Mauritius
Financial Sector Review

June 30, 1992
Industry and Energy Operations Division
Eastern Africa Department
Africa Region

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Document of the World Bank

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CURRENCY EQUIVALENTS

Currency Unit = Mauritius Rupee
US$1 = 15.5 Rs
Rs1 = 0.0645 US$

GOVERNMENT FISCAL YEAR

July 1 - June 30

ABBREVIATIONS AND ACRONYMS

ATM     Automatic Teller Machine
BCCI    Bank of Credit and Commerce International
BNPI    Banque Nationale de Paris Internationale
BOM     Bank of Mauritius
CCCE    Caisse Central pour la Corporation Economique
CPAs    Certified Public Accountants
DBM     Development Bank of Mauritius
EPZ     Export Processing Zone
ICOR    Incremental Capital Output Ratio
MCB     Mauritius Commercial Bank
MHC     Mauritius Housing Corporation
MLC     Mauritius Leasing Company
MPOSB   Mauritius Post Office Saving Bank
NMF     National Mutual Fund
NPF     National Pension Fund
OTC     Over-the-counter
SCB     State Commercial Bank
SEC     Securities Exchange Commission
SEM     Stock Exchange of Mauritius
SICOM   State Insurance Company of Mauritius
SIFB    Sugar Insurance Fund Board
WF      Welfare Fund
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PREFACE

This report is based on the findings of a financial sector mission which took place in July/August 1991. The mission team was led by Juergen Franz (AF2IE), and comprised Anita Ahmed (IFC), David Cole (Harvard Institute for International Development), Dan Mozes (CECFP), Fayez Omar (AF2CO), and Betty Slade (Harvard Institute for International Development). The mission would like to thank the Mauritian Government and many others in the financial sector for their excellent support and cooperation. Gregg Forte (consultant) carried out the initial editing of the report. William Wright was responsible for the production of the report.
SUMMARY AND RECOMMENDATIONS

0.1 The economy of Mauritius has performed exceptionally well during the 1980s, achieving significant growth at relatively stable prices. Cheap labor and preferential access to foreign markets fueled an export boom that was fed by high rates of government-stimulated investment. By the late 1980s, the central bank’s holdings of foreign exchange had grown large enough to drive money growth ahead of gains in output; and unemployment had fallen to near frictional levels, which helped push wage gains ahead of growth in labor productivity and reduce the competitiveness of Mauritian exports. With wage gains exceeding productivity and money growth exceeding output, annual price increases in the late 1980s broke into the range of 10-15 percent, and economic growth began to slow down.

0.2 The government is encouraging investments to expand, diversify, and modernize the productive capacity, infrastructure, and housing stock of Mauritius, but these require a turnaround in the saving rate, which has been falling, and the use of market mechanisms to efficiently channel savings to long-term productive uses. Standing in the way of expanded saving and investment are principally the government’s bank credit ceilings and interest rate controls, which are reducing competition among banks by causing them to hold excess liquidity under current inflationary conditions, and the underdeveloped capital markets, which could play a much larger role in giving investors access to long-term funds while meeting the demand of savers for liquid investments with a good return.

Alternative Policy Emphases for Financial Growth

0.3 The government has announced its intentions to reduce direct controls over the banking system and develop the money and capital markets in an effort to increase the pace of saving and investment initiatives that this report supports. The pace of the financial deepening that the government seeks over the next decade will depend in part on the policies that will shape the institutional structure in the financial sector. In the 1984-90 period, the growth of commercial bank assets accounted for much of the growth of the financial sector of Mauritius, and bank assets as a share of GDP are already fairly high by international standards. Over the coming decade, however, bank assets in Mauritius are not likely to maintain their share of total financial assets because the demand for financing will likely become more diversified and specialized and shift toward the long end of the maturity spectrum.

0.4 The government of Mauritius can adopt various policy emphases regarding the institutional structure best suited to the goal of financial growth. The two broadest alternatives concern the way in which banks would participate in the growth and diversification of the financial sector. The review suggests that a banking-centered strategy, in which banks continue their dominant role through direct expansion into new activities, is not the most appropriate for Mauritius, given the dominance of the banking sector by just two institutions and the urgent need to develop the capital markets to provide new vehicles for saving and investment.

0.5 A policy emphasizing the diversification of the financial sector would likely be more effective in advancing the growth of saving and investment. Such a strategy would limit the banks to their current activities of operating the payments system and intermediating between short- to medium-term deposits and loans. Other types of financial institutions, including the stock market and
specialized subsidiaries of the banks, would be expected to provide most other types of financial services, including the intermediation of longer-term savings and investment demands.

Accordingly, reforms are proposed in the following areas: banking, capital markets, other markets for long-term funds, and methods of diversifying economic activity. Some observations on taxes and fiscal policy are presented at the end.

Bank Reform

Competition in the banking system can be introduced in two phases, the first consisting of an immediate series of steps to liberalize controls, and the second consisting of several more years’ duration to develop indirect means of monetary control.

Phase 1: Lifting Controls

In the first phase, the government should immediately take the following steps:

1. Eliminate specific directives on interest rates for deposits and for lending.

2. Eliminate the ceilings on the amount of credit that may be extended to nonpriority sectors.

3. Liberalize foreign exchange transactions on current account.

4. Eliminate the individual credit ceilings on banks. For this, the Bank of Mauritius will need to develop the use of the liquidity ratio as its interim tool of monetary control, which could be accomplished within six months.

By enlarging the scope for competition in the banking industry, such reforms can be expected to raise interest rates on deposits (encouraging savings); lower interest rates for borrowers in low-priority sectors (giving a downward push on the prices of their goods and services); and raise interest rates to borrowers in high-priority sectors (thus making credit available to high-potential, higher-risk borrowers).

As banks compete for a larger share of the market, fees for financial services and spreads on foreign currency conversions can also be expected to decrease. Therefore, banks probably will lose some income both from interest margins and from fees and foreign exchange. The reforms therefore should be accompanied by new business opportunities for banks.

With regard to offshore banking, it is recommended that the offshore banks be consolidated into their related local banks, which in turn would themselves be allowed to provide offshore banking services to foreign customers. This move will save operating expenses, make better use of the expertise in international transactions that can be gained from offshore operations, and ease the supervision task for the Bank of Mauritius.
Capital Markets

0.12 The capital market can become an important tool for the stimulation of savings and their conversion into equity and long-term securities for financing investment. To achieve this goal the government should pursue the following policies:

1. Enact comprehensive legislation to govern the capital market, making the SEC the supervisory agency with responsibility over the issue of new securities as well as over the secondary market.

2. Take measures to increase the supply of securities, including the introduction of trading in all existing long-term debt instruments.

3. Promote the demand for securities.

4. Create a modern securities clearing system.

0.13 Comprehensive legislation for the capital market and its clearing system should strengthen the SEC, enabling it to regulate the private-sector issuance of securities, securities trading, and the licensing of brokers/dealers. The legislation would also grant appropriate enforcement powers to the SEC. The report does not, however, recommend that resources be developed to preparing an all-encompassing financial services act, but rather that priorities be given to closing gaps in existing legislation to facilitate the smooth functioning of the market.

0.14 A modern clearing system that will clear all transactions of a day's trading before the next day's trading is needed. This system should be designed to process a much larger volume than currently traded, and should enable daily trading.

0.15 To increase the supply of securities, and therefore expand the opportunities for the public to save, the government should

1. Introduce secondary trading in all government and corporate debt instruments.

2. Make the fiscal incentives for companies to list their issues on the exchange effective for all companies—currently, firms in the export processing zone (EPZ) and other priority sectors for registered companies pay a lower rate of corporate income tax than the rate for registered companies.

3. Remove the current double taxation of dividends flowing from corporations to individuals (taxing corporate income at the corporate level and again as dividends at the shareholder level).

4. Explore the potential for establishing a commercial paper market, perhaps through the stock exchange, a step that could also help formalize the existing intercorporate debt market.

5. Encourage well-run, profitable companies in the public sector to fund appropriate activities through the issue of bonds/debentures at market rates without a government guarantee.
6. Carefully divest good-quality public sector companies through the public sale of new and/or existing shares, and encourage the State Investment Corporation to divest its minority equity stakes once its catalytic role of helping new companies become established has been completed.

0.16 Steps the government could take to increase the demand for securities are to resolve conflicting investment incentives (forgiving taxes on the yields of long-term bank deposits and certain government debt instruments, for example, makes most private-sector issues uncompetitive), improve the availability and quality of financial information to the investing public, and create new investment vehicles with yields linked to movements in interest rates and exchange rates to offer savers more security. It is important, however, to ensure that measures to increase supply have taken hold before demand enhancing measures are introduced.

Other Markets for Long-Term Capital

0.17 The insurance industry is especially important to Mauritius, which is susceptible to highly destructive cyclones. Fortunately, the industry seems to be competitive and well developed. It needs strengthening, however, through more thorough supervision. In addition, higher capital standards would prevent potentially damaging failures resulting from the existence of thinly capitalized firms in the industry.

0.18 To stimulate the market for longer-term credit while the process of liberalizing all credit is being developed, the government should permit commercial banks, through subsidiaries, to compete in the medium- and long-term credit markets by exempting long-term deposits with such subsidiaries from liquidity requirements and medium- and long-term loans from credit ceilings. This wider market will need supervision, most appropriately by a new licensing and supervision unit within the Ministry of Finance.

