite high and may be unmanageable. MCB and SBM are widely considered "too big to fail" by depositors, and implicit insurance exists in a number of financial institutions with public sector ownership, including Development Bank of Mauritius (DBM), Mauritius Housing Company Limited (MHCL), and the Post Office

⁹However, the value of most collateral, in particular land, is linked significantly to the fortunes of the industries whose borrowing they secure (in the case of land, notably the sugar industry). As a result, sectoral shocks risk affecting companies' ability to service their debts and the value of the collateral related to those debts.

Savings Bank (POSB). In past cases of bank resolution, depositors did not suffer losses. In the 1995 liquidation of Mauritius Cooperative Bank, the BOM advanced funds to ensure all depositors were repaid. The authorities have examined the merits of the introduction of a formal limited deposit insurance scheme, with a judicious level of insurance to cover a significant portion of small depositors. Based on international experience, the introduction of such a scheme should be contingent upon further strengthening of supervision, the adoption of a more forceful prompt corrective action plan by the BOM, and a withdrawal of the government from direct involvement in depository institutions. Should the authorities decide to introduce deposit insurance, they will need to ensure that the design incorporates best practice in order to obtain the expected benefits in dealing with problem banks, and to mitigate potential adverse effects. To be credible and avoid the problems of cross subsidization and adverse selection, moreover, such a deposit insurance scheme would have to be mandatory, properly priced, and the political will to impose losses on uninsured depositors must exist.

31. The government could reduce the risks to taxpayers by further divestment of public sector ownership in depository institutions. It is important that government involvement in First City Bank (FCB) and New Cooperative Bank (NCB) is temporary in nature. The rationale of continued public sector ownership of DBM, MHCL, and POSB should also be reviewed, with the view of reducing the moral hazard resulting from the perception of an implicit blanket guarantee.

32. The provision of subsidized credit through the BOM should be discontinued. BOM has been used as a vehicle to subsidize credit to the sugar industry, to export promotion zone (EPZ) companies with significant euro/dollar exchange risk, to the Delphis Bank to finance the bailout of the failed Union International Bank, and to leasing companies. These facilities were in various ways secured by government of Mauritius (GOM) guarantees or treasury securities. The mission welcomes the intention of the authorities to phase out these subsidies and urges the BOM to terminate the practice of providing subsidized loans, since such quasi-fiscal operations undermine the credibility of the central bank.

B. Financial Vulnerability and Offshore Financial Business

33. Mauritius has developed a substantial offshore financial sector over the past decade. A large offshore banking system is accompanied by a large number of offshore funds, captive insurance companies, and global business companies engaged in nonfinancial activities. The offshore business segment is very active with 76 management companies offering services to more than 20,000 offshore companies (Box 6).

34. The offshore banking sector has grown rapidly, from seven institutions with assets of \$ 913.8 million (22 percent of GDP) at end-1997, to 14 institutions with assets of \$4.14 billion (94 percent of GDP) at end-September 2002. This corresponds to an average annual growth rate of 54 percent, although this rate has declined significantly in the past two

Box 6. Offshore Financial Sector in Mauritius

Foundations. Mauritius joined the ranks of offshore financial centers in 1988, when offshore banks were first permitted. Offshore businesses are attracted to Mauritius by a variety of factors: a very low tax environment supported by 26 double tax avoidance treaties; a package of modern business-friendly legislation for global financial and non-financial activities; macroeconomic policies favoring open trade, open capital flows and exchange convertibility; and good communications, low wages, bilingual skills of Mauritians and advantages of location.

Composition and size. The offshore financial sector included 14 banks, 11 captive and 4 non-captive insurers (in early 2003), and 221 offshore funds (June 2002). In addition, there were 19,349 Global Business License (GBL) companies (in June 2002), mostly engaged in non-financial services or personal/family trusts. Offshore financial activities are large relative to both GDP and similar domestic activities. Offshore bank assets amounted to 94 percent of GDP in June 2002, marginally smaller than the assets of onshore banks; offshore insurance premia were 4.3 percent of GDP in 2001 and comparable to domestic premia; and offshore mutual funds managed assets of \$6.7 billion, about 1.5 times GDP, while the domestic mutual funds' assets were relatively small.

Domestic and global relevance. All offshore businesses can deal only with nonresidents and in foreign exchange, with the exception of offshore ("Category 2") banks that can deal with residents but not in Mauritian Rupees. This restriction and the generally wholesale nature of the offshore financial business have implied a relatively small impact of offshore activities on employment and the level of economic activity. For example, offshore banks employed 168 persons in 2002, compared to about 3,500 in domestic banks, 17,000 in sugarcane and 72,000 in textiles. The share of the overall financial sector in GDP was 9.2 percent in 2002, and the share of the offshore sector (not published) is likely under 2 percent of GDP. But the offshore sector is the faster growing component of the overall financial sector, with indirect positive effects on telecommunications; development of financial, accounting, and legal skills; and retention of some skilled Mauritians who might otherwise emigrate. The contribution of the non-financial offshore companies is likely to be in the region of 0.5 percent of GDP. In offshore markets, Mauritius is still very small compared to Cayman Islands, Hong Kong, and Singapore and is expected to remain so for the foreseeable future.

Future prospects and challenges. As with other offshore centers globally, Mauritian offshore financial activities are founded primarily on favorable tax laws and absence of controls on capital flows and foreign exchange. The cost-efficiency considerations are important but secondary. Thus, relative changes in tax and regulatory regime could affect the growth of the offshore financial sector materially. Such developments are possible, though not imminent, in India and South Africa, the two most important markets for the Mauritian financial sector.

Over 70 percent of the offshore mutual funds' assets (some \$5.3 billion) are invested in India. There have been a few legal challenges in Indian courts essentially related to the argument that Mauritian tax vehicles may be abused by third country residents for tax-advantaged investments in India. While some of the challenges have been fairly broad (attempting to recover imputed back taxes, or challenging the validity of the tax treaty itself), they have not been successful so far nor has the Indian government sought to restrict or modify the treaty. But a significant narrowing or cancellation of the treaty would affect Mauritius adversely. Mauritius is guarding against these risks by (i) seeking to enter into treaties that follow good practices in avoiding the encouragement of "tax shopping;" (ii) defending legal challenges effectively; and (iii) negotiating treaties with other countries, including China.

Proposals by the South African authorities to tax world-wide income derived from South African sources may also affect a significant amount of the banking and insurance business driven by South African clients. Similarly, some of the offshore business motivated by exchange/capital controls in South Africa may diminish if these controls were relaxed.

years.¹⁰ Of these, five are branches of foreign banks, eight are subsidiaries of foreign banks, and one is a joint venture between a foreign bank and a domestic onshore bank. The offshore banking system is highly profitable, with an average return on assets consistently around 2.5 percent during the past three years and a return on equity in 2001/02 of close to 30 percent.

35. **There are very limited linkages between the offshore banks and the domestic economy.** Offshore banks are not allowed to operate in Mauritian rupees, but they can collect foreign currency-denominated deposits from residents and can lend in foreign currency to residents. Nonetheless, the offshore banks have focused on foreign markets, especially India and South Africa, and have limited their domestic operations to taking deposits from large depositors and to occasional large lending operations, mainly to public sector borrowers.¹¹ As a result, they do not have any significant retail activity in Mauritius and operate as wholesale banks. The banks finance themselves mainly through international interbank borrowing (37 percent of total funds), mostly within their own global financial group, and, increasingly, through deposits from nonbank customers (51 percent of total resources), often coming from the rest of the Global Business sector in Mauritius. Of the interbank borrowings, a small part (3 percent of the total) is from onshore banks in Mauritius. The offshore banks' main uses of funds are placements with banks abroad (60 percent of assets) and credit to nonbank borrowers (amounting to 34 percent of assets). Only 5 percent of their total credit is to resident borrowers in Mauritius. NPLs have been stable around half a percent of the total loan portfolio during the past three years.

36. **The offshore and captive insurance industry is relatively sound and does not pose a systemic risk.**¹² The licensing process for offshore companies is effective, and all the licensed companies are well-established firms of high standing and repute. Captive and offshore insurance companies do not deal with residents. They indirectly benefit the local insurance market through product innovation and improved risk management techniques. Their main risk lies in possible abuse of the facilities, which needs to be addressed by continued rigorous vetting for initial licensing.

37. **Both the benefits and potential vulnerabilities arising from the offshore sector are modest.** While the offshore industry confers important benefit in terms of global recognition, and development of world class financial, legal, accounting, and auditing skills, direct benefits in terms of economic growth and employment are modest. The offshore sector

¹⁰Two of the offshore banks came into operation in July 2002.

¹¹They maintain rather high thresholds below which they will not deal with customers.

¹²There are currently 11 licensed captive insurance companies, four noncaptive Category 2 global (insurance) business companies, four brokers, two reinsurers, and seven captive managers.

is vulnerable to significant changes in tax treaties. But given the effective separation of the offshore financial sector from the domestic economy, the very limited linkages between the onshore and offshore banks, and the relatively small contribution of the offshore sector to GDP, the sector does not necessarily create additional vulnerability to the domestic economy. However, the offshore environment in general and non-financial global business companies in particular are vulnerable to abuse from money laundering or terrorism financing purposes.¹³ As most of these non-financial companies were created at the time when Mauritius did not have a strong AML/CFT regime, these companies may have been set up without following AML/CFT due diligence. This potential vulnerability may create reputational risks for Mauritius. Mitigating these risks require the adoption of global regulatory standards, significant vigilance at entry stage, proper supervision of management companies, and periodic supervision of all offshore entities.

38. The authorities are aware of these risks, and have recently taken several major steps to mitigate them and align their prudential and AML/CFT framework with international standards. The measures taken include a program aimed at improving the supervision of management companies; increased vigilance by FSC in processing global business licenses by establishing more stringent criteria in line with international standards, strengthening on-site inspections, and, most recently, issuing new AML/CFT Codes covering insurance, securities and management companies, which are compliant with international norms and best practice.

