2. Policy Developments in Regulation and Supervision

2.1 Introduction

The period under review witnessed important policy developments consistent with the overall objective of strengthening the financial systems of Mauritius. Some of them are outlined in the ensuing paragraphs.

2.2 Legislative changes

The legislative changes were brought through the Finance Act 2006, enacted in August 2006. In regard to banking policy, the more significant amendments did away with the need for the places of banks being mentioned in the banking licence, reduced the periodicity of inspection and provided for fit and proper criteria for persons to whom financial institutions outsource a part of their activity. The details of these and other amendments are given in the appendix.

2.3 Policy developments

2.3.1 Basel II

The implementation of Basel II has been engaging the attention of Bank Supervisors all over the world. In Mauritius too the Bank has tentatively set 2008 as the year for implementation of Basel II. To facilitate the drafting of guidelines and smooth transition, eight working groups composing participants from the industry and the bank were set up in May 2005.

The Basel II document provides a spectrum of approaches with increasing risk sensitivity and complexity for computing capital requirements for credit, market and operational risk. The approaches available by risk categories are:

- Credit Risk
  Standardised Approach (SA)
  Foundation Internal Ratings-Based Approach (F-IRB)
  Advanced Internal Ratings-Based Approach (A-IRB)

- Market Risk
  Standardised Measurement Method (SMM)
  Internal Model Approach (IM)

- Operational Risk
  Basic Indicator Approach (BIA)
  Standardised Approach (SA)
  Alternative Standardised Approach (ASA)
  Advanced Measurement Approach (AMA)

On implementation date, banks will, as a minimum, be required to compute their capital requirements using the simplest available approach for each risk category. However, banks shall be free to use the more advanced approaches provided they meet the minimum requirements.

In July 2006, a survey conducted to ascertain the approaches that banks intend to adopt during the coming decade, revealed that most banks opted for the simplest approach for credit and market risks. Furthermore most of the banks moving to the advanced approaches for operational risk will adopt either the SA or the ASA. Charts 1, 2 and 3 display the results of the survey.

Chart 1: Intended Approach for Credit Risk

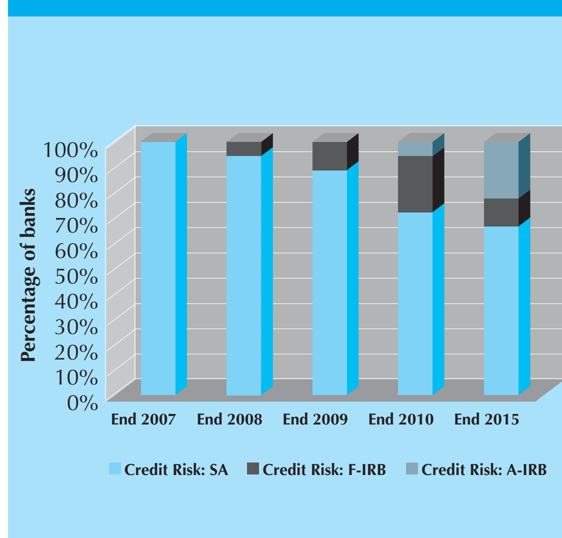


Chart 2: Intended Approach for Market Risk

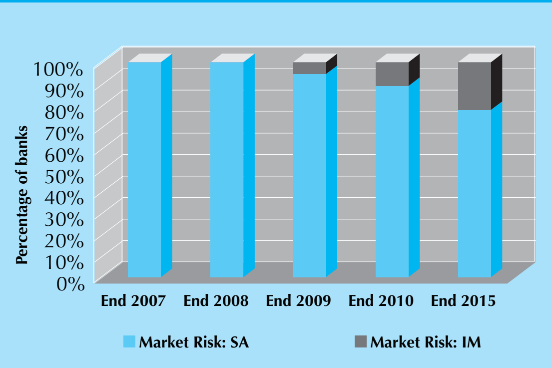
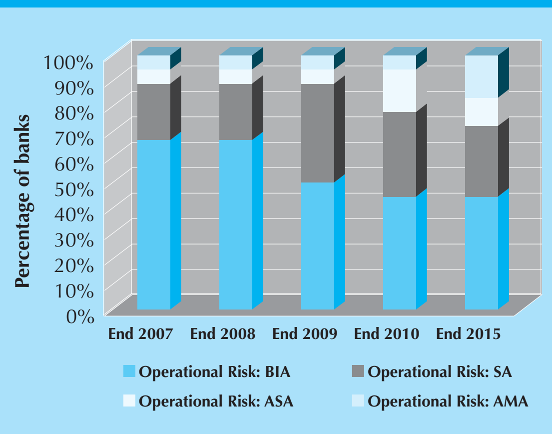