0.19 The Development Bank of Mauritius could also help develop the capital market by funding its programs through bond issues rather than borrowing abroad. However, the DBM, which has a large portfolio of nonperforming loans, needs to continue with its major effort to improve collection performance in order to make a positive contribution to the financial sector of Mauritius. The Mauritius Cooperative Central Bank is currently being restructured. The other financial institutions appear to be reasonably sound.

Diversifying Economic Activity

0.20 Even with a more diverse and competitive financial sector and a stronger flow of saving and investment, special measures will still be needed to improve the flow of resources to small or new businesses. The problem is a common one around the world; such firms are usually not desirable credit customers because of their riskiness, weak capital position, non-existent credit history, and lack of collateral.

0.21 Equity funds are usually the means of ascent for new and small firms, and the government can help in this regard by encouraging the establishment of commercially-oriented private sector venture capital funds, possibly piloted jointly with the State Investment Corporation. The proper taxation of capital gains and losses from venture capital funds would be a critical factor in supporting the creation of such funds.
0.22 The government could encourage the development of business parks where small or new businesses could rent the limited amounts of space they typically need; the DBM could pioneer such activity. As a further aid to small or new businesses, the government could encourage the expansion of possibilities for leasing widely usable kinds of equipment such as office equipment, motor vehicles, and so on.

Taxes and Fiscal Policy

0.23 This study has not specially addressed the tax system, but tax issues have arisen, particularly the large number of tax concessions. The government should carefully consider the benefits of dropping most of them in favor of a lower general tax rate. If such an approach is taken, special assistance to firms and sectors could still be delivered through direct, budgeted expenditures, which, because they are fiscally explicit, have the virtue of requiring periodic justification. The other principal tax issues have been the double taxation of dividends paid to individuals, the proper taxation of venture capital gains and losses, the distortionary effect of indirect taxes on imports, and the benefits of a smoother flow of income taxes through withholdir·. and more frequent business payments.

Timing

0.24 As shown in the last chapter, all recommendations could be implemented within three years, and most of them within eighteen months.
1. THE MACROECONOMIC ASPECT OF FINANCIAL SECTOR DEVELOPMENT

1.1 In the late 1970's the Mauritian government began implementation of a stabilization and adjustment program and embarked on an export-oriented growth strategy based on the country's abundance of labor and motivated by a number of tax incentives. The resulting economic performance was impressive. By the mid 1980s, Mauritius GDP per capita had risen to about $1400, up from $700 in the mid 1970s, and unemployment declined, to less than 3 percent of the workforce. Notwithstanding this remarkable success, today the economy faces new challenges which are manifested through increasing wage and price pressures which threaten the economy's competitiveness in export markets. With the economy near full employment, the current strategy is to regain the competitive edge through enhanced labor productivity and export diversification. This would require new investments to substitute existing technologies for more advanced (capital-intensive) well as investments in new product lines. To finance the new investments without exerting undue burdens on the country's external indebtedness the government would need to increase the level of domestic saving and improve the efficient allocation of investable funds.

1.2 Higher saving levels can be realized through increased private saving, government saving, or both. Enhancing private saving and their efficient allocation for investment can be best achieved through a well-functioning financial system. The steps which are necessary to improve the functioning of the financial system are discussed in the remainder of this report. Some of these steps, such as the lifting of credit controls on individual banks, can be accomplished in a few months; others will take several years. Even with the fastest possible action on financial sector reforms, however, the rise in private saving will necessarily lag behind the pressing investment needs. In the meantime, higher levels of government saving can be achieved relatively quickly, given the currently small size of the fiscal deficit. The government can achieve an ex-ante budgetary surplus and the proceeds in excess of what would be an ex-post balanced budget directed to finance the new investments. Such surplus would generate the funds that the government could make available for new investment and it could ease the transition away from certain inefficient tax incentives by making funds available through direct budgetary support for new investments.

1.3 This chapter reviews the current state of saving/investment gap in Mauritius and briefly describes the supportive role that a fiscal surplus might play until the government moves toward a more efficient financial sector.

Savings and New Investments

1.4 A combination of factors produced the economic success of Mauritius in the 1980s. The two most important were the success of numerous government incentives in raising the level of savings and investment in the private sector; and the rapid expansion of export-oriented industries, which gained a competitive edge in the European Community via preferential access and in other world markets via cheap labor. These conditions allowed the Mauritian economy to grow while external debt obligations were reduced. After achieving full employment, however, economic performance started to deteriorate under the inflationary effects of wage increases combined with static labor productivity.

1.5 To regain the high rates of growth in the face of labor constraints, the government is encouraging more capital intensive investments in new high value added industries, capital, equipment replacement, improved training and education and infrastructure that would increase labor
productivity, and the amount and diversity of the country's exports. To finance such investment, saving rates, which have declined in recent years, need to be restored and adequately channeled without exerting unsustainable pressures on external balances.

1.6 A simple approach to analyzing whether the new wave of investment can be financed without creating unsustainable external imbalances is by stipulating a certain growth rate over the next several years—say 5 percent, and assuming a reasonable incremental capital output ratio (ICOR). Although Mauritius has achieved rather impressive ICORs in the 3-4 range in the past, the current stage of development suggests that a higher rate may be more appropriate in the future. This is particularly so given that large new investments, combined with the scarcity of labor, and the lack of labor skills commensurate with the new technologies and production processes, may not translate into immediate growth. Thus until these temporary constraints are removed, an ICOR of about 6 may be reasonable, suggesting that the ratio of investment to GDP would need to remain at its current level of 30 percent at the targeted GDP growth rate of 5 percent per year. Assuming that the historical relationship between the saving rate and GDP growth holds, the saving rate corresponding to a GDP growth of 5 percent would be about 22 percent of GDP. This would imply a resource gap of 8 percent of GDP. And if past trends continue, it can be assumed that the net factor income, which has been negative, can be matched in magnitude by net private transfers, implying that the current account deficit would be about equal to the resource gap.

1.7 In the recent past, the current account deficit has been financed largely through sizable capital account surpluses. If the current level of reserves is held constant, and if long-term capital inflows are maintained at their historical levels, the financing of the current account deficit will be achieved through private capital flows and government borrowing. Here, an infinite number of combinations are possible, but even under an optimistic scenario of private capital inflows averaging 4 percent of GDP in the next five years, government external borrowing will continue to grow at an average annual rate of 8.2 percent over the next five years. Whether this growth rate in government borrowing is sustainable in the long run depends on the performance of exports. If exports are to grow at a rate of 6 percent annually, as assumed in the latest report of the World Bank (Expanding Horizons), then the economy cannot sustain this path of additional borrowing in the long run; instead, the desired level of investment will need to be financed by higher domestically mobilized savings.

1.8 Alternatively, if the analytical point of departure is maintaining the average growth in the stock of debt at 6 percent over the next five years (that is, at a rate equal to that of export growth), then under the same assumptions, one would end up with an investment rate of about 25 percent of GDP by the end of the projection period. If the ICOR is maintained at 6, this implies a GDP growth rate of slightly over 4 percent. Under such a scenario, higher growth rates may be achieved only if the ICOR is reduced by improved labor efficiency. Measures to achieve such gains in labor productivity might be similar to those already adopted by the government, such as the Educational Master Plan and the Industrial and Vocational Training Board.

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1 The ICOR is calculated as the ratio of investment to GDP divided by the growth rate of GDP.
The Role of Economic Policy in Mobilizing Savings

1.9 During the last few years, the domestic saving rate has begun to deteriorate, falling to 21 percent of GDP in 1990 compared to a high of about 29 percent in 1986 (figure 1.1). Meanwhile, investment rates have continued to increase, resulting in a widening gap between saving and investment and larger current account deficits (figure 1.2). The government's approach to raising domestic saving has focused on expanding the income tax incentive for investing in medium-term and long-term savings instruments and on the development of the capital market.

1.10 A rising ratio of M2 to GDP and of annual changes in the ratio of M2 to real savings (table 1.1) indicate that financial saving has responded positively to the incentive schemes, even though overall saving did not. This divergence of results is to be expected; the composition of savings and their channeling through the financial system are sensitive to real interest rates and yields, but income and substitution effects counteract the incentives and hold down the sensitivity of savings. Thus, the actual effect of the policies intended to encourage saving has been to raise the levels of disposable income (figure 1.3), but with larger increments going into consumption than into saving.

1.11 Private savings constitute by far the bulk of total savings in Mauritius, and the decline in total saving has occurred despite a continued, although moderate, increase in public saving. One possible source of the decline in saving is the government's general economic policy stance, which biased toward consumption (notwithstanding schemes to encourage saving). The consumption-biased stance includes the government's policy on wage increases, which scales raises to changes in the consumer price index rather than productivity; near-zero real interest rates on deposit (an effect of government credit controls); the increase in the number of tax deductions; price subsidies on some food items; and the elimination of tariffs on some durable imports and some consumer goods. Policy cannot effectively aim at a higher saving rate while encouraging consumption. So far, the growth of consumption has exceeded the growth of GDP for four consecutive years. If this trend continues, a strong case could be advanced for moving toward a consumption-based tax.