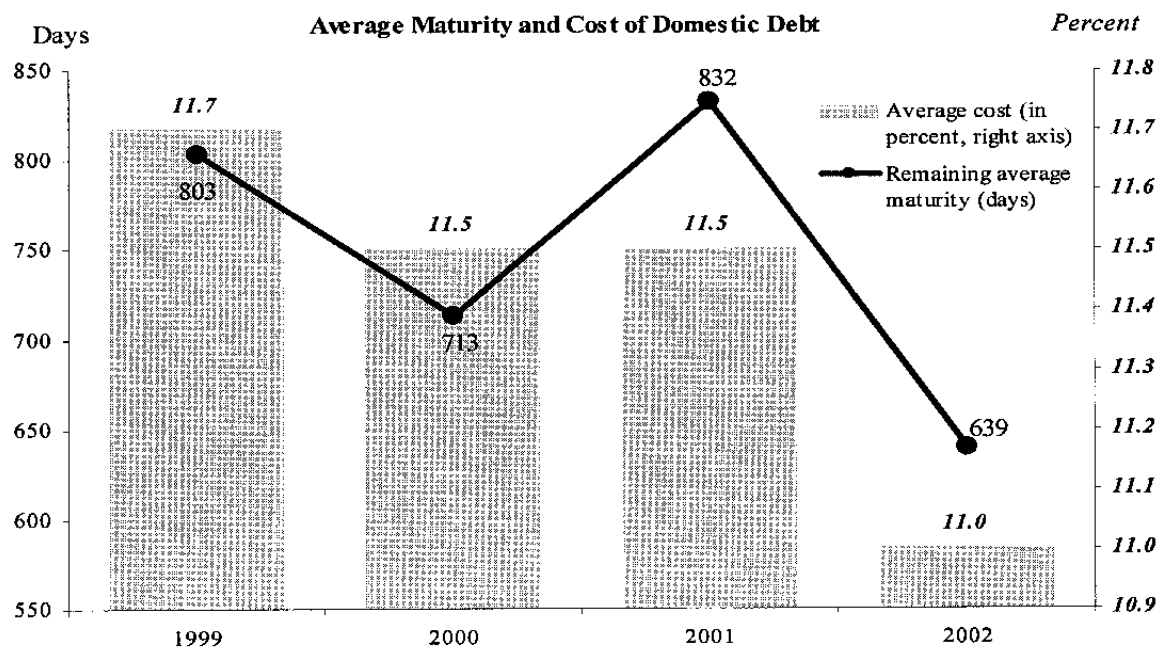
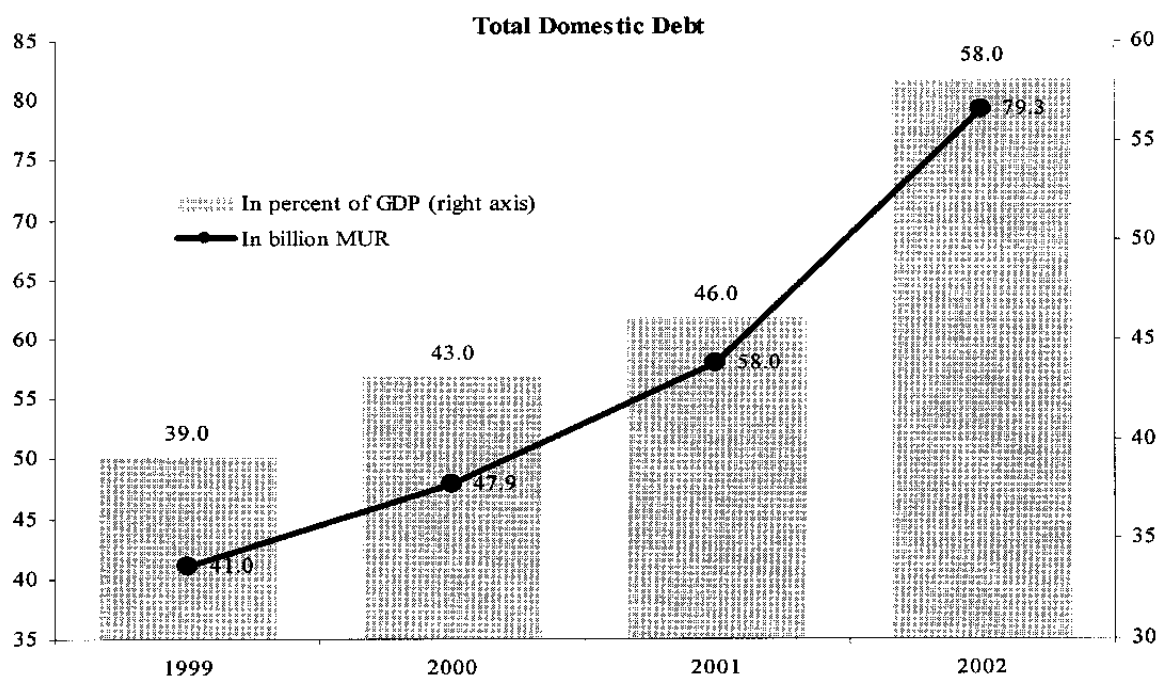
C. Issues in the Management of Domestic Debt

39. Mauritius has a moderately high and rising domestic debt. As of December 2002, total domestic debt amounted to about MUR 79.3 billion, equivalent to 58 percent of GDP (Table 4).¹⁴ The bulk of the domestic debt is in the form of treasury bills and is held by the commercial banks (40 percent) and institutional investors (51 percent). Nonresident holdings are very small, equivalent to 0.4 percent of total. Both domestic debt and debt/GDP ratios have risen rapidly in recent years, while the fiscal deficit, which stood at 5.9 percent of GDP in 2001/02, is expected to decline gradually to 2.6 percent in 2006/07 (Figure 2). The average

¹³The Global Business License 2 (GBL2) firms constitute the most significant source of potential AML/CFT risk to Mauritius. These companies have virtually no physical presence in Mauritius, and are inherently difficult to supervise and monitor closely. While most of these businesses may be legitimate, the license can easily be abused since many were created and licensed at the time when Mauritius did not have strong customer identification requirements in place. Stricter licensing requirements are now in place and monitored by the FSC.

¹⁴Total public debt is much higher and includes MUR 8.5 billion in external debt and a GOM-guaranteed parastatal debt of MUR 19.8 billion.

Figure 2. Mauritius: Selected Debt Indicators, 1999-2002



Source: Bank of Mauritius

maturity of domestic debt has been shortened significantly over the past several years, falling to an average of 639 days at end-2002 from an average of 802 days at end-1999, a fall of 20 percent. This rapid shortening in the maturity of the domestic debt is a source of concern.

40. **Significant improvements are needed in strategic and operational public debt management and the maturity of public debt needs to be increased.** The public debt management function is in its infancy and important improvements are needed in strategic planning and organization, the legislative framework, recognition of contingent liabilities, and the auctioning of public securities (Box 7). In particular, the GOM needs to extend the maturity structure to manage the significant rollover risk and to facilitate better risk management by institutional investors who have an unfulfilled demand for longer term securities.

Table 4. Mauritius: Domestic Debt, 1999-2002

	1999	2000	2001	2002
Total domestic debt stock	41.0	47.9	58.0	79.3
Increase in percent		17	21	37
In percent of GDP	39	43	46	58
Holders of domestic debt				
Bank of Mauritius	2.3	1.6	1.1	1.3
Commercial banks	16.8	16.7	21.8	31.3
Institutional investors	19.6	26.2	30.1	40.7
Others	2.1	3.2	4.5	5.6
Non-residents	0.3	0.2	0.4	0.4
Remaining maturity and cost				
Remaining average maturity (days)	802.9	712.9	832.0	639.3
Average cost (percent)	11.7	11.5	11.5	11.0

Source: Bank of Mauritius.

IV. DEVELOPMENTAL ISSUES

41. **Mauritius' domestic financial sector is comparatively well developed.** Mauritius belongs to a select group of developing countries where domestic bank assets represent approximately 100 percent of GDP, and contractual savings exceed 40 percent of GDP. The basic financial sector infrastructure, such as payment, securities trading and settlement systems is modern and efficient. Access to financial services is extremely high, with more than one bank account per capita and widespread branch banking and ATMs. Unlike in most developing countries, new and small firms do not face major constraints in accessing financial services and credit. In order to move to the next stage in financial sector development, however, Mauritius needs to further diversify its financial sector. While financial institutions are generally sound and profitable, the dominance of a few major players, and the concentration of risks within a narrow banking sector pose systemic risks and inhibit financial competition and innovation.

Box 7. Public Debt Management in Mauritius

Significant improvements are needed in the strategic planning, legal framework, organization, and management of public debt operations. As of December 2002, the debt management was still at an early stage of development. A primary dealer system was initiated in March 2002 and is being phased in. The key priorities in the area of debt management are as follows:

- The new **Debt Management Unit (DMU)**—established within MOF in October 2002—needs to be fully staffed. It needs to define a medium term debt management strategy to minimize risks and costs of public debt, and acquire capacity to implement operational decisions and guide the BOM as fiscal agent.
- The **current legislative framework** limits the GOM's borrowing authority for *long term* debt issuance under the Loans Act, without limiting *short-term or aggregate* debt issuance. Consistent with good international practice, it would be useful to define an annual ceiling on the aggregate debt stock, while removing restrictions on the desired maturity composition.
- There is a need to periodically take stock of all **contingent liabilities**, including guaranteed parastatal debt and implicit liabilities (for example, unfunded public sector pension liabilities) and consider funding them as needed.
- Several improvements are needed in the **auctioning of public securities** as detailed below.

The principal improvements needed in the treasury bill auction process are as follows:

- There is a **need to segregate issuance for GOM financing and monetary operations**. Currently, the treasury bill auctions serve dual purposes of funding GOM and mopping up excess liquidity, with the offer amount arrived at by adding up the GOM estimated financing needs to the BOM's estimate of excess liquidity. Due to high current systemic liquidity, the amount added for monetary tightening is large enough to cause frequent under-subscription, or apparent auction "failures," while leaving the treasury account at the BOM in a sizable surplus. Indeed, much of the recent rapid rise in public debt can be explained by a corresponding rise in GOM surplus at BOM. Funds raised for monetary policy operations are not placed in a "blocked" account, leaving scope for weaker fiscal discipline. The interest paid by the BOM on the surplus is lower than that paid by the GOM on treasury securities. The mission recommended and the authorities generally agreed that there is a need to separate monetary policy related issuance completely from GOM's issuance to the market, with proceeds placed in a blocked treasury account at the BOM, and actual interest payments received by the BOM credited back to treasury.
- **The auctions for different maturities need to be separated to achieve the desired maturity structure.** Currently, the 3-, 6-, 12- and 24-month bills are auctioned in one block, leaving the choice of the maturity structure to the market within the overall auction limit. Virtually all bids are accepted in undersubscribed auctions, and pro-rated across all four maturities in oversubscription auctions. Thus the market effectively dictates interest rates, maturities, and the repayment profile. At the same time, bidders are assured of a high probability of allotment as long as they align themselves near the previous week's yields. The system produces a stable interest rate, but not on an efficient price discovery mechanism nor a desired maturity structure.
- **Issuance frequency is too high and results in fragmentation of the outstanding stock.** There is a need to consolidate short-dated issuance with seasoned longer dated issues of comparable residual maturity.
- **There is little liquidity in the secondary market for treasury securities.** Possible explanations include the dominant share of the two banks and the small overall size of the interbank market, the high level of liquidity across the banking system, the large share of short-term securities in total issuance, weekly issuance calendar, and excess demand for longer-term securities, which make most institutional investors follow a "buy and hold" strategy. A shift toward longer-dated issuance, more consolidation of new and seasoned issues, and less frequent issuance should help promote greater liquidity in the secondary market.

42. A number of obstacles to diversification and growth need to be addressed:

- **The short-term money market, the foreign exchange market, and the treasury bill markets are relatively underdeveloped.** This makes it difficult for banks and other financial institutions to manage and allocate risks efficiently. This deficiency also represents a serious obstacle to the development of more sophisticated financial instruments that would enable Mauritian companies to efficiently hedge risks. The Mauritian authorities need to address a number of issues identified in the Treasury bill auction process and pursue efforts to stimulate more efficient money and foreign exchange markets.
- **The longer-term government and corporate bond markets are also underdeveloped.** This is paradoxical given the strong and rising demand for longer-term assets from contractual savings institutions, the need for the GOM to extend the maturity profile of public debt, and the excessive risk concentration of the banking sector on a few large corporate borrowers. To encourage the development of these markets, the government needs to harmonize the tax treatment of interest income on financial instruments, eliminating the current disincentives to hold corporate securities and to establish a yield curve through regular issuance of bonds and a more active secondary market. Strict enforcement of recent prudential requirements for banks regarding large exposures and related party lending should also foster the development of corporate securities.
- **While the institutional, legal, and technical infrastructure of the stock exchange (SEM) is highly developed, new issuance and trading volumes are low, and recent performance has been disappointing.** The SEM market capitalization declined to 19 percent of GDP in 2002 from 43 percent in 1997; the average price-to-earnings ratio fell from approximately 14 to 6 over the same period; and average turnover hovered around 5 percent, indicating that the market is small, even relative to the small economy. Many of the challenges facing the market fall outside the scope of government policy, including the small scale of the domestic market, the need for local investors to diversify internationally, the global bear market, and the withdrawal of foreign portfolio investment. However, the GOM can take certain policy measures to promote a more active capital market. Investor confidence can be enhanced by improved standards of disclosure and corporate governance, and by more effective regulation and supervision of market participants, which is particularly critical in a market where there is considerable overlapping ownership among issuers, traders and investors. The authorities' intention to introduce new legislation or measures enhancing corporate governance, accounting and auditing standards, and securities market regulation in 2003 are welcome developments. Measures to diversify the issuer base, including privatizations and greater regionalization, should also be pursued. Finally, the government should also review the role of government-sponsored funds, which may create distortions in the pricing of securities.