Chart 3: Intended Approach for Operational Risk



Consultative Papers

As at July 2006, the following three proposal papers have been issued to the industry for consultation:

(i) Scope of Application of Basel II;
(ii) Standardised Approach for Credit Risk; and
(iii) Management and Measurement of Market Risk.

The salient features of the three proposal papers are highlighted below.

Proposal Paper on the Scope of Application of Basel II

The proposal paper sets out a framework for the Scope of Application of Basel II. Indeed, banking groups predominantly engaged in banking business whose centre of economic interest is in Mauritius shall maintain capital adequacy requirements on a consolidated basis for the group and on a stand-alone basis for each individual member predominantly engaged in banking business in Mauritius. On the other hand, foreign banking entities incorporated and operating in Mauritius shall be subject to capital adequacy requirements on a sub-consolidated basis for their group operation in Mauritius and on a stand-alone basis for each individual member predominantly engaged in banking business in Mauritius. Furthermore, foreign branches shall maintain capital requirements with respect to their segment A operations only.

Proposal Paper on the Standardised Approach for Credit Risk

On implementation date, banks shall be required to compute their capital requirements for credit risk using, at a minimum, the SA. The Basel II document contains several areas of national discretion with respect to the SA. For instance, the ratings of Standard & Poors Corporation, Moody's Investor Services and Fitch Ratings shall be recognised whilst other rating agencies shall have to apply to the Bank for eligibility. Claims on the Government of Mauritius shall be risk weighted at zero per cent. Claims on other sovereigns denominated and funded in their local currency may be assigned a preferential risk weight as determined by the supervisory authority of the sovereign, subject to the prior written approval of the Bank. The Bank has adopted the second option proposed in the Basel II document for claims on banks. Hence, risk weighting of claims on banks shall be based on the external credit assessment of the bank itself with claims on unrated banks being risk weighted at 50 per cent. As regards the definition of the regulatory retail portfolio to be risk weighted at 75 per cent, the Bank has set the maximum aggregated retail exposure to one counterparty at Rs12 million.

Proposal Paper on the Management and Measurement of Market Risk

The implementation of Basel II will extend the coverage of the capital requirements for market risk. Banks are already maintaining capital requirements for foreign exchange risk using the SMM set out in the Basel II document. The proposal paper on measurement and management of market risk sets out the principles for managing market risks, namely, foreign exchange risk, interest rate risk, equity risk and commodities risk above a threshold. The paper also

introduces capital requirements for interest rate risk, equity risk and commodities risk. A survey conducted in 2005 revealed that interest rate risk in the banking book is by far the largest risk that banks in Mauritius are facing. Banks are thus required to assess the interest rate risk in the banking book. As a minimum, banks are required to measure the impact on their earnings using both an upward and a downward movement of 200 basis points in interest rate.

2.3.2 Electronic Banking

Electronic Banking normally refers to the use of technology for the delivery of banking products and services. These products and services are increasingly being accessed via computers and cellular phones. The development of e-banking, in an environment characterised by deregulation in the banking sector and increased globalisation, poses new challenges to the regulators. (Please see box No. 2.1) With a view to mitigating the risk of money laundering and financing of terrorism, the Bank issued the Guidance Notes on Anti Money Laundering and Combating the Financing of Terrorism in 2003, which were subsequently amended in 2005 following the enactment and proclamation of the Banking Act 2004 and Bank of Mauritius Act 2004. Further, in view of the rapid development of the provision of financial services via electronic delivery channels, the Bank issued a Guideline on Internet Banking in April 2001. The Banking Act 2004 has set out at sections 50, 51 and 52 relating to Electronic Banking, a framework within which banks may conduct e-banking business. Those sections also define the specific circumstances that require the Bank's approval and the minimum security measures that need to be put in place.