1.12 Furthermore, the recent decline in the rate of economic growth may have contributed to the declining saving rate. The aggregate saving rate in fast-growing economies tends to be closer to the saving rate of active workers than to that of retired workers; therefore, a strong correlation usually exists between growth rates and saving rates. This correlation, which has held for Japan, Korea, and Indonesia, also appears to hold for Mauritius (figure 1.4); strong growth appears to be the best guarantee of a high rate of saving.

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2 Some argue that a more broadly defined saving rate, including the consumption of durables, has not declined. The argument made is that as incomes grew and labor became scarce, households saved less to finance investments in capital goods but continued to purchase durables (from abroad) at an increasing rate, thereby more than offsetting the decline in narrow savings. Once such demand was met, the narrow saving rate would be restored to its earlier, higher levels. As shown in figure 1.1, however, real savings plus imports of durables continued to rise for only one year after the deceleration of narrow saving in 1987; after 1988, broad as well as narrow saving declined.

3 Higher rates encourage saving, but on the other hand the higher rates permit the same level of interest income to be earned on a smaller amount of savings.
Figure 1: Savings, Investment & CA

Figure 2: Savings & Durable Imports

FIGURE 1.1

FIGURE 1.2
(current account)
### Table 1.1: Broad Money, Real Deposit Insurance Rate, and M2 changes over Real Savings (Percent)

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<tbody>
<tr>
<td>M2/GDP</td>
<td>43.1</td>
<td>49.0</td>
<td>53.4</td>
<td>57.9</td>
<td>63.2</td>
<td>63.3</td>
<td>66.5</td>
</tr>
<tr>
<td>Deposit rate (1)</td>
<td>2.7</td>
<td>2.6</td>
<td>7.6</td>
<td>8.8</td>
<td>0.8</td>
<td>-1.4</td>
<td>-0.8</td>
</tr>
<tr>
<td>dM2/Real Savings</td>
<td>32.8</td>
<td>66.5</td>
<td>52.4</td>
<td>60.7</td>
<td>75.4</td>
<td>56.4</td>
<td>94.5</td>
</tr>
</tbody>
</table>

Source: IFS, CEM; (1) Period Average real interest rate on deposits.

### Table 1.2: EPZ Investment, Value added, and Export Growth (Percent)

<table>
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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Real Investments (1)</td>
<td>100.6</td>
<td>241.7</td>
<td>339.0</td>
<td>613.3</td>
<td>655.0</td>
<td>747.0</td>
<td>631.4</td>
<td>580.9</td>
</tr>
<tr>
<td>Investment growth</td>
<td>83.2</td>
<td>140.2</td>
<td>40.3</td>
<td>80.9</td>
<td>6.8</td>
<td>14.0</td>
<td>-15.5</td>
<td>-8.0</td>
</tr>
<tr>
<td>Value Added growth</td>
<td>8.9</td>
<td>33</td>
<td>30</td>
<td>35</td>
<td>22</td>
<td>14</td>
<td>5.7</td>
<td>9</td>
</tr>
<tr>
<td>Exports growth</td>
<td>2</td>
<td>33</td>
<td>34</td>
<td>40</td>
<td>22</td>
<td>12</td>
<td>1</td>
<td>9.8</td>
</tr>
<tr>
<td>GDP growth</td>
<td>.04</td>
<td>4.7</td>
<td>6.9</td>
<td>9.7</td>
<td>10.2</td>
<td>6.8</td>
<td>4.2</td>
<td>6.6</td>
</tr>
</tbody>
</table>

Source: CEM; (1) in Millions of 1987 Rupees.
The Role of Financial Policy in Encouraging Investment

1.13 Investment as a share of GDP has increased from about 17 percent in 1984 to about 30 percent in 1990, with most of the rise coming from increases in private investment. During that period, government policy provided tax breaks, tax holidays, and direct intervention in the volume and pricing of credit to what it considers to be the high-priority sector. Over the 1930s, these policies coincided with a conducive external environment, so their contribution to growth are impossible to gauge. In the last two years of the period, however, real investment and exports from the export processing zone (EPZ) have decelerated (table 1.2). At the same time, the growth rate of financial saving, like that of overall saving, has also decelerated. Between the year ending May 1990 and the year ending May 1991, for example, the growth rate of time deposits fell from 17 percent to 14 percent; the same rate for savings deposits fell from 28 percent to 24 percent over the same period.

1.14 These declines are likely the result of individual-bank credit ceilings imposed by the Bank of Mauritius, under which commercial banks discourage some deposits for fear of not being able to lend the funds. Individual bank credit ceilings have also resulted in excess liquidity in the commercial banking system, as has been the case in other countries with individual-bank credit ceilings. Moreover, the noncash component of excess liquidity (about Rs 900 million in 1989) had to be absorbed by the government in the form of treasury bills, the amount of which significantly exceeded that needed by the government to finance its deficit. The result has been a sizable increase in domestic interest payments by the government and a weakening in government savings. Thus, not only did the credit controls constrain saving; they also added to the budgetary burden.

4 Experiences in other countries also show that incentive policies, while benefiting some sectors in the economy, may have adverse effects on other sectors, and their net contribution to overall growth is impossible to measure. Some incentives may support an activity that would have been supported regardless of the schemes, a likelihood that grows with the number and complexity of such schemes (and they are indeed numerous and complex in Mauritius). Furthermore, incentive schemes create a constituency of beneficiaries who make it politically costly to stop them regardless of their efficacy.

Incentive programs also lose their effectiveness the longer they are maintained, and the potential for mistakes grows as economies become more complex. In the case of Korea, for example, where extensive credit allocation was exercised, the policy was successful as exports grew rapidly. Nevertheless, the government made mistakes in the late 1970s, encouraging large investments in shipping and heavy industry that resulted in excess capacity and slower growth in the early 1980s. Furthermore, the incentive structures, when poorly managed, lead to deliberate misclassifications, sometimes fail to reach the intended beneficiary, and in other instances lead to more profit rather than increased production.

More important, as the implicit subsidies associated with incentives grow in magnitude, they may become unsustainable by other private-sector companies and have to be charged to public spending or central bank support, or result in higher rates charged to other borrowers, lower rates paid to depositors, or smaller profits (higher losses) to financial institutions.

5 At year-end 1989, excess liquidity reached Mau Rs 1.1 billion (Mauritian rupees; hereafter, Rs), Rs 200 million of which were held as cash (zero interest); at the same time, the average interest rate paid on deposits was more than 11 percent.
Government's directed credit programs subsidizes high-priority sectors through higher interest on loans to non-priority borrowers and in particular to low-priority sectors. The magnitude of the total loss subsidy may be substantial. There was also some fiscal cross-subsidization; an analysis of estimated corporate taxes paid in fiscal 1991 shows, for example, that all high-priority companies combined paid an estimated Rs 65 million in corporate taxes, of which firms in the EPZ paid about Rs 20 million; those in the low-priority sector paid about Rs 780 million. Under the assumption that corporate taxes are proportional to the corporate share in GDP, equitable tax treatment of EPZ and non-EPZ firms would have raised corporate taxes paid by EPZ companies by Rs 80 million, i.e., to a total of Rs. 100 million.

In addition, the government sector has borne part of this subsidy through foregone income, as did the financial sector, which has been pressed hard to provide cheap credit to high-priority sector. Estimates by the State Commercial Bank show that the break-even rate of interest on lending by the commercial banks is about 15 percent. Assuming that the average lending rate to high-priority sector (category I) is 13 percent, with about 50 percent of total credit allocated to them, the average rate of interest on lending to the rest of the borrowers must be about 17 percent if the commercial banking system is to break even. The Rs 5.6 billion in credit extended to high-priority sector in 1990 means that through this preferential measure alone, high-priority sector were subsidized roughly in the amount of Rs 112 million, or about 0.3 percent of GDP, in 1990. Providing cheaper credit to high-priority sector while maintaining profitability required commercial banks to charge high fees for services and widen the spread between borrowing and deposit rates to above 10 percent for some borrowers, thus discouraging financial intermediation. The imposition of low rates on loans to high-priority sector also prevents banks from lending to high-priority-sector firms and projects whose riskiness would require a higher interest rate than allowed, even though such projects might be more profitable than others.

The combination of fiscal and financial incentives created a bias against low-priority industries, crowding them out of the market for bank credit and forcing them to rely on retained earnings. On the other hand, the government has afforded the low-priority sector high rates of protection through high tariff rates. It would not be surprising if these high protection rates and the increased cost of operations have led to results contrary to the government's goal of increasing productivity and reducing inflationary pressures.

Mobilizing Savings and Targeting Investment through a Budgetary Surplus

The combination of fiscal and financial incentives has created a bias against non-EPZ industries. To counteract this result, the government has afforded non-priority industries high rates of protection through high tariff rates for import substitution activities. It can be argued, however, that this may have contributed to significant market distortions with adverse effects on economic

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6 In the last four years, Rs 4 billion had been raised by the government in excess of its financing needs, and the annual interest payment on such bills averaged Rs 400 million, or about half of the budget deficit in 1990. In fiscal 1990, recurrent expenditures exceeded the target by Rs 313 million mainly because of increases in the cost of domestic debt servicing incurred to mop up excess liquidity. While government savings continued to be positive, they declined relative to GDP.
growth through resource misallocation\textsuperscript{7}, and may have added to price level increases, which the government is trying to limit through the imposition of price controls.