- **While the domestic insurance industry is well developed, and larger companies are efficient and financially strong, policies to promote a consolidation of the insurance industry would be advisable.** Total annual premiums amounted to MUR 5.3 billion in 2001 (4.1 percent of GDP) with life premiums representing 61 percent of total. The small insurance companies are preponderantly involved in motor insurance, an area that relies less on reinsurers' commissions. In addition, these smaller companies have higher administrative costs, inadequate capital, and poor accounting. Thus, several of the smaller companies—not systemically important—have weak financial ratios, and suffer long delays in settling claims, often forcing their customers to seek redress in court; four of them have been intervened recently and remedial action has been taken. Further consolidation should be promoted by raising the level of the minimum capital and introducing risk-based capital requirements.
- **Mauritius has a well-balanced multi-pillar pension system.** However, the Basic Retirement Pension (BRP) scheme faces issues of affordability, while the civil service and Central Electricity Board (CEB) pension schemes are effectively unfunded. Due to a rapidly aging population the cost of an unchanged BRP is projected to double by 2020. Under a reform program supported by the World Bank, the government is considering various options for containing the cost of this scheme. Increasing the entitlement age to 65 and applying an affluence test that would exclude high-income people would contain the projected cost to 3.2 percent of GDP by 2020. The financial situation of the CEB pension funds is currently complicated by the fact that the CEB is suffering losses, has accumulated a huge debt, and has plans under study for a major restructuring. The civil service pension scheme operates on an unfunded basis and suffers from a growing deficit. The government faces a critical policy decision regarding the establishment of an appropriate basis and level of funding in order to protect benefits from future budgetary pressures.
- **The development of independent non-deposit-taking lenders could increase competition, and lead to greater access to financing at lower rates.** Although both small and large firms seem able to access outside financing, rates remain relatively high and firms may have difficulties financing growth due to the widespread bank practice of taking "floating liens" that include all current and future business assets of the firm and personal assets of the owner. While leasing is already well-established in Mauritius, further development of NBFIs such as leasing, factoring, and venture capital companies can be facilitated by removal of tax policies that discourage the NBFIs' financing from bond markets. The establishment of a comprehensive credit information bureau would also assist banks and NBFIs, and the GOM's efforts in this direction are welcome.
- **While property rights are enforceable and respect for the rule of law is high, financial and commercial legislation needs be brought in line with modern practice in a number of key areas.** To this end, the government plans to introduce modern new legislation in banking, securities, insurance, accounting and auditing,

and corporate insolvency during the current legislative session. Authorities should also seek to address procedural weaknesses and inefficiencies in the judicial process in order to resolve unnecessary delays and ensure the business community retains respect for the courts as the primary dispute resolution mechanism.

V. ANTI-MONEY LAUNDERING ISSUES

43. **Overall the legal and institutional framework regarding the anti-money laundering and combating the financing of terrorism (AML/CFT) in Mauritius is being aligned with best practices.**¹⁵ The Mauritian authorities have made important progress in tackling AML/CFT issues and initiating the implementation of a comprehensive AML/CFT regime in the past three years. The recent efforts of the authorities are commendable and demonstrate strong political will and commitment to meeting international standards. The AML/CFT framework, however, will need additional strengthening in line with the recommendations made in Part II of this report to fully comply with the FATF 40 + 8 Recommendations.¹⁶ Technical assistance has been provided to the authorities and deficiencies are currently being addressed. Areas where further work are needed include: (i) modification to certain confidentiality provisions that appear to hamper the sharing of information on suspected money laundering cases between supervisory authorities and the FIU; (ii) the need to expand the scope and focus of AML/CFT reviews during onsite inspection of financial institutions in line with recently issued Guidance Notes and Codes; and, (iii) *better coordination of law enforcement efforts.*

44. **The Mauritian authorities are taking steps to remove ambiguities in the main AML/CFT laws with respect to the responsibilities of law enforcement authorities, working with a national AML/CFT committee representing relevant government agencies.** In addition, the Mauritian authorities are strengthening the AML/CFT legal framework by: (i) drafting a bill to implement the United Nations Convention for the Suppression of the Financing of Terrorism 1999; (ii) drafting a Mutual Assistance Bill and an Extradition Bill; and, (iii) further revising legislation which would strengthen the

¹⁵ A detailed assessment of Mauritian AML/CFT regime was conducted under the pilot program approved by the IMF/World Bank Board using the October 11, 2002 version of Methodology for Assessing Compliance with AML/CFT international standards that was endorsed by the Financial Action Task Force.

¹⁶ Part II of this paper includes summaries of the detailed assessments of the standards and codes conducted by the FSAP mission. They include the summary for Basle Core Principles for Effective Banking Supervision, the Payment System, Transparency of Monetary Policy, and Anti-Money Laundering and Combating the Financing of Terrorism.

enforceability of the BOM's Guidance Notes. Additional concrete steps taken recently by the authorities include: (i) providing training to supervisors in AML/CFT examination techniques and planning additional training in the future; (ii) establishing a National AML/CFT Committee to clarify the roles of supervisors and law enforcement agencies; and (iii) requesting a technical assistance to establish a task force to develop written procedures and guidelines for the investigation and prosecution of AML/CFT cases. Finally, the FIU has recently issued a standard form for reporting suspicious transactions and accompanying guidance notes to reporting parties and substantially increased its technical staff, staff training, the processing of suspicious transaction reports, and its information technology capacity. The FIU's application for membership in the Egmont Group is expected to be approved at the next plenary session in July, 2003.

PART II. SUMMARY ASSESSMENT OF OBSERVANCE OF STANDARDS AND CODES

- This section contains the summary assessments of the standards and codes that were carried out as part of the FSAP missions undertaken in October and December 2002. The standards assessed include: (1) the *Basel Core Principles for Effective Banking Supervision* (BCP); (2) *Committee on Payment and Settlement Systems Core Principles for Systemically Important Payment Systems* (CPSS); and (3) the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies* (MFP Transparency Code). These assessments provided input in formulating the overall assessment of financial stability, identifying areas for improvement and an action plan in areas of non-observance.
- The assessments were prepared by Messrs. Michael Andrews (IMF) and Kee Meng Lee (Monetary Authority of Singapore) for the Basel Core Principles for Effective Supervision; Mr. Tomáš Hládek (Czech National Bank) for the CPSS; Mr. Wim Fonteyne (IMF) for the Code of Good Practices on Transparency in Monetary Policy; and Ms. Nancy Rawlings (IMF), Mr. Alain Damais (World Bank), and Ms. Diana Wong (Hong Kong Security Bureau, Government Secretariat) for Anti-Money Laundering and Combating the Financing of Terrorism. The assessments were prepared on the basis of information provided by the Mauritian authorities, discussions with relevant officials and private sector representatives, and a review of relevant legislation, websites and other documentation.
- While Mauritius has made significant progress in building the foundation for a sound financial system and in aligning its supervisory and regulatory framework with internationally accepted standards, weaknesses identified in the assessments of observance of standards and codes relate mainly to the transitional state of the relevant institutions and legislation.

A. Basel Core Principles for Effective Banking Supervision

General

45. The assessment of implementation of the Basel Core Principles for Effective Banking Supervision has been completed as part of a Financial Sector Assessment Program. It requires a review of the legal framework, both in general and more specifically as related to the financial sector, and a detailed examination of the policies and practices of the institutions responsible for banking supervision. The assessment team¹⁷ received the full cooperation of its counterparts and received all information required.

Institutional setting

46. Bank supervision is the responsibility of the Bank of Mauritius (BOM), with the Financial Services Commission (FSC) being responsible for regulated nonbank activities. The FSC is newly established, and thus far has exhibited little coordination of routine supervision activities with respect to two large bank-based conglomerates, and one large

¹⁷Michael Andrews (MAE) and Kee Meng Lee (Monetary Authority of Singapore).

insurance-based conglomerate, which are among the most important financial institutions in Mauritius. The BOM and FSC recently entered into a formal memorandum of understanding, which now must be developed into a practical agreement on the roles of the respective supervisors in the oversight of financial conglomerates, the establishment of a regular flow of relevant information, and coordination of supervisory activities.

General preconditions for effective banking supervision

47. Financial sector infrastructure is well established in Mauritius, with a generally appropriate body of commercial law in place. While legal proceedings can take an extended time period to complete, Mauritius has generally benefited from a regime with a strong rule of law, despite some difficulties arising from the use of common law for contracts and the Napoleonic code for property rights. A savings and credit culture appears well established, with the total number of savings accounts held at domestic banks far exceeding the number of Mauritian residents. Mauritian accounting standards are based on IAS (International Accounting Standards), and the level of disclosure in the annual reports of the two large banks is of a high standard.

48. The BOM has a history of dealing decisively with problem banks, having revoked the licenses of three banks since 1995. Although no explicit deposit insurance scheme has been enacted, in each case depositors have not suffered losses. While this practice of orchestrating rescues to avoid losses to depositors may have contributed to maintaining confidence in the smaller domestic banks, it may also have had the effect of negating any potentially beneficial market discipline. The BOM should improve transparency with respect to supervisory intervention, providing full disclosure after the fact even if stability concerns preclude public disclosure at the time of intervention. This should include details of extraordinary financial support provided by the BOM, government, or government entities. The current draft of the new banking bill contemplates the subsequent introduction of a deposit insurance law, which could contribute to orderly exit as an alternative to rescues of weak banks.

Main findings

49. Improvement of the implementation of the Basel Core Principles requires changes in the legal framework for supervision as well as further enhancements in the practical application of the Principles. Most legal deficiencies would be addressed if the current drafts of the new banking bill and Bank of Mauritius Act were enacted.

50. For the most part, the quality of supervision is of a good standard, reflecting significant progress made in building the capacity of the BOM in recent years. However, there are a number of areas requiring further improvement. The most important of these would be developing measures to achieve effective consolidated supervision. The two largest banks are both part of financial conglomerates with nonbank affiliates in Mauritius and significant international operations. There is also a large insurance-based conglomerate. Effective information sharing and coordination between the BOM and FSC is vital to ensuring financial stability. International exposure of the two large banks is already

significant and likely to increase, making globally consolidated supervision also vital to the soundness of Mauritian institutions. A number of broad understandings have already been established with foreign supervisors, but there is scope to substantially increase the working level exchange of supervisory information with the authorities in jurisdictions where Mauritian banks have significant establishments.

51. Good prudential limits have been introduced for credit concentration and related parties exposure. It has been appropriate to provide a phase-in period and limited exemptions during this phase-in, but the BOM should as a general policy avoid permitting banks to exceed prudential rules.

52. Given the ongoing improvements in the practice of supervision and the expected early proclamation of revised banking and central banking acts, it would be worthwhile to reassess the implementation of the Basel Core Principles for Effective Banking Supervision. This should take place one to two years after the enactment of new legislation, allowing a period of time to gauge the practical implementation of the new laws.

Objectives, Autonomy, Powers, and Resources (CP 1)

53. The current legislation is dated and in need of revision. The guidelines issued by the BOM are of a generally good standard, and taken together with the legislation provide a reasonable foundation for effective supervision. The lack of a clear regulation-making authority in either the BOM Act or banking law raises the possibility that the guidelines might not be enforceable if subject to legal challenge. This problem would be addressed by the current draft of the new banking bill. While there is no evidence of political interference in banking supervision, legal provisions currently in force could impinge on the autonomy of the supervisor. The draft of the new banking bill would remove the provisions for appeal of decisions on licensing and remedial measures to the Prime Minister and/or Minister of Finance. The BOM Act currently does not provide fixed terms for senior officers of the BOM; however, it does provide for the Minister of Finance to direct the BOM to take, or avoid taking, specific actions. The draft of the new central bank law would provide greater legal independence by removing these provisions. The areas of concern with respect to information sharing (1.6) relate more to practical implementation rather than the legal framework. Enhanced information sharing with the FSC and foreign supervisors regarding routine supervisory activity is vital to achieving effective consolidated supervision.

Licensing and Structure (CPs 2–5)

54. Mauritius has a high level of compliance with these principles, and the contemplated revisions to the banking act would address most of the noted deficiencies.

Prudential Regulations and Requirements (CPs 6–15)

55. The BOM guidelines on corporate governance, internal control, and credit classification are all of a commendable standard, and the BOM's capacity to enforce

guidelines has substantially increased in recent years. The deficiencies with respect to these principles relate primarily to the need for additional guidelines to address areas such as country and market risks, and credit policy, and the need to enforce the new guidelines on credit concentration and related parties transactions. Subsequent to the completion of the field work for the assessment of the Basel Core Principles, the authorities have undertaken significant work to strengthen the legal framework for prevention of use of the banking sector by criminal elements. This has included the drafting of new guidance notes on anti-money laundering and combating the financing of terrorism for banks and cash dealers, which came into effect at end-April 2003. These guidelines incorporate the most recent developments in international standards, including the Basel Committee's guidance on customer due diligence. While the guidelines have been issued by the BOM, an enabling regulation pursuant to the FIAML Act is still required. New guidelines for examiners have also been developed to enhance the ability of the BOM to assess the internal policies of banks with respect to countering the use of the banking sector by criminal elements.