Box No 2.1

Electronic Banking

Electronic Banking normally refers to the use of technology for the delivery of banking products and services. These products and services are increasingly being accessed via computers and cellular phones. The development of e-banking, in an environment characterised by deregulation in the banking sector and increased globalisation, poses new challenges to the regulators.

Cross Border Transaction

With e-banking, banks' potential for expanding their geographical coverage has improved, resulting in increased cross-border transactions. However, it is imperative that banks be fully aware of the existing regulatory framework of the country with which they are transacting.

AML/CFT Issues

The integration of the world's financial systems, the free movement of capital and the development of e-banking have to some extent contributed to money-laundering activities in countries with inadequate regulation and supervision. With a view to mitigating the risk of money laundering and financing of terrorism, many countries have issued specific guidelines on customer identification and due diligence to be conducted before establishing a banking relationship. In that respect, the Bank issued the Guidance Notes on Anti Money Laundering and Combating the Financing of Terrorism in 2003, which were subsequently amended in 2005 following the enactment and proclamation of the Banking Act 2004 and Bank of Mauritius Act 2004.

Other risks

The heavy reliance on technology in e-banking exposes providers of electronic banking services to operational risks, such as security threats and system failures, which in turn can lead to legal and reputational risks.

Risk Management Principles for Electronic Banking

The BCBS has recognised that the rapid development of e-banking services has modified the overall profile of banking. New aspects of the traditional risks associated with banking services, namely strategic, operational, legal and reputational risks, have gained prominence. The BCBS has thus identified fourteen Risk Management Principles for Electronic Banking with a view to helping banking institutions adapt their risk management policies and procedures to include e-banking activities. These principles can be grouped into three broad categories, namely Board and Management Oversight, Security Controls and Legal and Reputational Risks Management.

2.3.3 Developments in Private Banking

During the last decade, the financial sector has witnessed a series of significant changes, prompting banks to diversify and expand their activities beyond traditional banking. Banks are presently offering a wide range of new products to their customers, including banking solutions tailored to individual requirements. In this respect, financial institutions have started to exploit the opportunities present in the management of private funds of wealthy customers. (Please see box No.2.2) Banks in Mauritius have recently shown an interest to capture a share of private client business.

With the integration of the offshore and domestic banking sectors under a single banking licence regime, the Mauritian banking industry has been subject to a major overhaul. It is expected that this major financial reform would set a level playing field for all licensed institutions, with adherence to international norms and standards. In the same vein, a series of initiatives has been undertaken by Government to stimulate the Mauritian financial services sector and to position Mauritius as a financial services hub in the region. As announced in the 2006-07 Budget Speech, amendments would be brought to the Banking Act 2004 to expand banking activities to include private banking services.

Box No 2.2

Private Banking

Private banking can be defined as the provision of wealth management services designed specifically for high net worth individuals. These services cater for the special needs of investors comprising wealthy individuals with inherited property, successful and established entrepreneurs in emerging and developing economies who require a diversified investment portfolio, company executives and professionals who have made substantial gains and have accumulated personal assets over a period of time and mature investors who have gradually built up a complex portfolio of investments. However, product differentiation and investment options offered by the private banker depend on the risk appetite of the client.

Critical features of private banking service delivery are confidentiality with respect to client's information, extensive choice of products including access to global financial markets, capability to address concerns ranging from legal issues to tax planning, and preservation and fructification of family fortunes. At the international level, the scope of private banking services has considerably widened through increasing financial sophistication. New service providers are now capable of offering highly specialized financial products. The sector is thus adopting a new concept of one-stop shop for financial services.

Private banking is quite common in European and North American financial markets. The country of reference remains Switzerland, which has been labelled the 'leading offshore money manager' given that it holds and manages about a third of cross-border wealth in the world. According to a study published in June 2006 by London-based consultancy Scorpio Partnership, the largest Swiss bank, UBS was the world's largest bank for wealthy clients at the end of 2005, with over US$1 trillion worth of client assets.