1.19 In this regard, government policy appears to be one of compensation for some market imperfections rather than attacking them. A more effective and sustainable approach would involve the review of the incentive scheme (both fiscal and financial), with a view to eliminate, to the extent possible, the resulting distortions. Alternatively, until capital markets are sufficiently developed, the government might want to consider the benefits of a budgetary surplus as an interim restraint on inflation and a source of investment funds that could be made available to the private sector on a nonconcessionary, competitive basis.\textsuperscript{8} Such surplus would give the government a powerful and flexible tool that would considerably simplify government support to productive private investment.

1.21 The surplus would improve the overall performance of the economy by reducing government demand on financial resources. The consequent reduction of inflationary pressures would tend to enhance the confidence of the private sector, which may have been recently shaken by the surge of inflation. The policy also offers the government great flexibility in directing resources toward productive investments carried out by domestic or foreign private investors. Unlike tax incentives, the strategy is useful for existing as well as newly contemplated investments. In contrast, tax incentives may increase the liquidity of established enterprises and facilitate their development, but they are not much help to start-up enterprises.

1.22 From the point of view of the supply side, the fiscal surplus policy need not be an alternative to all existing tax incentives. Rather, it should be considered as a parallel course of action alongside a rationalized structure of tax incentives. On the demand side, this strategy should be viewed as a transitional stance until anomalies in the financial sector are corrected by a comprehensive reform that would include the removal of credit controls and a move toward indirect monetary controls.

1.23 A budgetary surplus is particularly appealing in the case of Mauritius for two reasons. First, it is consistent with the current government philosophy of active encouragement of saving and high-quality investment; it merely substitutes some of the "automatic" incentive measures with a more deliberate and discretionary policy. Second, given the currently small budget deficits, a budget surplus can be achieved with only a minimally adverse effect on private saving\textsuperscript{9}.

\textsuperscript{7} See World Bank report: \textit{Mauritius Expanding Horizons}, p. 26, Section E.


\textsuperscript{9} Although increases in public saving would be expected to reduce private saving, such a reduction in the case of Mauritius would be much smaller than the observed fall, given that private savings have been four to five times the level of public savings. In addition, empirical evidence suggests that for a given increase in public saving, private saving generally declines by significantly less than the increase in public saving (\textit{World Development Report 1991}, p. 122). The reasons for the decline in overall saving, therefore, lie elsewhere.
2. THE FINANCIAL SYSTEM OF MAURITIUS

2.1 From 1982 through 1987, Mauritius enjoyed a high rate of economic growth and a rapid expansion of bank deposits and credit; in the same period, the fiscal and monetary authorities kept prices and the exchange rate relatively stable. Since 1988, however, inflationary pressures have been mounting as monetary growth, driven by large accumulations of foreign exchange at the central bank, has significantly exceeded the growth of real output. The central bank’s reliance on bank-specific credit ceilings and liquidity requirements to restrain the growth of bank credit began to have significant negative side-effects as the growth of money became excessive; they led to a large accumulation of excess liquidity in the banking system, discouraging banks from further efforts to mobilize deposits, reducing competition among banks, and constraining the development of the country’s capital markets.

2.2 This chapter describes the scope and the problems of the financial system of Mauritius—the institutions, the controls under which they currently operate, and the markets through which savings are currently deployed.

Commercial Banks

2.3 The thirteen commercial banks in Mauritius dominate the country’s financial sector, holding more than 70 percent of all assets. The banks provide the whole range of contemporary banking services and products except certain foreign-exchange hedging instruments not allowed by the Bank of Mauritius. Automation in the sector is advanced; the banks offer automatic-teller-machine services and credit cards, and they are developing on-line teller systems.

2.4 Deposits. The commercial banks are by far the country’s most important depository institutions. Most households keep savings deposits in the banks; the interest rate on the deposits, around 11 percent, is indirectly but strongly influenced by the central bank. The savings deposits can be withdrawn at any time at the bank or by using ATM cards. Checking accounts carry no interest and are used mainly by businesses. For larger amounts, fixed-term deposits are available with interest negotiated between the depositor and the bank. At year-end 1990, deposits in the commercial banks totaled Rs 21.6 billion, of which 49 percent were savings deposits, 39 percent time deposits, and only 12 percent demand deposits. The amount of deposits in other financial institutions is relatively insignificant.

2.5 Industry structure. At year-end 1990, the commercial banks operated 125 branches, employed 3,260 staff, and had total assets of Rs 26.5 billion. Of the thirteen banks, five are domestically owned, including Mauritius Commercial Bank (MCB), the biggest and oldest in the country; MCB also fully owns MCB Finance Company, the third largest bank. Families prominent in the sugar industry are the dominant owners of MCB, whose shares are traded on the stock exchange. MCB together with its subsidiary controls 43 percent of the industry’s assets, 47 percent of all deposits, and 55 percent of all commercial bank loans and advances to the non-government sector. MCB operates 36 branches and employs 1,230 workers (29 percent of all bank branches and 38 percent of all bank employees).

2.6 State Commercial Bank (SCB), the second largest bank, was established by the government in 1970 to counter the virtual monopoly of MCB. SCB holds about one-fourth of the
industry’s assets, deposits, and total loans and advances to the non-government sector, operates about one-third of the industry’s branches, and employs about one-fourth of its staff.

2.7 Three branches of foreign banks, Barclays Bank PLC, Banque Nationale de Paris Intercontinentale, and Hong Kong and Shanghai Banking Corporation, are next in size. They are well established in Mauritius, each with approximately 5 percent of the sector’s total loans and advances and each operating five to ten branches.

2.8 The seven remaining banks are the Mauritius Co-operative Central Bank, owned by the small sugar growers’ credit societies, the Indian Ocean International bank, also domestically owned, and five banks that are branches of foreign banks or foreign-owned local banks.

2.9 The commercial banks are the only major source of short-term credit, which constitutes the major type of borrowing in Mauritius. At year-end 1990, total loans and advances by the commercial banks were Rs 12 billion, half of it short-term and an additional 27 percent medium-term. Additional funds are provided by the banks by discounting trade bills, but these are not significant.

2.10 Monetary controls. The central bank requires that the commercial banks keep 10 percent of their deposits in non-interest-bearing reserve accounts and an additional 23 percent of their deposits in liquid assets. The most important type of asset that qualifies as liquid is BOM bills and Treasury bills, issued by the BOM on behalf of the Treasury. These bills used to be available on demand at yields fixed by the BOM, and the BOM was redeeming them on demand with no penalty; the bills are now issued periodically rather than on demand, but still at fixed rates. Two more reforms regarding BOM bills are in train: the first will impose a penalty on early redemption, thus creating an interbank market in BOM bills; the second is expected to establish an auctioning process in the periodic issue of bills.

2.11 These changes are expected to cause the six largest banks to lend money overnight to each other to meet reserve and liquidity ratios. The smaller banks will probably be excluded from this market and will adjust their positions by trading in BOM bills. When the BOM moves to an auctioning system, which is being developed with IMF technical assistance, the banks will have to adjust their interbank money market operations to constantly changing interest rates.¹

2.12 The income tax system, which has no provision for withholding of taxes from wages and salaries, is a major source of seasonal fluctuations in bank reserves and liquidity. The tax system provides for an annual filing of income tax returns and semiannual payments in the following year. Plans to introduce withholding on wages and salaries and to divide income tax from others into more payments will reduce the fluctuations in the liquidity of the banking system. An interim measure, may be for the Treasury to leave tax revenues in the banks as deposits and withdraw them only gradually (the government currently is depositing its revenue only with BOM).

2.13 The BOM and the Ministry of Finance both are officially committed to the liberalization of interest rates and foreign exchange. In practice, however, the BOM continues to

¹ Since this report was prepared, the auctioning method for issuing BOM bills was introduced. Due to the surplus liquidity position of most commercial banks and the continued use of credit ceilings as the main BOM monetary policy tool, it is too early to evaluate the impact of the move to auctions on the financial sector.
exercise a variety of direct and indirect controls on rates, credit, and foreign exchange transactions that create excess liquidity in the banks and distort the interest rate structure. For example, although the banks theoretically are free to set deposit rates independently, the BOM exerts indirect control through strong protests delivered directly to banks that attempt to deviate from the BOM’s desired rate structure. Such an episode occurred recently when the banks tried to lower deposit rates.

2.14 A discussion of the interest rate structure must take into account the rate of inflation and the pace of devaluation of the Mauritian rupee. For example, in the three years from year-end 1987 to year-end 1990, the rate of inflation in Mauritius, as measured by annual changes in the consumer price index, ranged from 11 percent to 16 percent. With rates of 11 percent to 12 percent paid on deposits and a rate of 13 percent charged on loans to high-priority sectors, savings accounts and high-priority loans earned roughly a zero to negative real return. On the other hand, borrowers in nonpriority sectors were paying rates above those that would be expected in a free market.