Methods of Ongoing Supervision (CPs16–20)

56. An appropriate structure of on-site and off-site supervision is in place, with some further improvements required to achieve full compliance with these principles. The quality of off-site supervision will be enhanced by the planned introduction of routine risk-assessment of banks using the CAMEL framework. Requiring “category two” banks to report on the same basis as “category one” banks is important in enhancing off-site supervision. The effectiveness of on-site examinations can be improved through more forceful recommendations and aggressive follow-up on serious deficiencies.

57. Consolidated supervision is a critical issue because of the importance of two large bank-based and one insurance-based financial groups. Specific requirements include coordination between the BOM and FSC to ensure that there are no lacuna in the oversight of regulated activities and to provide an understanding of risks and enforcement of prudential requirements on both a solo and group basis. While a number of broad information sharing agreements are in place internationally, the working level exchange of information with foreign supervisors should be enhanced.

Formal Powers of Supervisors (CP 22)

58. The BOM has demonstrated the ability to deal with problem banks using the existing legal framework. However, inclusion of conservatorship provisions and more specifically defined powers to issue cease and desist powers or compel specific actions, as contemplated in the draft of the new banking bill, will improve the legal framework. Prompt corrective action provisions could improve the resolution process for problem banks.

Home-Host Supervision (CPs 23–25)

59. The BOM should enhance its supervision of the foreign branches of Mauritian banks by establishing a formal framework for assessment of the risks of foreign activities, including

periodic on-site examinations outside Mauritius. Working level communication with foreign supervisors needs to be enhanced, especially with respect to the countries hosting the foreign operations of Mauritian banks. The reporting requirements for category two banks need to be made consistent with those of category one banks to ensure that the same standard of supervision applies to branches and subsidiaries of foreign banks as is applied to domestic banks.

Table 1. Recommended Actions to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
CP 1: Objectives, Autonomy, Powers and Resources.	<ul style="list-style-type: none"> • Establish a regulation-making authority to provide a legal foundation for guidelines. • Revise the legal framework to establish a fixed term of appointment for BOM senior officers. • Remove powers given to the minister to direct the supervisory authority to take or avoid specific actions. • Remove avenue of appeal to the prime minister on licensing and ownership decisions. • Ensure that the Development Bank of Mauritius and Mauritius Housing Company Limited, if accepting retail deposits, are subject to bank-like regulation. • Review staffing requirements. • Provide for additional powers to remove officers and directors and issue cease and desist orders. • Introduce protection for staff against legal action for actions taken in good faith in the performance of their official duties. • Establish efficient working level exchange of information with the FSC. • Increase the frequency of working level contact with foreign supervisors.
CP 3: Licensing Criteria.	<ul style="list-style-type: none"> • Document procedures and criteria for the review of a license application. • Expand the analysis of new banks' proposed operational procedures, policies and controls. • Develop more explicit requirements for determination of suitability, fitness and probity. • Over time, introduce a substantially higher minimum initial capital requirement.
CP 4: Ownership.	<ul style="list-style-type: none"> • Introduce a requirement for a "fit and proper" review of prospective owners of a 5 or 10 percent shareholding. • Amend the law to introduce a cease and desist order or a suspension of voting rights of shares of shareholders.
CP 6: Capital Adequacy.	<ul style="list-style-type: none"> • Obtain quarterly prudential reports on capital adequacy reports of category two banks .
CP 7: Credit Policies.	<ul style="list-style-type: none"> • Promulgate minimum requirements for sound credit and investment policies. • Implement quarterly reporting requirements for returns of nonperforming loans in category two banks.

Reference Principle	Recommended Action
CP 9: Large Exposure Limits.	<ul style="list-style-type: none"> • Introduce requirement that banks need to capture, consolidate, and monitor group exposures. • Obtain regular submission on concentration risk for category two banks.
CP 10: Connected Lending.	<ul style="list-style-type: none"> • Require all members of the Conduct Review Committee to be independent directors. • Require related party exposures to be collateralized or deducted from capital. • Obtain more frequent submissions of related party returns.
CP 11: Country Risk.	<ul style="list-style-type: none"> • Promulgate guidelines on country and transfer risk.
CP 12: Market Risks.	<ul style="list-style-type: none"> • Promulgate comprehensive market risk policies and procedures.
CP 13: Other Risks.	<ul style="list-style-type: none"> • Promulgate guidelines on other risks. • Over time, develop capital adequacy requirements taking into account operational risk as contemplated in Basel II.
CP 14: Internal Control and Audit.	<ul style="list-style-type: none"> • Require having only independent directors on the Audit Committee, Remuneration and Nomination Committees.
CP 15: Money Laundering.	<ul style="list-style-type: none"> • Conduct specific inspection on anti-money laundering activities to improve bank compliance with guidelines.
CP 16: On-site and Off-site Supervision.	<ul style="list-style-type: none"> • Perform systematic assessment of individual banks under the CAMEL framework. • Develop detailed supervision and examination manuals and compliance templates. • Make more forceful recommendations in inspection reports.
CP 18: Off-site Supervision.	<ul style="list-style-type: none"> • Obtain both individual and consolidated data for banking groups. • Introduce risk rating system (CAMEL). • Standardize prudential reporting requirements. • Increase use of computer systems.
CP 20: Consolidated Supervision.	<ul style="list-style-type: none"> • Establish prudential standards on a consolidated basis. • Enhance communication and cooperation with the FSC.
CP 22: Remedial Measures and Exit.	<ul style="list-style-type: none"> • Develop prompt correction action measures.
CP 23: Globally Consolidated Supervision.	<ul style="list-style-type: none"> • Develop specific supervisory guidelines and procedures for overseas operations. • Conduct periodic on-site inspections abroad.
CP 24: Host Country Supervision.	<ul style="list-style-type: none"> • Establish working level contacts with foreign supervisors.
CP 25: Supervision of Foreign Bank's Establishments.	<ul style="list-style-type: none"> • More regular communication with home country supervisors. • Standardize reporting requirements. • Undertake assessment of home country supervisors. • Share information of material interest.

Authorities' response

60. The authorities were in general agreement with the assessment, but expressed concern that in the case of some core principles, the process does not provide full recognition of the continuing efforts to strengthen supervision as also the fact that financial sector operators broadly viewed the regulators with awe and due respect. In some areas, such as those producing anti-money laundering guidance notes, work has essentially been done by the regulators but needs updating due to changing circumstances in the local legislation and at the global level. In these instances, the authorities considered certain assessments of "materially non-compliant" as too harsh, given the various practical improvements in financial sector supervision with a view to adhering to best international practices.

B. The CPSS Core Principles

General

61. During October 2002 a joint mission of the World Bank (Bank) and the International Monetary Fund (Fund) visited the Republic of Mauritius as part of the Financial Sector Assessment Program. One of the areas covered by the mission was that of payments, where an assessment of the stability, efficiency and soundness of systemically important payments activities was conducted and measured against the Core Principles for Systemically Important Payment Systems (CPSS). The primary purpose of this assessment was to identify any vulnerabilities to which the domestic payment systems may be susceptible, as well as to assess the potential systemic risks posed to the financial system by the payments systems. The assessment was made by Mr. Tomáš Hládek (Czech National Bank).

Institutional and market structure

62. Existing legislation confers on the BOM powers to promote, regulate, and organize the efficient and secure operation of payments and clearing systems. Payment systems and mechanisms have recently been upgraded, notably through the introduction of the real-time gross settlement system (RTGS) in 2000 and associated real-time cash management support functions required by the BOM, the Ministry of Finance (MOF), and commercial banks. This project, which was implemented with World Bank support, was designed to conform to international standards.

63. Common payment instruments in Mauritius include checks, credit cards, debit cards, and cash. The systematically important payment system used in Mauritius is the **Mauritius Automated Clearing and Settlement System (MACSS)**. The BOM also chairs the **Port Louis Clearing House (PLCH)**, an interbank clearing mechanism for checks, drafts, debit and credit vouchers, and other claims on member banks drawn in MUR and foreign exchange. This mechanism is still based on manual processing, with final settlement achieved through the MACSS. Electronic **payment cards** are widely used. The netting of these payments is provided by VISA, settlement is provided by the Mauritius Commercial Bank (MCB).

64. **Securities settlement.** The Central Depository & Settlement Co. Ltd. (CDS) provides its services via an on-line computer system. Trades are settled within a rolling T+3 settlement cycle on a strict DVP (delivery vs. payment) basis. Final settlement of the cash leg—transfer of funds—occurs through the MACSS on settlement day.

Main findings—summary

Legal foundation (CP I)

65. Today the “**zero hour rule**” still exists in Mauritius presenting a major problem regarding the recognition of the timing of payments of a bankrupt bank.¹⁸ The BOM, recognizing the potential difficulties created by the zero-hour rule has added a definition of real-time gross settlement to the MACSS contracts so as to circumvent such difficulties. The BOM staff believe that consistent with Mauritian legal standards, contractual provisions are upheld by the courts if not deemed to be against public policy and can be enforced like provisions of laws themselves. Thus, according to the BOM, the rules pertaining to MACSS at present make every transaction settled through MACSS final and irrevocable. Nevertheless, the assessor believes that from the international standards perspective, this could raise questions regarding the irrevocability (and thus finality) of payments within the system. To avoid any confusion, he recommends adding a short, clear clause addressing the problem of the recognition of the finality of payments in a proper part of the Mauritian legislation. The **legal recognition of (bilateral and multilateral) netting** arrangements (not used in the MACCS, but in other systems) poses similar problems. As far as the assessor is aware, there is no specific legislation covering netting arrangements, but only contractual arrangements. According to the BOM’s legal opinion, contractual arrangements, which are not against banking practices, are sufficient and have legal standing under Mauritian law.

Understanding and management of risks (CPs II-III)

66. The MACSS has clear rules and procedures for the clearing and settlement of **payment** instructions. These are properly documented and are available to all participants in the payment system. They describe the responsibilities of all participants the financial risks to which they may be exposed, and how the various risks are monitored and managed. They also describe the roles of participants under both normal or abnormal circumstances or system disruption.

¹⁸The “zero-hour rule” involves the possibility that a court may date the bankruptcy of an institution from midnight prior to the date of a bankruptcy order, thereby threatening the irrevocability of the payments made in the real-time gross settlement system.

Settlement (CPs IV–VI)

67. The MACSS provides real-time settlement, without using any netting. Settlement of transactions takes place on the books of the BOM in the participants' accounts. From the international standards point of view, finality and irrevocability should be more clearly defined (see CP I, Legal issues).

Security and operational reliability, and contingency arrangements (CP VII)

68. The MACSS provides secured facilities to protect data, payments in transit and control user access. Participants are responsible for ensuring the integrity of transactions, data and user access within their own organizations. In the event of failure of the main server, the back-up site takes over. Arrangements have been put in place for 24-hour remote diagnostic and repair arrangements with the applications provider.

Efficiency and practicality of the system (CP VIII)

69. The MACSS is a fully automated system that allows funds to be transferred between two counterparties immediately and without risk. This eliminates the uncertainty associated with the use of paper checks and provides the opportunity for using the available money stock many times per day without inflationary risks to the economy.

Criteria for participation (CP IX)

70. Participation in MACSS is restricted to institutions supervised by the BOM and licensed to undertake banking activities in Mauritius. All category one banks are participants in the MACSS. The access and exit criteria are specified in the rules and procedures and are readily available to all participants.

Governance of the payment system (CP X)

71. The system has clearly defined rights and responsibilities of participants as set out in the MACSS Rules and Procedures. The leading role of the BOM is clearly stated, each participant in the MACSS is fully aware of its role in the system. There is a Project Coordination Committee headed by the managing director of the BOM to deal with any issues arising from the operation of the system. Major decisions are made after consultation with all interested parties.