In the Asian region, Singapore and Hong Kong remain the main centres for private banking business. The growth rate of affluent individuals in this part of the world has outstripped that of North America and Europe. Private bankers are aware of the opportunities that exist to exploit this booming market. Accordingly, they have set up private banking units to cater for the sophisticated needs of their potential clients who expect high returns on their investments.

2.3.4 Developments in Islamic Banking

Islamic banking refers to a system of banking activity which is consistent with Islamic law (Sharia) and is guided by Islamic economics. Islamic law prohibits usury and the collection and payment of interest, also commonly called riba in Islamic parlance. (Please see Box No 2.3)

A Steering Committee, under the Chairmanship of the Bank of Mauritius, has been instituted to study, inter alia, the social and legal aspects of Islamic Financial Services in Mauritius and to advise on an appropriate institutional framework in respect thereof.

The Committee comprises two representatives of the Bank of Mauritius, the Permanent Secretary of the Ministry of Arts and Culture, the Chief Executive of the Mauritius Bankers Association, the Chairman of the Islamic Cultural Centre, a representative respectively from the Ministry of Finance and Economic Development, the Attorney General's Office, the Financial Services Commission and the Insurers Association of Mauritius.

A forum on Islamic Finance organized by the Islamic Cultural Centre was held at the Grand Baie International Conference Centre on 25 and 26 July 2005 to create awareness in Islamic finance.

Box No 2.3

Islamic Banking

Principles of Islamic Banking

The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of '*riba*' (interest). Islamic banking differs from conventional banking in that it operates in accordance with the rules of Sharia, known as Fiqh al-Muamalat (Islamic rules on transactions). Common Islamic concepts used in Islamic banking are profit sharing (Mudarabah), joint venture (Musharakah), and cost plus (Murabahah).

Mudarabah is venture capital funding by the bank to an entrepreneur who provides expertise, management and labour, with both sharing the profit and risk involved.

The practice of *Musharakah* is a different approach whereby Islamic banks lend their money to companies by issuing loans with floating interest rate pegged to the company's rate of return. Thus, a certain percentage of the company's profits represents the bank's revenue from the loan until the principal amount of the loan is fully repaid.

The concept of *Murabahah* involves the purchase of an asset by the bank which resells it to the acquiree at a profit and the payment is effected to the bank in instalments. The asset is registered in the name of the acquiree and given as collateral to the bank.

The Global Scenario

The growth of the Islamic Financial Services Industry has gathered momentum and overall assets are estimated at hundreds of billions of dollars. Islamic banks today offer a wide range of products from basic Sharia-compliant retail products to insurance, mortgages, investment instruments and large-scale project financing and are increasingly present in the western world. In Malaysia, Bahrain and a few other countries of the Gulf, Islamic banks and financial institutions are working alongside those involved in conventional banking.

An effective regulatory and supervisory framework, good corporate governance and market discipline, robust risk management framework and an enabling legal infrastructure are the Pre-requisites for a stable Islamic financial system.

2.3.5 Guideline on Outsourcing

The Bank issued the Guideline on Outsourcing by Financial Institutions.

With a view to reducing costs, financial institutions are increasingly having recourse to external service providers. However, outsourcing exposes financial institutions to increased risks, particularly with regard to confidentiality of data. The need was felt to develop a set of principles that would give guidance to financial institutions on how to manage those risks. The Guideline on Outsourcing by Financial Institutions was issued on 30 May 2006 to all financial institutions falling under the regulatory purview of the Bank and it came into effect as from 1 June 2006.

The Guideline follows the high-level principles on 'Outsourcing in Financial Services' developed by the Joint Forum, which comprises the BCBS, International Organisation of Securities Commission (IOSCO) and International Association of Insurance Supervisors (IAIS).

The main objective of the Guideline is to set out a broad framework for financial institutions that have engaged in outsourcing or are planning to outsource their business activities to service providers, in line with Principle 15 of the revised Core Principles for Effective Banking Supervision. This Principle requires financial institutions to establish an appropriate policy laying down the minimum requirements to be fulfilled when outsourcing an activity. The Guideline supersedes section 12 of the Guideline on Internet Banking that deals with the outsourcing of banks' Internet banking activity.