2.15 The BOM limits commercial bank lending in several ways. It annually sets credit ceilings at each bank as a percentage increase over the bank’s previous year-end closing balance. The government also sets a stringent limit on the amount of its allocated credit that each bank can extend to the low-priority (Category III) sector—18 percent. Finally, the government fixes the interest rate for loans that the banks choose to extend to the Export Processing Zone (EPZ). That rate, usually announced in the annual budget speech, is concessionary—it is set below the level that would cover costs (interest on deposits, reserve and liquidity requirements, administrative costs, and a reasonable allocation to bad-debt reserve); it also applies to high-priority borrowers regardless of their riskiness. The BOM applies no specific credit or interest rate limits to loans to the various industrial and service firms that make up the mid-priority (Category II) sector.

2.16 Another policy tool for the allocation of credit is the use of nonbank, specialized financial intermediaries for long-term loans, described later in this chapter. The long-term credit outstanding at the specialized financial intermediaries at year-end 1990 was less than one-fourth the amount of commercial bank credit outstanding. For one year, 1990, the BOM allowed banks to use deposits with maturities longer than three years for long-term lending outside the credit ceiling and thereby to compete with the specialized intermediaries in housing and industrial development. As of July 1991 the exemption was removed, however, and the banks ceased making such loans.

2.17 The credit controls and the distorted interest rate structure have created excess liquidity in all but one of the commercial banks; excess liquidity leaves the banks with no incentive to compete for deposits, keeps downward pressure on deposit rates and upward pressure on fees, and helps depress saving as a share of GDP.²

2.18 Profitability. The spread between the interest rate paid on saving deposits, and the officially fixed lending rate to the high priority sector is very low. Therefore, the banks rely on high interest rates to borrowers in the mid- and especially the low-priority sectors to create an acceptable average spread. The interest margin (interest received less interest paid over average total assets) for two banks for which detailed profit and loss data are available is 3.3 percent, similar to margins in

² The excess liquidity also explains the negligible amount of BOM credits to the commercial banks, as advances or as rediscounting of bills (less than Rs 100 million), and the very low level of interbank lending. Most of the BOM credits relate to two directed credit programs: sugar crop financing, which is seasonal and self-liquidating; and the small businesses financing scheme, which amounts to only Rs 50 million.
the USA and the UK. The non-interest income (mostly fees) of the banks contributes more than 40 percent to banks' income, when interest income is calculated on a net interest margin basis. This is a high percentage by international comparisons, where 25-33 percent are common.

2.19 For 1990 the banks earned a net profit after tax of Rs 363 million. This profit represents a return of 1.6 percent on average total assets, and of 25 percent on average net worth (including reserves). These figures are high when compared with bank profit ratios elsewhere. The high profitability enabled the banks to double their net worth in less than two years and shows that the banks compensated themselves for the BOM interventions in deposit and lending rates.

Offshore Banks

2.20 Mauritius has licensed six offshore banks since 1988, when the country passed legislation establishing an offshore banking industry under the supervision of the central bank. Only one of the offshore banks is not associated with a local bank; the other five are owned by the same international groups that own branches registered in Mauritius or are joint ventures between a local Mauritius bank and a foreign banking group.

2.21 The offshore banks are small. The requirement that they operate completely apart from the related local banks (separate premises, separate computers, separate management) imposes a high level of fixed costs and reduces their profitability.

2.22 Local companies operating in the export processing zone are allowed some access to the offshore banks' services. But the local Mauritius banks could probably provide the same services that the offshore banks offer if the local banks were allowed to operate with foreign deposits free of foreign exchange restrictions. Indeed, with the relaxation of controls on foreign exchange in Mauritius, at least on current account transactions, the justification for the separation of offshore banking from local banking decreases.

2.23 In addition, the recent scandals in international banking require the BOM to supervise the offshore banks with greater care. Such efforts may divert BOM resources from more important activities, i.e. the supervision of the local banks and the move to indirect monetary control of the economy.

The Central Bank

2.24 BOM provides the typical functions of a central bank: banking services to the government, monetary control of the economy, supervision of the banking system, and issuance of the national currency. The BOM also supervises foreign exchange regulations and manages the country's reserve of foreign currency. The section on commercial banks, above, discusses the BOM's tools of monetary control, including credit and interest rate controls. This section focuses on supervision, foreign exchange controls, and the BOM balance sheet.

2.25 BOM supervises the banks (including the offshore banks) through reports supplied by the banks and through infrequent on-site inspections. The level of detail required in the reports and their frequency seem high by international standards. The nonbank financial intermediaries are
not supervised by the central bank, are not required to meet reserve or liquidity ratios, and are not limited by credit ceilings.3

2.26 In its capacity as foreign exchange supervisor, the BOM fixes a daily buying and selling rate with asymmetrical margins for the Mauritian rupee. The exact formula for the daily fixing of the exchange rate is not disclosed, but it is based on a weighted basket of currencies that are significant in the country's foreign trade.

2.27 The BOM strictly controls foreign exchange; it requires banks to report all transactions, although no prior approval is required for current account transactions. The BOM buys and sells all foreign currencies required by the commercial banks, allows the banks to keep only very small balances with foreign banks, and expects the Mauritius banks to sell to the BOM daily their excess holdings of foreign exchange. The foreign exchange reserves of the country grew continuously in recent years, to more than US$ 700 million by the end of 1990; less than 4 percent of that amount was held by the commercial banks. No details are available on BOM management of the reserves.

2.28 In the case of foreign exchange, as in the case of the deposit interest rate, policy and practice diverge. The official policy calls for a liberal approach to current account transactions, under which exporters would be allowed to keep export receipts in foreign currency to pay for imports and other expenses. In practice, however, exporters are required to convert all their receipts immediately into Mauritian rupees and to convert them back to foreign currency when paying for imports; and prohibits direct conversion between foreign currencies.

2.29 According to the BOM balance sheet at December 31, 1990, assets totaled Rs 11.7 billion, of which Rs 10.6 billion were holdings in foreign currency. Claims on commercial banks and on the government amounted to less than Rs 0.1 billion. The BOM’s main liabilities were Rs 3.5 billion in currency notes, Rs 1.3 billion in deposits of banks, and Rs 2.9 billion in government deposits; other liabilities totaled Rs 4.0 billion.

2.30 As mentioned above, BOM, with assistance from the International Monetary Fund, has been working on an integrated program to shift from direct to indirect instruments of monetary control, to relax controls over current foreign exchange transactions, and ultimately to remove direct controls over foreign capital movements. The program entails a basic reorientation of the whole financial system and will require several years of evolution.

2.31 At present, money markets are of limited significance: Almost all banks have excess liquidity, and because of foreign exchange restrictions and credit ceilings, they can channel the funds only into government or BOM securities. Shuttering down the automatic repurchase of such securities on July 1, 1991, was an important first step in pushing the banks toward greater reliance on interbank money markets to adjust their liquidity positions, but so long as most banks hold excess liquidity, the money market will not be able to grow very rapidly. Thus, the BOM will have to issue a substantial amount of its own bills both to replace Treasury bills and to reduce total liquidity.

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3 The nonbank financial intermediaries, discussed later in this chapter, are the Development Bank of Mauritius, the Mauritius Housing Corporation, the Mauritius Leasing Company, the State Investment Corporation, and the Mauritius Post Office Saving Bank.
The move to replace Treasury bills with BOM bills is creating a major change in the BOM balance sheet. The balance sheet values of December 31, 1990 are used to illustrate the effect of the replacement of Rs 8.2 billion in outstanding Treasury bills: The Treasury would pay the BOM the Rs 2.9 billion in funds it held on deposit in the BOM and would borrow from the BOM the remaining Rs 5.3 billion. The transaction thus changes the position of the government with the BOM from that of a depositor of Rs 2.9 billion to a borrower of Rs 5.3 billion; and it increases the total assets of the BOM by 5.3 billion, assuming no other changes. Correspondingly, the BOM becomes a net lender to the government and has a new major liability—BOM bills—which will be held by the banks to meet their liquidity requirements and by other financial and non-financial institutions.

BOM has announced its intention to retain credit ceilings and foreign exchange controls until it is confident that the indirect monetary management instruments are working well. Such a stance is understandable, given all the demands for credit prevalent in the economy; but aside from the perpetuation of distortions in the banking market that full reliance on credit controls entails, the decision leaves untapped the substantial foreign exchange reserves of the BOM, which could be used, at least in the short run, to mop up domestic liquidity and to finance additional imports, both of which would help to reduce inflationary pressures.

BOM appears to have left open the question of whether it will rely on the cash-to-deposit or liquid-asset-to-deposit ratio, or both, when it gives up the credit ceilings. However, when employing both ratios for monetary control only one ratio is likely to be binding at any given time. The liquid asset requirements may need to be retained as a transitional measure so that the BOM will be willing to give up the credit ceilings on individual banks. The ultimate consequence of the liquid asset ratio in many countries, however, has been to force banks to buy such instruments as government securities carrying below-market interest rates, which they would not normally be willing to hold. It would seem desirable, therefore, ultimately to do away with the required liquid-asset ratio in favor of the cash-reserve ratio, thereby letting banks allocate their portfolios as risk and profit suggest.

By thus focusing their attention on the cash ratio, the monetary authorities should be better able to exercise control over reserve money (and thereby over short-term interest rates) and also to give greater support to the development of the money markets as the arena in which to carry out their open market operations.