Central bank responsibilities in applying the CPs

72. Although MACSS is the major real-time gross settlement payment system in Mauritius, there are other smaller regional payment systems in Mauritius. The BOM, of course, is the leading player in most of the payment systems in the country. It is aware of its functions and responsibilities. The payment systems objectives are set out publicly in the document called the Business Objective Overview. All major changes of the systems are

built under supervision of the Project Coordination Committee. The only systematically important system of the country, the MACSS, widely complies with internationally accepted core principles. The BOM is fully involved in activities of the most of the other different payment systems, with oversight done on a daily basis by the Accounting, Budgeting and Payment System Department as well as by the Supervision Department. The increasing activity, and thus importance of card payments, warrants greater BOM focus. The BOM has close collaboration and cooperation with the Financial Services Commission (FSC) on matters relating to prudential norms and standards. The BOM also cooperates with other central banks in the region especially those who are members of SADC (Southern African Development Community) and COMESA (Common Market for Eastern and Southern Africa) toward the development of regional payment systems along the lines of MACSS.

Table 2. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the MACSS

Reference Principle	Recommended Action
Legal foundation	
CP I. The system should have a well-founded legal basis under all relevant jurisdictions.	Additional clauses should be added to the appropriate legislation to avoid any discussion or confusion and to protect any payment system in Mauritius against the possibility of revocation of any settled transactions.
Understanding and management of risks	
CPs II–III.	No recommendation.
Settlement	
CPs IV–VI.	The reason for lower assessment grade is the same as for the CP I. In addition, to protect systems which settle via the MACSS, the netting should be enforceable by the law—with new clauses being added to the appropriate legislation.
Security and operational reliability, and contingency arrangements	
CP VII.	The relatively low staffing levels of the BOM Accounting, Budgeting, and Payment System Department, as well as the IT Department should be revised to avoid any future operational risks in cases where technical or operational difficulties arise, or in the event that more than one specialist were to leave the bank.
Efficiency and practicality of the system	
CP VIII.	No recommendation.
Criteria for participation	
CP IX.	No recommendation.
Governance of the payment system	
CP X.	No recommendation.
Central bank responsibilities in applying the CPs	

Reference Principle	Recommended Action
Responsibilities A-D.	While the BOM controls all other means of interbank transfers, it is not directly involved in the settlement of card payments. Even though the value of an average card transaction is not high (about MUR 1,500), the volume of card payments is growing rapidly and the values are high enough to warrant attention from the supervisor of payment systems. The BOM should pay closer attention to card payments in order to contribute to the stability and efficiency of the payment systems infrastructure in Mauritius.

Authorities' response

73. The authorities consider that, in the present legal environment, adequate precaution has been taken in the formal Rules pertaining to the operation of the payment system on a contractual basis, as agreed upon by all payment system participants, to address the matter of finality and irrevocability of transactions and to circumvent any adverse effect of the operation of the "zero hour rule." Action will be taken, as recommended, to explicitly reinforce this principle by a suitable reference to the matter in the forthcoming Insolvency Act. The BOM has in the past taken steps to define the duties and responsibilities of card issuers and card users by enforcing the adoption of a Code of Banking Practices setting out these responsibilities. The forthcoming Banking Bill takes up further the issue of electronic funds transfers; the BOM agrees that this matter should continue receiving its full attention as part of its duties of payment system oversight.

C. Transparency of Monetary and Financial Policies

Transparency of monetary policy

General

74. This assessment of the observance of the Code of Good Practices on Transparency in Monetary and Financial Policies for monetary policy was conducted in the context of the joint IMF-World Bank FSAP missions that visited Port Louis in October and December 2002. The assessment covered the Bank of Mauritius, in its capacity as agency responsible for monetary policy, and was made by Mr. Wim Fonteyne (IMF).

75. The assessment is based on discussions with Bank of Mauritius officials, the authorities' response to a pre-mission questionnaire, and a comprehensive review of the central bank law, the banking law, other legislation, central bank publications, a wide range of public and internal documents, and the website of the Bank of Mauritius. The cooperation received from the authorities was excellent. The main discussions were held at the Bank of Mauritius with Mr. Jankee (Director of Research) and Mr. Sooben (Assistant Director of Research). The assessment further benefited from discussions with Mr. Pandoo (Assistant Director, Financial Markets Department). The assessment was further supported by discussions with commercial bankers.

76. The assessment could not take into consideration laws that are currently under preparation but have not yet been enacted. The mission received and reviewed a draft of a proposed new central bank act (draft dated June 6, 2002). Where relevant and possible, the assessment indicates where the new law would make a difference, and how it could be further improved to ensure consistency with the Code.

Main findings—summary

Clarity of roles, responsibilities and objectives of the Bank of Mauritius

77. The clarity of the roles, responsibilities and objectives of the Bank of Mauritius is hampered by an outdated Bank of Mauritius Act (BOM Act). While this is a publicly disclosed document that outlines ultimate objectives and an institutional framework for monetary policy, as well as listing responsibilities for the central bank, this law is no longer in line with the actual context for and practice of monetary policy, which have evolved substantially since the enactment of the law in 1966. The BOM Act is also no longer in line with international best practices. In particular, it gives the central bank very limited independence. This lack of independence in turn hampers the transparency of monetary policy, due to the resulting influence of outside forces in monetary policy decision making.

78. Important weaknesses are the fact that the objectives for the central bank are formulated in general terms without specifying an order of priority among them (Practice 1.1.1); there is little clarity toward the general public on the institutional responsibility for the different aspects of exchange rate policy (Practice 1.1.4); there is a lack of specificity on the modalities of accountability for the responsibilities assigned to the central bank (Practice 1.1.5); the Minister of Finance has the authority to override central bank policy decisions without having to disclose such interventions to the public (Practice 1.1.6); the absence of specific legal provisions on the terms of office of the Governor and the Managing Director of the BOM and on the criteria for removal of central bank officials (Practice 1.1.7); the absence of publicly disclosed specific procedures for the BOM's participation in the markets for government securities (Practice 1.2.3); the absence of written and publicly disclosed procurement policies and procedures (Practice 1.2.4); the lack of legal responsibility for the central bank to manage the country's foreign exchange reserves (1.3.1); and the absence of a clear and publicly disclosed set of regulations and/or procedures governing the primary and secondary market in government securities (Practice 1.3.2).

79. Many of these deficiencies could be addressed by adopting a new and modern central bank law that establishes an independent and accountable central bank with a strong mandate for price stability. A new central bank law has been under preparation for some time, and a draft of it has been reviewed by the mission. However, the draft would not resolve all of the legal issues identified above, and would not fully achieve the objective of an independent and accountable central bank with a mandate for price stability. The mission provided advice to the authorities on areas in which the draft could be further improved to resolve transparency issues.

80. Minor deficiencies are the absence of public disclosure of the terms of government deposits and advances to the government (Practice 1.2.2).

Open process for formulating and reporting of monetary policy

81. The openness and transparency of the process for formulating and reporting monetary policy in Mauritius benefits from frequent consultations between the Bank of Mauritius and the commercial banks, in a number of institutionalized committees as well as on an ad hoc basis. Commercial bankers are generally satisfied with their dialogue with the central bank. The transparency of monetary policy is further enhanced by a good website, a thorough and well-presented annual report, a comprehensive monthly statistical publication and a relatively open policy toward the media.

82. However, the openness of the process has been less than optimal because the publicly announced monetary policy framework and public explanations of monetary policy decisions have not always been entirely consistent. The Bank of Mauritius adopted a monetary targeting framework in July 1996, and publicly announced that it was conducting monetary policy using such a framework in its 1998 Annual Report. However, the monetary targets are not made public, and public announcements and explanations of monetary policy decisions do not always refer to this policy framework. As a result, there is a risk of creating the impression that monetary policy decisions may be technically inconsistent with the central bank's policy framework. Furthermore, the public explanations of the monetary policy framework itself have not been sufficiently comprehensive and frequent to ensure transparency.

83. The assessment identified the following specific weaknesses: the public disclosures and explanations of the framework, instruments and targets that are used to pursue the objectives of monetary policy are insufficiently frequent and comprehensive (Practice 2.1); there is insufficient reference to monetary policy issues and the monetary policy framework in some central bank publications (Practices 2.4 and 2.4.2); there is a lack of detailed regulations and procedures governing the BOM's instruments (Practice 2.1.1); there are gaps in the rules and procedures for the central bank's relationships and transactions with its counterparties (Practice 2.1.2); the explanation to the public of changes in the monetary policy instruments could be improved and phrased better in the context of the publicly announced monetary policy framework (Practices 2.3 and 2.3.1); the de facto presumption in favor of public consultations could usefully be formalized (Practice 2.5); and not all requirements for the reporting of monetary data by financial institutions have been publicly disclosed (Practice 2.6).

84. The assessment indicated that the monthly announcement on inflationary developments could be turned into a progress report on the achievement of the monetary policy objectives (Practice 2.4) and the updates on macroeconomic developments published in the Monthly Statistical Bulletin could also discuss the implications of these developments for monetary policy (Practice 2.4.2).

Public availability of information on monetary policy

85. The public availability of information on monetary policy benefits from a good website, a thorough and well-presented annual report, a comprehensive monthly statistical publication and a relatively open policy toward the media (see also above). Most practices in this area are either observed or broadly observed.

86. The assessment identified only one major and one minor weakness, namely the insufficient formalization of rules and arrangements in publicly disclosed regulations (Practice 3.4) and the insufficiently consistent disclosure of emergency financial support provided by the BOM to financial institutions (Practice 3.2.3). The former problem could be resolved through a sustained and comprehensive effort aimed at formalizing the BOM's interaction with the outside world in a set of regulations that is made readily available to the public.

Accountability and assurances of integrity by the central bank

87. The arrangements to ensure accountability and integrity at the central bank are less than optimal, due to the constraints posed by an outdated central bank law, and the fact that some important documents are not made public.

88. More specifically, the assessment found that there is no designated public authority to which the central bank is accountable. In practice, accountability is to the government and usually takes the form of informal consultations (Practice 4.1); the internal governance procedures and internal audit arrangements are not publicly disclosed (Practice 4.2.2); and the main document covering the standards of conduct of central bank staff is not publicly disclosed (Practice 4.4).

89. The main medium-term challenge for the transparency of monetary policy is to come to a new institutional situation created by a new central bank law, in which an independent BOM takes sole responsibility for monetary policy and the transparency of monetary policy.

Table 3. Recommended Plan of Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy	
1.1	Specify the objectives of monetary policy and the priority among them more clearly in the new central bank law.
1.1.2	Identify the responsibilities of the central bank in the new central bank law.
1.1.3	In the new central bank law, allow for the provision of credit to banks in

Reference Practice	Recommended Action
	a form to be determined by the Board of the BOM. Allow the Board to define eligible assets for required reserves.
1.1.4	Delineate the different responsibilities for (components of) foreign exchange policy in the new central bank law.
1.1.5	Specify the modalities for accountability for the central banks' responsibilities in the new central bank law.
1.1.6	Abolish or restrict the executive branch's authority to override central bank decisions. If maintained, specify clear and strict conditions.
1.1.7	Specify the terms of office of central bank officials in the new central bank law, review the appointment procedures, and limit the power of the president to dismiss central bank officials to certain well-specified cases.
1.2.2	Publicly disclose the terms of advances to the government and of government deposits at the central bank.
1.2.3	Compile and publish a set of documents that outlines the procedures governing the primary and secondary markets for treasury bills, in particular the rules for the allocation of treasury bills in the primary market and the procedures to follow for the BOM to participate in the market. Introduce a clear distinction between the issuance of treasury bills for sterilization and for government financing purposes.
1.2.4	Publish positions held by central bank officials in other organizations in the annual report.
1.3.1	Give the BOM explicit responsibility for managing foreign reserves in the new central bank law. Include in the annual report an overview of tasks fulfilled for the government, and publish a detailed overview of the BOM's responsibilities on the website. Clearly delineate and publish responsibilities for domestic debt management.
1.3.2	Revise the legal provisions regarding the issuance of treasury bills, so as to bring them in line with current practice and to better delineate the responsibilities of the Ministry of Finance and the BOM. Issue and publish a clear set of regulations and/or procedures governing the primary and secondary markets in government securities.
II. Open process for formulating and reporting monetary policy decisions	
2.1	Publish a thorough explanation of the monetary policy framework on the website and in additional suitable forms. Make the explanation of monetary policy a continuous exercise.
2.1.1	Put in place, for each monetary policy instrument, a regulation that specifies the objectives, the modalities of use, access conditions, and other similar regulations..
2.1.2	Put in place and observe clear regulations governing the primary and secondary markets for treasury bills, including the repo operations.
2.2	Consider establishing a publicly announced schedule of meetings for the Board.
2.3	Explain changes in the setting of monetary policy instruments in more detail, and on the basis of the publicly announced monetary policy framework.
2.3.1	Periodically publish a report that provides an evaluation of monetary developments and explains monetary policy in light of those