Pending the development of well-functioning money markets, participants in medium-
medium-and long-term security markets may worry that they lack an adequate short-term interest rate
to serve as an anchor for their pricing or that sharp fluctuations of interest rates in a still-limited
money market may add to instability in the longer-term debt markets. The experience of other
countries suggests that having both short- and long-term debt markets linked by a smooth yield curve
is not essential for the development of either market. If the monetary authorities do not interfere
significantly in the longer-term debt markets, and if those markets are reasonably competitive, it
should be possible to establish reasonable market interest rates that reflect both the preferences of
savers and the potential returns on investment of borrowers. Such rates will tend to move with the
overall liquidity conditions of the economy even if these are not clearly manifested in short-term
money market rates.

Contractual Savings Industry

2.37 Mauritius has a well-developed insurance industry, whose services are critical in
managing the significant risk of damage from cyclones and in generating a pool of long-term savings.
Two other institutions, the National Pension Fund and the Welfare Fund, also generate important
saving flows.

2.38 Insurance companies. Most of the twenty insurance companies operating in
Mauritius offer a full line of life and general insurance products; fourteen of the firms are locally
owned. The industry is highly concentrated, however; just two of the firms, one of them
government-owned, account for more than two-thirds of the industry’s assets.

2.39 The largest insurance group, Swan Insurance Company (40 percent of industry
assets), operates in the general insurance field directly; it operates in the life insurance field indirectly
through a wholly owned subsidiary, The Anglo-Mauritius Assurance Society. The second largest
insurance company, State Insurance Company of Mauritius (SICOM) (28 percent of industry assets),
is the only public-sector company in the industry; besides offering both general and life insurance,
it manages the pension funds of most parastatals.

2.40 The general insurance business is well developed, and public awareness of its
importance is based on the island’s exposure to very severe cyclones. A severe cyclone may cause
damages far beyond the capacity of the local insurance industry, a situation that requires a high rate
of foreign reinsurance. The insurance industry allocates an estimated 60 percent of its Rs 600 million
in general insurance premium revenues to pay for reinsurance.

2.41 Besides the twenty insurance companies there is the Sugar Insurance Fund Board
(SIFB); a 1946 statute created the SIFB and required all sugar cane planters to insure their crops
through it. Annual premiums from growers (more than 36,000 of them currently) exceed Rs 300
million, and the historical ratio of annual compensation payments to premiums fluctuates between 0.1
and 4.3. The SIFB uses the claims history of growers to adjust premiums and compensation rates
continuously. The importance of SIFB becomes obvious comparing its annual premium revenue of

amounts of specific money market instruments because the artificial demand thereby created prevents interest rates
from reflecting the true market value of the instrument; (iv) for the same reason as in point 3, avoid special tax
treatment of money market instruments; (v) encouraging a number of financial institutions to become active participants
in the money markets to assure competition and prevent collusion; (vi) setting clear rules for money market activities
but permit flexible adjustment if some new rules do not work as expected; and (vii) adjusting bank prudential
regulations to fit with and encourage the use of money market instruments.
Rs 300 million which is 50 percent of the premium revenue on general insurance received by the rest of the insurance industry.

2.42 Life insurance premiums reached Rs 560 million in 1989, about equal to the premiums for general insurance excluding SIFB. The accumulated life insurance funds reached Rs 1.5 billion at the end of 1989, and the number of individual life insurance policies exceeded 100,000. The life insurance funds, and the pension funds managed by SICOM, are an important source of long-term financing. These funds are invested in property, bank deposits, and government securities and to a lesser extent in equities. They are also an important source for housing loans to middle- and high-income households and businesses. The outstanding loans of the two largest insurance companies amounted to more than Rs 1 billion in 1990. And at least some of the individual life insurance policies are issued to customers who are more interested in the mortgage loans that the companies offer to them than in the life insurance itself.

2.43 The National Pension Fund. Through its annual budget, the government of Mauritius finances a basic pension plan covering all citizens. (The pensions of government employees are also serviced through the government budget; pensions of parastatal employees are managed by SICOM, the public-sector insurance company.) In 1976 the government established the National Pension Fund (NPF) to supplement the budget-based plan and to provide a pension scheme to all private-sector employees not covered by a job-related pension. The NPF today covers more than 300,000 employees as well as their dependents.

2.44 The pension scheme is based on annually valued points. Sums paid to the NPF by employees and their employers accumulate points; the amount necessary to earn a point changes annually to compensate for inflation. The contribution to the NPF ranges from 3 percent to 5 percent for employees and from 6 percent to 10.5 percent for employers. All contributions are tax exempt. When an employee reaches age 60 or becomes disabled, the NPF begins annual pension payments to the employee at a specified, annually adjusted amount per point accumulated.

2.45 For 1991, NPF forecasts its revenues to reach Rs 885 million (about half from premiums and half from interest on reserve funds), and its expenditure to reach only Rs 107 million (for pensions and administration); net accumulation of funds for the year will therefore reach Rs 778 million. As of June 30, 1991, total accumulated reserves of the NPF amounted to Rs 3.76 billion. Of this sum, 75 percent was invested in government bonds and another 21 percent in other government securities. The residual of Rs 140 million was invested in bonds of the Development Bank of Mauritius (DBM), in shares of the SCB and the Mauritius Housing Corporation (MHC), and in long-term loans to the MHC.

2.46 Actuarial evaluation predicts that net accumulations of reserves will continue at the NPF to the year 2025. These reserves can be significant to the long-term investment needs of Mauritius if loaned to the business community and for high-priority projects of nonbank financial intermediaries. The financing of the DBM, the MHC, and the Mauritius Leasing Corporation can be considered to serve such priorities.

2.47 The Welfare Fund. A new source of long-term funds, the National Welfare Fund (NWF), was introduced in 1991. The NWF collects from employers a compulsory 2 percent of total payroll. An estimated Rs 250 million will be collected in 1991, which currently are intended to finance housing through the MHC. The NWF is expected to increase its annual accumulation
gradually by raising the employers’ contribution and by imposing some contributions on employees. Such funds can add to the resources available for long-term uses.

Nonbank Financial Intermediaries

2.48 The major nonbank financial institutions are the Development Bank of Mauritius, the Mauritius Housing Corporation, the Mauritius Leasing Corporation, and the State Investment Corporation, all of which are sources of long-term financing or equity investment. In addition, the Mauritius Post Office Saving Bank collects savings deposits, all of which are invested in government securities.

2.49 The Development Bank of Mauritius. The government established the Development Bank of Mauritius (DBM) in 1964 as a statutory body to finance the development of industry, tourism, and agricultural diversification. Upon its creation, the DBM took over the assets and liabilities of the Mauritius Agricultural Bank, which then ceased operations. The DBM is a major source of medium and long-term loans for investment in fixed assets. It operates a number of programs reflecting the government’s priorities in economic development.

2.50 The main activity of the DBM is the provision of long-term (10-year) loans to industrial and tourism enterprises. In the year ended June 30, 1990 (fiscal 1990), the DBM approved financing for 78 full-scale projects for a total of Rs 280 million. Special programs finance small businesses, small industries, small rural enterprises, and agricultural projects. The special programs provided a total of Rs 90 million to 1,323 projects. At the end of fiscal 1990, DBM loans outstanding totaled Rs 1.2 billion.

2.51 The total amount of loans approved in fiscal 1990 was Rs 370 million, with actual disbursements of Rs 276 million; in fiscal 1989 and 1988, the DBM disbursed 242 million and 225 million respectively. Most loans carry an interest rate of 15 percent, but for investments of EPZ companies in modernization and environmental improvements, the government subsidizes the interest rate and the borrowers pay only 10 percent. In addition, some small-scale business programs benefit from government grants that cover the bank’s administrative expenses and/or convert a part of the loan into a grant.

2.52 The main sources of funds are international lending institutions, including the IBRD, the African Development Bank, the Export-Import Bank of India, the Caisse Centrale pour la Corporation Economique (CCCE), the European Investment Bank, the Commonwealth Development Corporation, and the Finance Fund of the International Fund for Agricultural Development. In fiscal 1990, outstanding loans from these institutions amounted to Rs 936 million, most of which was borrowed with a government guarantee. The government on-lends the foreign loans to the DBM at the interest rate charged by the original lender and insures against exchange rate changes for an annual premium of 4 percent. Taking into account devaluations in recent years, the exchange rate insurance provided by the government constitutes a significant subsidy.

2.53 In the DBM accounts for fiscal 1990, interest expenditures averaged 6.4 percent on outstanding debt, and interest income averaged 13 percent. Administrative expenses for the year were 2.2 percent of the average loan portfolio, but they included some expenses related to the industrial parks owned and managed by the DBM. For fiscal 1990 and 1991, DBM had a net profit of Rs 54 million and Rs 41 million respectively before taxes and before provisions for loan losses, but after write-off of bad debt. This represented a return of 23 percent on equity plus reserves for
1991 and 18 percent for 1990. The main problem of the DBM is that 40 percent of its loan portfolio—Rs 540 million—is in arrears for more than six months. DBM management wrote-off only Rs 31 million of bad debt in fiscal 1990 and Rs 24 million in 1991. According to management, most loans in arrears are fully covered by collateral, and current efforts at improving collections could change the picture dramatically in the next few years.

2.54 At Rs 138 million, government loans are much less important to the DBM than are the loans from international lending institutions. The DBM has also issued bonds, bought mainly by financial institutions. The fiscal 1990 balance sheet shows bonds outstanding at Rs 134 million; in fiscal 1991, the DBM issued an additional Rs 125 million in bonds. Interest rates on the old issues are 8-9 percent; on the latest, 11-12 percent.

2.55 The Mauritius Housing Corporation. The Mauritius Housing Corporation (MHC), owned by government, is the main financial intermediary providing long-term housing loans (up to 25 years' maturity). The MHC is also the only source of subsidized mortgage loans to low-income households. The MHC's total outstanding loans reached Rs 500 million in 1990. These loans were financed from funds obtained from foreign lenders with government guarantees and exchange rate coverage (49 percent), from the government, the BOM, parastatals, and NPF (22 percent), and insurance companies (6 percent). The residual amount (23 percent) was financed by capital and reserves.

2.56 The number of loans granted annually more than doubled last year, to 2,100. The MHC is expected to be a major participant in the government program to promote housing in the immediate future, and it will probably obtain funds from the NWF. The drive for better housing may be constrained by land-use restrictions and physical limits on the speed of construction rather than by lack of funds or bottlenecks at the financial intermediaries.

2.57 The MHC offers a small, restricted savings program that pays qualifying depositors 15 percent interest (3 percentage points of which come from the government budget) if the amount saved is withdrawn for housing purposes and if a housing loan is taken from the MHC at the same time. Thus, the program is of interest only to savers who plan to buy or build a house and who qualify for MHC loans by income level and house size. By June 30, 1990, the total amount deposited with the MHC was Rs 30 million.

2.58 The Mauritius Leasing Company. The Mauritius Leasing Company (MLC) was established in 1987 and started operations in 1988. It is owned in equal shares by private banks (the MCB and the BNPI, 25 percent each) and government-owned financial institutions (SCB, 25 percent; State Investment Corporation, 15 percent; and DBM, 10 percent). By June 30, 1990, the MLC had financial leases outstanding in the amount of Rs 120 million. The financing is mostly for four to five years (the major exceptions are sugar mill equipment and electronic knitting machines, which are financed for seven years, and computers, which are financed for three years). With the recently introduced legal possibility of splitting title between the owner and operator, the MLC is now leasing motor vehicles.

2.59 MLC has obtained its funds primarily from the issue of bonds. In 1989 it issued Rs 75 million of bonds (debenture stock) for five years, bearing 11.5 percent interest and guaranteed by commercial banks (the bonds are held mainly by SICOM—Rs 45 million—and by the Sugar Industry Pension Fund—Rs 20 million). In fiscal 1991 MLC floated a second issue of five-year bonds with
a face value of Rs 75 million and paying 12.5 percent interest tax-free, that was listed on the stock exchange. Additional funds came from Rs 26 million in long-term loans and from net worth.

2.60 According to Mauritius tax laws, all the tax benefits related to the investment in fixed assets accrue to the lessees, including the investment allowance and the depreciation allowance. For tax purposes the lease is viewed as a loan. The interest charged on MLC leases—18-20 percent—is 2 percent higher than on bank loans and 3-5 percent higher than on DBM loans. The MLC is the only financial institution in Mauritius that offers leases, but other financial institutions should be allowed to provide this form of financing, especially because no tax subsidies are involved for the lessees.

2.61 The State Investment Corporation. The government established the State Investment Corporation (SIC) in 1984 and is the sole owner of the company. All government investments in the SIC took the form of equity investments: Rs 60 million in 1984, Rs 20 million in 1986, and Rs 20 million in 1989. Through six years of operations, the SIC accumulated Rs 113 million in retained earnings after paying Rs 16 million in dividends. The SIC is an important government arm for investing in and controlling companies operating in essential industries and services. It is profitable, liquid (short-term deposits of Rs 48 million as of June 30, 1990), and managed by a very small team at a modest annual administrative cost of Rs 5 million.

2.62 The SIC portfolio includes controlling interests in the State Stockbroking Company and in all the casinos in Mauritius. It also includes controlling investments in some of the EPZ companies that were taken over for restructuring after they faced bankruptcy under their previous ownership. These rehabilitated companies are expected to be sold to private owners and are not considered part of the permanent portfolio.

2.63 The SIC is a minority shareholder in many financial institutions: DBM (15 percent), MLC (15 percent), SICOM (40 percent), and the National Mutual Fund (25 percent). The total portfolio as recorded in the SIC balance sheet, at cost, amounts to Rs 165 million; the value of this portfolio on a net asset basis (and at stock exchange prices for quoted shares) is Rs 577 million for June 30, 1990.

2.64 Although the SIC has been instrumental in rescuing private sector companies that were about to collapse, it has not helped entrepreneurs establish new businesses or expand existing ones. Nor has the SIC been instrumental in promoting the stock exchange by driving the companies it controls to issue shares to the public or by offering to the public some of its holdings.

2.65 Mauritius Post Office Saving Bank. A government savings bank existed in Mauritius as early as 1836, when it operated through the cashiers’ offices of the Treasury. In 1951 the savings bank was transferred to the post office, to be managed by the Post Master General, with investment policy controlled by the Ministry of Finance.

2.66 The Mauritius Post Office Saving Bank (MPOSB), whose central management is currently located in the headquarters of the postal service, operates through 75 post offices located throughout the island and has 210,000 accounts. It primarily serves low-income families—a savings account paying 12 percent can be opened with as little as 10 Rs. The bank offers no banking services except savings accounts, and that service is very slow; the savings books are collected twice annually from all depositors for the posting of interest income in the head office. The MPOSB invests its deposits, which exceed Rs 300 million, in bonds and bills of the Treasury and the BOM. The
MPOSB manages its investments manually, buying and redeeming securities through letters to the central bank.

2.67 The bank's main features are its large number of outlets, its handling of very small accounts, and its monthly lottery, in which one depositor wins Rs 25,000 and eighty-five depositors win smaller sums. All administrative expenses and the lottery prizes are charged to the government; the MPOSB incurs only interest expenses.

2.68 With the development of commercial bank branching and the increased affluence of the population, the importance of the MPOSB is diminishing. Nonetheless, the continued growth in both the number of accounts and in total deposits shows that its functions are of value to the population.

Capital Markets

2.69 The market in Mauritius for equities and long-term debt securities as distinguishable from short-term finance is extremely thin, and the stock exchange has grown little since its creation in 1989. For a variety of reasons, enterprises in Mauritius have little incentive to issue equities, and the issuance of bonds has been kept down by credit allocations, subsidies, and the lack of a secondary market. This section discusses the institutional structure and regulation of the stock exchange, the two investment funds recently created by the government, and the constraints limiting the growth of the capital market.

2.70 The Stock Exchange of Mauritius. Before the government initiated the formation of the Stock Exchange of Mauritius (SEM) in July 1989, a limited amount of securities traded within the more informal structure of the Chambre des Courtiers, an association of individual brokers and traders traditionally dealing in commodities. At its inception, the SEM had five companies on its "official list," with a market capitalization of Rs 1.1 billion. Two years later, in June 1991, the market had added only a dozen more companies, for a total of seventeen and a total market capitalization of Rs 4.4 billion; the index of share prices had risen 56 percent over the two years.

2.71 The Stock Exchange Act of 1988 provides the framework for current stock market activity. The act created the Stock Exchange Commission (SEC), which has the ultimate authority for the regulation and operation of the SEM. Only two of the seven members of the SEC are officially appointed by the government, but in reality all are approved by the Minister of Finance, to whom the commission reports.

2.72 The SEM is a private company, owned in equal shares by eleven stock brokerage companies, and only stockbrokers affiliated with one of the companies and licensed and bonded by the SEC may transact business on the exchange. Under the authority of the SEC, the SEM operates and manages the exchange through its executive committee of fourteen members (nine of whom are from the owner brokerages) and through subcommittees, which meet regularly to review trading, compliance, and other issues. The SEM is also responsible (subject to SEC approval) for creating a clearinghouse and for drafting regulations governing trading, dealing, settlement, and the provision of information.

2.73 Most matters concerning the operation of the exchange, particularly the implementation of those parts of the act covering listing, trading, clearing, and settlement, are in flux. The clearinghouse has not yet been established, and although brokers must have performance bonds,
the compensation fund has not yet been created. Also, it probably is too early to see any action on
the enforcement of the rather detailed rules on prohibited dealing. The SEC is still a relatively new
body and in some areas its authority needs to be clarified and strengthened, as discussed in the next
chapter.

2.74 The SEM can trade in any admitted securities, as well as in Treasury bills, other
government securities, and unit trusts. Shares traded outside the SEM are subjected to a 13.2 percent
transfer tax which has brought most trading to the SEM. Trading can be either through the official
list or over the counter (OTC). The official list comprises those companies that meet the SEM’s
listing requirements: five years of profitability, a minimum of 200 shareholders, and a minimum of
25 percent of its capital in the hands of the general public. To encourage qualifying companies to
list their shares, the government grants them a 10 percent reduction in the corporate income tax rate,
from 35 percent to 25 percent. Companies in the high-priority sector, however, already pay less than
25 percent and therefore have no tax incentive to list.