Reference Practice	Recommended Action
	developments.
2.4.1	Expand the explanation of monetary policy objectives to the public.
2.4.2	Include in the Monthly Statistical Bulletin a discussion on the implications of macroeconomic developments for monetary policy.
2.5	Formalize the de facto presumption in favor of public consultations and specify minimum delays that need to be respected. Try to involve a wider public.
2.6	Publish the reporting requirements for monetary data.
III. Public availability of information on monetary policy	
3.1	Continue efforts toward full implementation of the Fund's data dissemination standards.
3.2.2	Consider adding specific information on the special facilities for sugar and EPZ sectors to the Monthly Statistical Bulletin.
3.2.3	Put in place a mechanism to consistently disclose emergency financial support, while respecting confidentiality and privacy of information, and maintaining financial system stability.
3.3	Continue to improve public information services.
3.4	Engage in a sustained and comprehensive effort to formalize the rules and arrangements governing the BOM's interaction with the outside world.
IV. Accountability and assurances of integrity by the central bank	
4.1	It is advisable that Bank of Mauritius officials appear before a designated public authority at least once a year.
4.2.2	Publicly disclose internal governance and internal audit arrangements.
4.4	Publish the "Terms and conditions of service" or at least that part of it that deals with standards for the conduct of personal financial affairs, conflicts of interest, and fiduciary obligations of staff.
4.4.1	Include clear provisions on suitable legal protection of central bank officials and staff in the new central bank law.

Authorities' response

90. The authorities believe that the forthcoming central bank law clearly expresses the intention of the authorities to depart from the provisions of the 1966 central bank legislation whereby BOM's policy decisions could be theoretically overridden by ministerial directives. This power has actually not been exercised and has remained largely of academic importance. All the other requirements, such greater public accountability for monetary policy and other proposes by the BOM, security of tenure of office of BOM's senior officers, explicit legal power to the BOM to manage foreign exchange reserves, setting out in the law clearly the order of priority BOM objects, are incorporated in the proposed central bank law. Steps are being taken by the authorities to shift the issue and management of public debt to the ministry of finance. This development should set forth more clearly the market practices for monetary policy and fiscal policy objectives as regards the government securities market.

The BOM agrees that it will continue its present efforts to engage formally in a sustained and comprehensive effort to enhance public availability of information on its dealings with the outside world in matters of public interest.

Transparency of banking supervision

General

91. This assessment of the observance of the Code of Good Practices on Transparency in Monetary and Financial Policies for monetary policy was conducted in the context of the joint IMF-World Bank FSAP missions that visited Port Louis in October and December 2002. The assessment covered the Bank of Mauritius in its capacity as the agency responsible for banking supervision. It reflects BOM transparency practices as of October 2002. This assessment was made by Messrs. Michael Andrews (IMF) and Kee Meng Lee (Monetary Authority of Singapore).

92. The assessment is based on answers provided by the Mauritian authorities to the questions contained in the *Code of Good Practices on Transparency in Monetary and Financial Policies*; a review of the relevant laws and regulations; discussions with the officials of the BOM; and other information provided by the authorities. The assessment could not take into consideration laws that are currently under preparation but have not yet been enacted.

Main findings—summary

Clarity of roles, responsibilities and objectives of the Bank of Mauritius in matters of banking supervision and regulation

93. The BOM is the sole agency in charge of banking supervision in Mauritius. It exercises a broad mandate for financial sector supervision and stability, but the current central bank and banking legislation does not explicitly establish policy objectives for banking supervision and regulation. To correct this shortcoming, the BOM's mandate on banking supervision could be more clearly specified in law.

94. Specific weaknesses identified by the assessment include the insufficient clarity on the objectives of banking supervision and regulation (Practice 5.1) and the absence of precise specifications on the terms of office of the Governor and Managing Director of the BOM, along with the overly general nature of the criteria for removal of senior central bank officials (Practice 5.1.4).

95. These weaknesses should be addressed with the introduction of a new central bank law (see also discussion under transparency of monetary policy).

Open process for formulating and reporting of banking supervision and regulation policies

96. Banking supervision policies are generally formulated and reported in an open and transparent way. There is adequate disclosure in central bank publications and on the BOM's website, and there are regular meetings between the central bank and the CEOs of commercial banks to discuss banking supervision and regulation issues. These regular meetings are complemented by occasional meetings on an as-needed basis. There is a de facto presumption in favor of public consultations for substantive changes to banking regulations that is well implemented.

97. Some minor specific weaknesses identified in the assessment are that not all reporting requirements by banks are fully disclosed to a wider public (Practice 6.1.2); the fact that agreements with foreign supervisors and the general terms of these agreements are not publicly announced (Practice 6.1.5); and the fact that clarity on the objectives with respect to supervision in the annual supervision report and other publications is not optimal (Practice 6.3). These weaknesses can easily be corrected by publishing the new guideline for quarterly reporting.

Public availability of information on banking supervision and regulation

98. In general, an adequate level of information on banking supervision and regulation is made publicly available through the BOM's annual report, its annual supervision report, a Monthly Statistical Bulletin, its website, and in the government's Gazette.

99. The only minor weakness in this area is that the BOM could usefully disclose greater detail in its annual report on emergency financial support provided to financial institutions (Practice 7.3.1).

Accountability and assurances of integrity by the banking supervisor

100. As in other areas of responsibility of the central bank, the accountability and assurances of integrity of the central bank in matters of banking supervision is hampered by deficiencies of the legislative framework (see also monetary policy and banking supervision).

101. More specifically, there is no designated public authority to which the central bank is accountable for the conduct of banking supervision and regulation. In practice, accountability takes the form of non-public meetings between central bank officials and the Minister of Finance (Practice 8.1).

102. Other weaknesses identified in the assessment are the absence of a specific time put in legislation for the publication of audited statements (Practice 8.2); the non-disclosure of internal governance and audit procedures (Practice 8.2.2); the absence of separate reporting of banking supervision and regulation related expenses and revenues of the BOM (Practice 8.3); the non-disclosure of the internal standards for the conduct of personal

financial affairs of staff (other than senior officials) of the BOM (Practice 8.4); and the absence of adequate legal protection for officials and staff of financial agencies in the conduct of their official duties (Practice 8.4.1).

103. These weaknesses could be addressed by specifying adequate accountability arrangements to a public body and appropriate legal protection for staff in the new central bank law, by additional disclosure of internal documents, and by establishing (pro forma) separate accounting for the banking supervision department of the central bank.

104. The main medium-term challenge for the transparency of banking supervision is the need to put in place an adequate legal framework (i.e., in the current context a new central bank law), and the need to make that new framework operational.

Table 4. Recommended Plan of Actions to Improve Observance of IMF's MFP Transparency Code Practices—Banking Supervision

Reference Practice	Recommended Action
V. Clarity of roles responsibilities, and objectives of financial agencies responsible for financial policies	
5.1 The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation.	Explicitly state the objectives with respect to supervision and regulation of the financial system in revised versions of the central bank and banking legislation.
5.1.1. The broad objective(s) of financial agencies should be publicly disclosed and explained.	Amend the central banking and banking legislation to provide a clear legal foundation for the supervisory role of the BOM.
5.1.2. The responsibilities of the financial agencies and the authority to conduct financial policies should be publicly disclosed.	Clarify in legislation the responsibilities for banking supervision.
5.1.4. Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.	Amend central banking legislation to clearly establish that the governor can only be removed for reasons enumerated in the legislation.
VI. Open process for formulating and reporting of financial policies	
6.1.2. The regulations for financial reporting by financial institutions to financial agencies should be publicly disclosed.	Implement quarterly publication of financial statement information by banks.
6.1.5. Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.	Publicly disclose existence of agreements for information sharing with foreign supervisors, and the general terms of these agreements.
6.3. Financial agencies should issue periodic public reports on how their overall policy objectives are being pursued.	Clearly specify BOM objectives with respect to supervision and report progress against these objectives.
VIII. Accountability and assurance of integrity	

Reference Practice	Recommended Action
by financial agencies	
8.1. Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in pursuing their objective(s), and, as appropriate, exchange views on the state of the financial system.	Implement formal program of meetings with a designated public authority to report on the activities of the BOM.
8.2. There is no specific time cited in the legislation for publication of audited statements, with Section 45 of the BOM Act requiring completion of the annual report as soon as possible after year-end. In practice, the BOM's annual report is typically published in October, four months after fiscal year-end.	Specify a deadline for the submission of the BOM's audited financial statements.
8.2.2. Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.	Include in the annual report a discussion of internal governance and audit procedures.
8.3. Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually.	Report revenues and expenses related to banking supervision separately.
8.4. Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.	Develop and publish a more general code of conduct for staff of the BOM.
8.4.1. Information about legal protections for officials and staff of financial agencies in the conduct of their official duties should be publicly disclosed.	Introduce protection for BOM staff against legal actions arising from good faith performance and publicly disclose this fact.

Authorities' response

105. The authorities do not agree that the present central bank and banking legislation does not explicitly establish policy objectives for banking supervision and regulation. Their thinking is that such an objective may be understood from the provisions of Section 20, in particular 20(c), of the Bank of Mauritius Act 1966, Section 7(1)(a) of the Banking Act 1988, and Section 7(1)(a)(iv). Nevertheless, as stated in the BOM's publications, there is scope for more direct statement of those objectives. The authorities agree that there is no designated public authority to which the BOM is accountable for the conduct of banking supervision and regulation and that this matter will be looked into. The BOM has been restructured recently, entailing the centralization of the budgeting function in one department. Separate departmental budgets have started being issued, including that of the Banking Supervision Department. Steps have been taken for the publication of quarterly financial statements of banks (see Guidelines on Public Disclosure). The authorities welcome the recommendations to fix deadlines for audited financial statements of the BOM, to ensure public disclosure of a report on internal governance, and audit procedures in the BOM as well as the publication of a Code of Conduct for BOM staff. They note that most of the principal concerns of the

assessment team will be addressed by the planned introduction of new banking and central banking legislation, including appropriate enforcement powers.

Transparency of payment systems oversight

General

106. This assessment of the observance of the Code of Good Practices on Transparency in Monetary and Financial Policies for payment systems oversight was conducted in the context of the joint IMF-World Bank FSAP missions that visited Port Louis in October and December 2002. The assessment covered the Bank of Mauritius, in its capacity as agency responsible for payment systems oversight, and was made by Messrs. Tomáš Hládek (Czech National Bank) and Wim Fonteyne (IMF-MAE).

107. The assessment is based on discussions with Bank of Mauritius officials, the authorities' response to a pre-mission questionnaire, and a comprehensive review of relevant legislation, central bank publications and other documents, along with the websites of the Bank of Mauritius and other financial agencies in Mauritius. The main discussions were held at the Bank of Mauritius with Mr. Googoolye (Director of the Accounting, Budgeting and the Payment System Department). The assessment could not take into consideration laws that are currently under preparation but have not yet been enacted.

Main finding—summary

Clarity of roles, responsibilities and objectives of the Bank of Mauritius with regard to payment systems

108. The roles, responsibilities and objectives of the Bank of Mauritius in matters of payment systems oversight are defined, in general terms, in the 1966 Bank of Mauritius Act. However, there is a need to modernize this law and bring it better into line with current best practices.

109. Specific weaknesses identified in the assessment include the absence of clarity on the broad modalities of accountability for the central bank in regard to issues related to payment systems-related responsibilities assigned to the central bank (Practice 5.1.3); the absence of clearly defined and publicly disclosed terms of office for the Governor and Managing Director and general criteria for removal of central bank officials (Practice 5.1.4); the non-disclosure of the relationships between the BOM and other financial agencies in payments-related matters, and the lack of an organized supervisory relationship between the BOM and

the commercial banks' netting system (Practices 5.2, 5.3, and 5.4); the less than optimal disclosure of the roles of the BOM with regard to payment systems (Practice 5.3); and the insufficient disclosure of general policy principles that affect the robustness of systemically important payment systems (Practice 5.3.1).

110. Most of these weaknesses can be addressed with the introduction of a new, modern central bank law. Others will require some changes in the practices and policies at the BOM.

Open process for formulating and reporting of payment systems policies

111. Payment systems policies are generally formulated and reported in an open way. Transparency and openness benefit from regular consultations between the BOM and payment system participants. The rules and conditions of the systemically important MACSS system are transparent, clear and comprehensible, and compatible with normal confidentiality requirements and the need for the regulator to preserve the effectiveness of its actions.

112. Specific weaknesses identified in the assessment are that not all regulations and operating procedures are disclosed to a wide audience (Practice 6.1.1); only part of the financial reporting requirements to the BOM by payment system participants are publicly disclosed (Practice 6.1.2); and the absence of formal procedures for information sharing and consultation between financial agencies on payments-related issues (Practice 6.1.5). These weaknesses can easily be dealt with in a straightforward manner.

Public availability of information on payment systems policies

113. The BOM reports on its payment systems policies in its annual report, occasionally in its Monthly Bulletin, and on its website. However, there is scope for improvement in this reporting.

114. Specific weaknesses found in the assessment include the absence of published data on transactions in the commercial banks' netting system (Practice 7.2). Another difficulty is that not all payments-related regulations and generally applicable directives and guidelines are systematically published (Practice 7.5). These weaknesses could be solved relatively easily.

Accountability and assurances of integrity by the payment systems overseer

115. The accountability and assurances of integrity by the BOM in matters of payment systems, are impeded by the deficiencies of the legislative framework (see also monetary policy and banking supervision).

116. Specifically, the assessment identified the following weaknesses: the absence of a designated public authority to which the central bank is accountable (Practice 8.1); the absence of a binding requirement to publish the annual report on a preannounced schedule

(Practice 8.2); and the non-disclosure of internal governance and internal audit arrangements and of the standards for the conduct of personal financial affairs of officials and staff of the BOM (Practices 8.2.2 and 8.4).

117. In the medium term, transparency should improve substantially with a new central bank law. The BOM will also have to organize and publicize its relationship with the commercial banks' netting system.

Table 5. Recommended Plan of Actions to Improve Observance of IMF's MFP Transparency Code Practices—Payment Systems Oversight

Reference Practice	Recommended Action
V. Clarity of roles, responsibilities, and objectives of financial agencies responsible for financial policies	
5.1 The broad objective(s) and institutional framework of financial agencies should be clearly defined preferably in relevant legislation or regulation.	Adopt a new central bank law.
5.1.3. Where applicable, the broad modalities of accountability for financial agencies should be publicly disclosed.	Establish clear channels of accountability in the new central bank law.
5.1.4 Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.	Establish clearly defined terms of office and criteria for removal from office for senior central bank officials in the new central bank law.
5.2 The relationship between financial agencies should be publicly disclosed.	Define and disclose the relationship between all financial agencies in Mauritius, as well as the supervisory relationship between the BOM and the commercial banks' netting system.
5.3 The role of oversight agencies with regard to payment systems should be publicly disclosed.	Improve the public disclosure of the BOM's payment system responsibilities and clarify its role vis-à-vis the netting system.
5.4 Where financial agencies have oversight responsibilities for self-regulatory organizations, the relationship between them should be publicly disclosed.	Clarify and publicize the relationship between the BOM and the netting system.
VI. Open process for formulating and Reporting of financial policies	
6.1.1 The regulatory framework and operating procedures governing the conduct of financial policies should be publicly disclosed and explained.	Improve the disclosure of the regulatory framework and operating procedures, including to the general public.
6.1.2. The regulations for financial reporting by financial institutions to financial agencies should be publicly disclosed.	Publish the regulations and requirements governing the reporting of payments-related data by financial institutions.

6.1.5. Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.	Establish and publicly disclose formal procedures for information sharing and consultation between financial agencies, domestic and international, on payments-related issues.
6.4. For proposed substantive technical changes to the structure of financial regulations, there should be a presumption in favor of public consultations, within an appropriate period.	Formalize the existing presumption in favor of public consultations in a public policy statement or in a regulation that also establishes minimum consultation periods.
VII. Public availability of information on financial policies	
VIII. Accountability and assurance of integrity by financial agencies	
8.1. Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in pursuing their objective(s), and, as appropriate, exchange views on the state of the financial system.	Have Bank of Mauritius officials appear at least once a year before a designated public authority to report on the way the BOM carries out its responsibilities, including payment systems oversight.
8.2. Where applicable, financial agencies should publicly disclose audited financial statements of their operations on a preannounced schedule.	Establish a formal requirement that the annual report needs to be published in October.
8.2.2. Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.	Publicly disclose internal governance procedures, including internal audit arrangements.
8.4. Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.	Publish the "Terms and Conditions of Service," or at least the part of it that deals with standards for the conduct of personal financial affairs, conflicts of interest and fiduciary obligations of staff.
8.4.1. Information about legal protections for officials and staff of financial agencies in the conduct of their official duties should be publicly disclosed.	Establish suitable legal protection for members and staff of the Bank of Mauritius in the new central bank law.

Authorities' response

118. The authorities did not raise any issues of substance regarding the assessment. However, they declared their intention to take appropriate action to address the issues identified in the assessment.

D. Anti-Money Laundering and Combating the Financing of Terrorism

Introduction

119. This Report on the Observance of Standards and Codes for the *FATF 40 Recommendations and 8 Special Recommendations on Terrorist Financing* (FATF 40 + 8 Recommendations) was prepared by a team composed of staff of the International Monetary

Fund (IMF) and World Bank (WB), and another expert not under the supervision of the Bank and the Fund, who was selected from a roster of experts in the assessment of criminal law enforcement and non-prudentially regulated financial activities.¹⁹ The report provides a summary of the level of observance with the FATF 40 + 8 Recommendations, and provides recommendations to strengthen observance.

Information and methodology used for the assessment

120. The assessment is based on the review of relevant anti-money laundering and combating the financing of terrorism (AML/CFT) laws and regulations, and supervisory and regulatory systems in place to deter money laundering and financing of terrorism among prudentially regulated financial institutions. Other experts not under the supervision of Fund and Bank staff reviewed the capacity and implementation of criminal law enforcement systems. Subsequent to the completion of the fieldwork in December 2002, the Mauritian authorities have taken a number of concrete steps to remedy weaknesses identified during the initial December 2002 mission. In addition, a technical assistance mission was conducted in March 2003 to assist the authorities in addressing certain of the weaknesses identified during the initial assessment.

Main findings

121. The Mauritian authorities have made significant progress in tackling anti-money laundering and combating the financing of terrorism issues and initiating the implementation of a comprehensive AML/CFT regime in the past three years. The Mauritian government passed the Economic Crime and Anti-Money Laundering Act (ECAML) in June 2000. Further efforts by the Mauritian government to improve the country's anti-money laundering legal and institutional framework and effective supervision have resulted in the enactment of major legislation including the Dangerous Drug Act 2000, the Financial Services Development (FSD) Act 2001, the Prevention of Corruption Act 2002 (PCA), the Prevention of Terrorism Act 2002, the Financial Intelligence and Anti-Money Laundering Act 2002 (FIAML Act), which replaced the ECAML, and the issuance of a regulation under the FIAML Act. The enactment of these legislative pieces represents major steps forward in bringing Mauritius toward full compliance with the international standards in the AML/CFT area.

¹⁹The assessment was conducted by Alain Damais (WB, FSEFI), Nancy Rawlings (IMF, MAE), and Diana Wong (Security Bureau, Hong Kong), the independent anti-money laundering expert (IAE) on the team. Throughout this report, portions of the assessment attributable to the IAE is shown in italicized text. The roster of experts is based on the names of competent persons identified by the FATF, FSRBs, the United Nations, and the Egmont Group.

122. The Mauritian government has created and designated various competent authorities to ensure the effective implementation of these laws. Considering the progress made in having new legislations in place and the creation of special bodies to implement the laws, the Mauritian government has demonstrated strong political will and commitment in meeting the international standards for anti-money laundering and combating terrorist financing systems. In addition, Mauritius has been one of the leaders in the AML/CFT area in the region through its membership in the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG).

123. The AML/CFT legal and institutional framework of Mauritius is well advanced, but needs additional strengthening to fully comply with the FATF 40 + 8 Recommendations. Areas where further work is needed include: (i) modification to certain confidentiality provisions that appear to hamper the sharing of information on suspected money laundering cases between supervisory authorities and the FIU; (ii) the need to expand the scope and focus of AML/CFT reviews during onsite inspection of financial institutions in line with the recently issued Guidance Notes and Codes; and, (iii) *better coordination of law enforcement efforts*. The Mauritian authorities are taking measures to address all of the above issues.

124. Mauritius is host to considerable offshore business activities, with 76 management companies offering services for more than 20,000 offshore companies, for which approximately 13,000 have no physical presence in Mauritius. The Financial Services Commission has recently initiated a program to vet dormant GBL2 companies through the onsite inspection of the management companies and intends to revoke licenses from those which fail to satisfy the due diligence. Many of these companies were created at a time when Mauritius was still developing its AML/CFT regime and they present a money laundering risk. In addition to these increased efforts, consideration is being given to requiring that GBL2s undergo a re-licensing requirement within a reasonable period of time, which would subject them to enhanced due diligence review as is required by the stricter licensing procedures now in place.

Criminal justice measures and international cooperation

125. The Mauritian authorities are taking steps to remove ambiguities in the main AML/CFT laws with respect to the responsibilities of law enforcement authorities. The authorities, working with a national AML/CFT committee representing relevant government agencies, intend to introduce amendments to existing legislation during the current legislative session to: (i) broaden the Independent Commission Against Corruption's (ICAC) ability to conduct investigations on money laundering cases to include those referred by other law enforcement agencies or those that are self-generated; (ii) grant ICAC clear powers to cooperate and exchange information directly with foreign law enforcement agencies; and (iii) clarify that the FIU's activities are focused on intelligence collection, analysis, and dissemination.

126. The legal provision for the criminalization of ML and FT are in place, in a manner which is broadly consistent with the FATF standard. The UN Convention against Transnational Organized Crime (Palermo Convention) has recently been ratified. Measures towards the confiscation of the proceeds of crime or the property used to finance terrorism are in place. In addition, the authorities have recently drafted a bill to give effect to the United Nations Convention for the Suppression of the Financing of Terrorism which will also provide the Mauritian authorities with a broader legal basis for international cooperation. The assessment notes that the Dangerous Drug Act needs some revision to ensure that it is consistent with FIAML Act regarding the definition of money laundering offense. Finally, regulations have been issued to give legal basis for the Mauritian authorities to implement the United Nations Security Council Resolutions against the financing of terrorism.

127. *The ICAC and the FIU, which are the two new agencies tasked with AML/CFT responsibilities, have been created for some months pursuant to the enactment of the PCA and the FIAML Act. However, the recruitment process has just commenced and the two agencies are still not fully operational. At the time of mission, the ICAC was staffed with only nine investigators seconded from the police who were responsible for conducting 180 corruption or money laundering cases, while the FIU consisted only of a director and his deputy. It was recommended that the Mauritian authorities should regard it as a priority to fill the vacancies quickly and provide staff with the necessary training and resources to enable full swing operations. To this end, the FIU has recently increased its technical staff, staff training, the processing of suspicious transaction reports, and its information technology capacity. The FIU's application for membership to the Egmont Group, under the sponsorship of US FinCen, has been endorsed by the Legal Working Group, and is expected to be ratified in July, 2003.*

128. *Further, the assessment team identified a lack of coordination between law enforcement efforts. It therefore recommends that the relevant agencies should draw up a set of procedures to facilitate and enhance the workflow between the different agencies on AML/CFT matters. To this end, the Mauritian authorities have requested technical assistance to establish a task force to develop written procedures and guidelines for the investigation and prosecution of AML/CFT cases. With regard to prosecutorial duties, there have been no additional resources allocated to the attorney general's office to handle AML/CFT cases. This is compounded by the heavy backlog which has been created by the freezing orders under the DDA. It is therefore recommended that the Mauritian government should consider increasing the number of prosecutorial staff and reviewing the cost-effectiveness of the freezing provision under the DDA in freezing assets, irrespective of their minimal value, from all dealers of drugs.*

129. The FIU, which was established in June 2002 under the FIAML Act, has in place processes for receiving, analyzing, and disseminating intelligence at the domestic and international levels. Its activities are supervised by a Review Committee, which is an independent establishment outside the FIU consisting of a chairperson (former judge) and two other members of the Mauritian community of high repute. The Review Committee is charged with giving its consent prior to any dissemination of information by the FIU to any

other domestic or foreign authority, including approving responses to requests for information from foreign FIUs. Experience elsewhere suggests that this mechanism could create an unnecessary burden on the FIU in effectively performing its duties. Consideration should be given to streamlining the FIU's structure in order that the Review Committee function be formally integrated into the FIU. Spontaneous or upon request exchange of information mechanisms need to be put in place as soon as possible by the FIU with its foreign counterparts. Accession to the Egmont Group should help address this.

130. *Mauritius has been cooperating and providing legal assistance to overseas jurisdictions through Letters of Request. While most of these requests were acted on, some of the cases were turned down for various reasons including the confidentiality provision under the Banking Act. Some sections of the FIAML Act (Section 22) and the FSD (Section 33), appear to hamper the supervisory authorities' ability to pass information to the FIU. In addition, Section 22 of the FIAML Act prevents the passing of information to the FIU without also seeking the prior consent of the financial institution or the customer. Section 33 of the FSD Act accords GBLs with exceptional confidentiality protections that are dissimilar to those for other financial institutions. In addition Section 25(3)(a, b) of the FIAML Act creates obstacles to the exchange of information between the Mauritius FIU and foreign FIUs by attaching conditions to the provision of information, which are inconsistent with good international practice because they require the requesting FIU to provide justification which will not be available at the intelligence phase of a money laundering case. These provisions should either be removed or amended.*

131. *It was the understanding of the assessment team that different agencies with responsibilities over AML/CFT matters, including the FIU, ICAC, police, attorney general and prosecutions' offices kept statistics in respect of their day-to-day operations. However, there is an absence of a set of coordinated statistics to which the ministry responsible for AML/ CFT could make reference when drawing up a national strategy against money laundering and financing of terrorism. It is therefore recommended that the ministry with purview over AML/CFT area should coordinate relevant operational statistics to be used for such a reference.*

132. It is also recommended that the Mauritian authorities review the laws and procedures for mutual legal assistance, treaties, arrangements for information exchange, cooperative investigations and extradition, in order to ensure that there are adequate gateways for international cooperation and information exchange at each stage of a money laundering investigation and that all the authorities involved in a money laundering case (such as the FIU, the ICAC, the police, and customs) have the ability to cooperate at the international level with their foreign counterparts in the performance of their duties. With respect to international cooperation, the authorities should pursue formal ratification and implementation of the UN International Convention for Suppression of Financing of Terrorism 1999. It is understood that subsidiary legislation to give effect to this convention has reached an advanced stage of preparation and will be tabled shortly in the national assembly. Subsequent to the mission, the authorities have drafted a Mutual Assistance Bill

and an Extradition Bill. In addition, the BOM is awaiting responses from its counterparts in several countries to enter into MOUs to formalize the exchange of supervisory information.

Preventive measures for financial institutions

133. ***Prudentially-regulated sectors.*** The BOM functions as the regulator for banks and the Financial Services Commission (FSC), created by the recent enactment of the FSD Act, functions as the regulator of the insurance and securities sectors. The authorities have recently enacted a regulation which elaborates on the general requirements regarding customer identification and record keeping contained in the FIAML Act and the Banking Act. In addition, the regulation also includes provisions that require financial institutions to pay special attention to all complex, unusual large transactions. The enactment of this regulation represents significant progress in developing an adequate legal AML/CFT framework and brings Mauritius more closely in line with the FATF 40 + 8 Recommendations.

134. The BOM also recently issued new guidance notes under the Bank of Mauritius Act to banks and cash dealers, bringing their content in line with Basel's CDD Principles and the FATF 40 + 8 Recommendations, including requiring that financial institutions, including money remitters, include accurate and meaningful originator information on funds transfers and related messages and that financial institutions give enhanced scrutiny to wire transfers that do not contain complete originator information.²⁰

135. The above step represents important progress towards a more comprehensive AML/CFT framework, which will need to be followed with enhanced inspection procedures to ensure that financial institutions are complying with the guidance notes requirements. It is recommended that the legal basis for the guidance notes, however, should be strengthened with respect to their enforceability. The Mauritian authorities have indicated they intend to introduce amendments to the FIAML Act during the current parliamentary session to this effect.²¹

136. While there remain shortcomings in the law and regulation at present, and it is too early to assess whether banks and cash dealers are complying with the BOM guidance notes, the BOM indicates commitment to ensure an effective implementation in the future. In this respect, the BOM recognizes the need to be rigorous in its onsite inspection program to ensure compliance with all areas covered by the new guidance notes, and has recently developed inspection procedures for reviewing compliance with the new guidance notes.

²⁰ This requirement is set forth in FATF Special Recommendation VII. Jurisdictions are allowed a two year period to make the necessary adaptations to their systems and procedures.

²¹ The authorities have communicated their opinion that the Bank of Mauritius and Financial Services Commission currently have adequate legal authority to enforce these directives.

137. The BOM's enforcement authority is currently limited and should be enhanced. The FIAML Act provides for criminal sanctions for failure to comply with certain AML/CFT requirements; however, the range of administrative powers of the BOM, sanctions and penalties is absent in the law. The Mauritian authorities have included a provision in the draft Banking Act, which will grant the BOM with clear and wide powers to take on their own initiative dissuasive, effective and proportionate sanctions against financial institutions that do not comply with the AML/CFT requirements.

138. In addition, the FSC, through its onsite inspection program should continue to ensure that financial institutions have adequate internal AML/CFT programs, by verifying that financial institutions develop internal policies and procedures that reflect the recent guidance notes and codes, and that they strengthen their internal AML/CFT compliance testing function, and ensure that staff obtains a thorough understanding in these specific areas in order to carry out their related responsibilities. On-going training should continue to be provided, and all banks should ensure that their foreign branches and subsidiaries observe appropriate AML/CFT measures. Technical assistance has been provided in this area and the Mauritian authorities are contemplating modifying the draft Banking Bill or, alternatively, issuing a regulation that would provide a special provision requiring financial institutions to establish internal control systems. A number of training programs have been conducted or are planned for both supervisors and staff of financial institutions.

139. The FSC has taken concrete steps to implement the FSD Act with respect to AML/CFT and has given high priority to management companies. Recent attention has been specifically focused on: (i) improving the supervision of management companies, which are responsible for processing the application of global business licenses with the FSC; and (ii) tightening the licensing process. The FSC has issued new Codes on the Prevention of Money Laundering and Terrorist Financing for management companies to strengthen requirements for licensing, customer identification, and suspicious activities, which appear to have a mandatory and binding nature. They form the basis of onsite inspections and these are welcome developments.

140. With respect to the insurance and securities sector of the financial industry, the FSC recognizes the need to extend the same obligations to these entities and has started taking steps to improve its efforts in this area. Since its creation, the FSC has adopted a risk-based supervisory approach and concentrated its limited resources on improving the supervision of management companies; however, supervision of the insurance and securities sector is expected to be strengthened in 2003. The FSC has also recently issued Codes on the Prevention of Money Laundering and Terrorist Financing for the insurance and securities sectors.

Summary assessment against the FATF Recommendations

Table 6. Recommended Action Plan to Improve Compliance with the FATF Recommendations

Reference FATF Recommendation	Recommended Action
40 Recommendations for AML	
General framework of the recommendations (FATF 1-3)	Review, as recommended, confidentiality provisions in legislation to ensure that there are adequate mechanisms for information sharing at both domestic and international levels (Sections 22 and 25 of the FIAML Act, and Section 33 of the FSD). Additional multilateral treaties, and/or bilateral agreements are recommended to enhance cooperation at the international level.
Scope of the criminal offense of money laundering (FATF 4-6)	Modify the Dangerous Drugs Act so that the ML offence provided by this Act is not more difficult to establish than the ones contained in the FIAML Act.
Provisional measures and confiscation (FATF 7)	<i>Law enforcement efforts should be coordinated with clearly defined procedures and workflow. Steps should be taken to fill the posts in the FIU and ICAC as soon as possible and additional resources should be given to the attorney general's office to clear backlog of freezing orders and to meet with additional prosecutorial work generated from the AML/CFT legislations.</i>
Increased diligence of financial institutions (FATF 14-19)	Financial institutions should strengthen their internal AML/CFT programs by developing adequate internal policies and procedures to reflect the recently issued supervisory guidance notes, increasing compliance testing and ensuring that staff receive adequate training.
Other measures (FATF 22-25)	Financial institutions should ensure that their foreign branches and subsidiaries observe appropriate AML/CFT measures.
Implementation and role of regulatory and other administrative authorities (FATF 26-29)	The ministry responsible for AML/CFT matters should coordinate relevant operational statistics which may be used as reference when drawing up national AML/CFT strategy.
Administrative Cooperation—Exchange of information relating to suspicious transactions (FATF 32)	Legislative provisions which reduce the ability of the FIU to exchange information with its foreign counterparts should be revised to ensure full cooperation at the international level. The role and responsibilities of the law enforcement authorities, including the independent commission against corruption should be enhanced and clarified. The authorities should consider streamlining the FIU's structure in order that the Review Committee function be formally integrated into the FIU, and revise the relevant provisions of the FIAML Act (Sections 22 and 25) and FSD (Section 33).
Other forms of cooperation—Basis and means of cooperation in confiscation, mutual assistance, and extradition (FATF 33-35)	The authorities should enact the draft bill for mutual legal assistance in order to ensure there are gateways for international cooperation and information exchange.
8 Special recommendations on terrorist financing	
I. Ratification and implementation of UN instruments	Ratify UN International Convention for Suppression of Financing of Terrorism 1999.

Table 7. Other Recommended Actions

Reference	Recommended Action
Offshore companies created before the enactment of an AML/CFT regime	With respect to the global business entities, the FSC should continue its procedures to eliminate any dormant GBL2 companies and other high-risk entities and implement its intention to require management and GBL2 companies to apply for license renewal within a reasonable period of time under the stricter licensing requirements now in place.
Ratification and Implementation of UN instruments	Introduce criminalization of participation in an organized crime group, as well as other offences related with organized crime activities.

Authorities' response

141. The government has indicated its full commitment to carry out all necessary changes in legislation to harmonize the AML/CFT regime practiced by different law enforcement agencies, and to support supervisory guidance notes and codes by issuing appropriate regulations. The authorities believe that it is not practicable to burden the law with detailed reference to routine supervisory practices (such as customer identification, record retention, verification of originator information of fund transfers, complex transactions, etc.) which, in any event, are fully covered in regulatory guidelines to financial institutions. Legal changes to back the regulatory guidelines will be in force by early-June 2003. Mauritius has demonstrated a track record in its willingness to engage in information exchange on AML/CFT issues. Legislative changes are being drafted to deal with certain residual provisions in the law that are no longer compatible with Mauritius' current views on exchange of information, for introduction in the present session of the national assembly.

142. The emphasis placed in the reports on some conjectural legislative shortcomings (e.g., regulations) fails to take into consideration the real, proactive attitude and practices adopted by the authorities in Mauritius over the years. With regard to AML/CFT issues, we consider that these shortcomings are of a "technical" nature only and are being addressed in priority. Real work on the AML/CFT issue has in fact been carried out, both in terms of legislation and supervisory practices. The number of legislation enacted on the subject in past years as well as regular updating of supervisory practices to the latest international standards, demonstrate an effective compliance culture with international standards and norms. This being said, we agree that there is always scope for improving compliance with international norms, and Mauritius' endeavor has steadfastly been in this direction.