2.75 The OTC market, which commenced trading on April 19, 1990, comprises companies
that either do not wish to be publicly listed or do not meet the requirements of the official list.
Requests to place a company on the OTC list are usually made by shareholders who wish to trade
their shares to avoid share transfer tax. The only requirements for the OTC list are that the company
have at least Rs 1 million in capital, have a minimum of 30 shareholders, and submit audited annual
financial statements for the two previous years. Currently the shares of about 80 companies are
eligible for trading in the OTC market; the shares of about 40 of these are actively traded.

2.76 Trading sessions are held only once a week, on Wednesdays, and the volume of
trading is still very small—about Rs 2.2 million on the official list and about Rs 1.1 million OTC
during each weekly trading session. Trading on the official list is on the open outcry system, which
has recently been introduced for all shares. To date, only one bond issue has been listed on the
SEM, that of the Mauritius Leasing Company, which was listed in November 1990, at a 12.5 percent
interest rate.

2.77 Mutual and Country Funds. The government recently took the initiative to promote
investor interest in the capital market by creating a mutual fund and by announcing its intention to
permit foreign investment in the securities market through closed-end country funds. The National
Mutual Fund (NMF), established in 1990, is a limited company; half of it is owned by government
institutions, the other half by private insurance companies. The NMF is authorized to launch unit
trusts and employee and pension funds as well as to manage provident and pension funds.

2.78 As of June 30, 1991, the NMF had launched two unit trusts. The NMF General
Fund, an open-end fund, has raised about Rs 83 million for investment primarily in listed securities.
A novel feature of the fund is its authority to invest up to 40 percent of its assets overseas. It is also
open to investment by foreigners as well as local individuals and institutions. The NMF Property
Trust, launched more recently, has attracted Rs 50 million for investment in local real estate.

2.79 The government has granted an attractive incentive for investing in the two NMF
funds: a tax credit equal to 10 percent of the investment amount, up to a maximum of Rs 8,000.
However, the NMF is believed to have had difficulty in placing its funds because of the small size
of the market and the small number of tradable shares available for most companies.
2.80 As closed-end funds, country funds can be an efficient vehicle for bringing foreign capital into the economy and could provide an important stimulus to the market. The introduction of foreign specialist expertise (in trading, underwriting, fund management) can speed the transfer of new concepts and techniques to the local market and increase its dynamism. However, given the existing size of the listed market, the total amount of foreign investment permitted at any one time should be restricted, at least in the early stages of opening the securities market. Funds structured with a broad investment objective, perhaps encompassing other regional securities markets and unlisted securities, would also provide a more gradual inflow of funds, avoiding the boom/bust syndrome that is likely if the market inflates too rapidly.

2.81 Constraints to growth. A wide range of securities may be issued without excessive restriction in Mauritius, including ordinary and preferred shares, bonds/debentures, and convertible securities. Yet, only twelve companies have joined the exchange in the two years between its inception and mid-1991 despite the seemingly attractive incentive of a large reduction in income taxes; and only one bond issue has been traded on the exchange—the November 1990 issue of the MLC, noted above. The limited growth in the capital market is attributable to a variety of factors concerning both the supply and the demand for capital.

2.82 A significant part of the household sector's savings (the nonvoluntary part) is channeled to pension funds managed by the government or by the insurance companies (mainly SICOM), who dominate the bond market. Households will probably invest in bonds only after these securities become easier to sell—that is, when they are actively traded on the stock exchange, thus providing liquidity to the investors.

2.83 Most of the voluntary savings of the household sector are in commercial bank deposits. Given their excess liquidity, the banks have no incentive to compete for deposits; and in any case, the requirement that they meet their reserve and liquidity ratios with fixed-yield BOM bills prevents them from raising their deposit rates.

2.84 With the higher inflation rate of recent years and associated downward pressure on real interest rates, the demand of savers for long-term debt instruments may be enhanced by inflation-resistant or adjusted bonds. Examples of such instruments may be (i) floating-rate bonds, that provide an annual or semi-annual adjustment in the interest paid, based on prevailing market rates that are assumed to reflect the rate of inflation and (ii) bonds linked to the changes in the foreign-exchange rate, e.g., the US$/Rs, and the rates in such currency.

2.85 The major type of borrowed money in the economy is short-term loans from the commercial banks. Long-term finance in the Mauritian economy is provided by commercial banks and the specialized nonbank financial intermediaries to a limited extent. Consequently the real sectors of the economy operate with relatively low financial leverage and depend heavily on accumulated internal resources for their investments. At the diversified Rogers Group, for example, short-term deposits and loans equal short-term borrowing and overdrafts; long-term borrowing equals 21 percent of long-term resources, with the balance coming from capital and reserves. Small enterprises suffer from a lack of both equity and long-term loans, but their lack of collateral will make the extension of additional credits difficult, even if credit ceilings are removed.

2.86 Closely held private-sector companies, of which there are many in Mauritius, have been reluctant to share ownership with outside shareholders and hence issue equity; and because they stay relatively liquid, such firms will issue bonds only to finance major expansion plans. Moreover,
Mauritius has a relatively large number of state-owned companies and parastatals, which currently have no need to approach the capital market for either new equity or long-term debt. And finally, the more dynamic sectors of the economy—the export and tourism industries—have little incentive to tap the securities markets: they receive a significant portion of their funding at subsidized rates from banks or nonbank financial institutions and receive other benefits, including a reduction in corporate income tax rates to 15 percent.

2.87 Private and government enterprises in Mauritius have issued very few bonds to date. The introduction of bond trading to the stock exchange would establish a secondary market, and hence encourage a popular demand, for bonds. At that point, more companies, particularly those that are closely held, will probably issue bonds—the controlling interests in these firms are less threatened by bonds than by new stock. On the public-enterprise side, the MHC, with its good collection record, will probably be well placed to take advantage of a secondary market in bonds.

2.88 The Treasury issues bonds, but again, the lack of a secondary market discourages the general public from investing in them. The bonds, called "Mauritius Development Loan Stocks," carry maturities ranging from four years to twenty years, bear interest rates ranging from 12.5 percent to 13.25 percent, and are sold at a discount ranging from 1.3 percent to 3.95 percent according to their maturity. The amount outstanding at the end of 1990 was approximately Rs 5.5 billion and was held almost entirely by institutions. To increase general investor interest in Treasury bonds the government should list them on the stock exchange to create a secondary market. To increase their appeal further, the government could issue them at floating rates or with their value linked to changes in foreign exchange rates.

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6 In 1987 the BOM issued savings bonds with a maturity of eight years for investment by nonfinancial companies and by individuals, but it did not continue to issue these bonds. Most of the Rs 250 million issue was in zero coupon bonds sold at 33 percent of face value. Zero coupon bonds, of course, are as vulnerable to changes in inflation rates and interest rates as fixed interest bonds.

The only two nonbank financial intermediaries that have issued bonds in Mauritius have been the DBM (Rs 269 million in 1989 with maturities of seven and fifteen years) and the MLC (Rs 75 million in 1989 and again in 1991 with maturities of five years; the 1991 issue was listed on the stock exchange). Interest paid by these issues ranges from 11 percent to 12.5 percent and is tax exempt.

7 The main holder of these bonds was the NPF, with about Rs 2.8 billion (75 percent of its portfolio). The commercial banks held Rs 2 billion and the insurance companies held Rs 0.5 billion (with SICOM holding the major part for the pension funds managed by it); the MPOSB held about Rs 0.2 billion.
3. THE LEGAL AND REGULATORY FRAMEWORK

3.1 Mauritius has well-developed laws and an adequate judiciary system. Although the law in Mauritius is underpinned by the French civil code (the Napoleonic Code was adopted in Mauritius in the early 1800s), the entry of the British to the island began a trend toward the adoption of English juridical procedures and of English influences on modern financial laws. Lawyers in Mauritius therefore are familiar with both the French and English sets of legal traditions, a dual orientation that appears to be working fairly well. The adoption of English-style trust laws in 1989, for example, introduced the concept of a fiduciary trust, which does not exist in the civil code, and demonstrates the willingness of the legal establishment to adapt Mauritius law to the needs of modern times.1

3.2 The law seems to provide for a balanced approach to the rights of the debtor and creditor, the use of the courts is an accepted tradition, and the judiciary appears to be well-respected. But the country also has well-developed methods to settle disputes without litigation, such as the process of receivership in the case of nonperforming loans.2 In general, therefore, the basic legal system broadly defined is conducive to the further development of the financial sector.3

3.3 The need to liberalize the government's controls on interest rates and credit are economic issues treated elsewhere in this report; this chapter treats issues in the legal and regulatory structure of the country. The largest and most urgent of these issues, discussed immediately below, is the need to strengthen the capital market. The remainder of the chapter covers certain gaps in the regulation of the pension and insurance industry and nonbank financial institutions, discusses general considerations regarding the scope of prudential regulation, and concludes with a broad proposal for the licensing, registration, and supervision of financial activities in Mauritius.

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1 Under the civil law, property has only one owner with all the attendant rights and obligations of ownership. A fiduciary trust arrangement divides ownership between the trustee, who manages the property, and the beneficiary of the property, for whom the trustee must act in good faith.

Trust arrangements are significant in schemes involving groups of savers or investors, such as pension funds and closed-end or open-end mutual funds. The fiduciary relationship in trust law is the basis for the "nominee" form of such schemes, in which shares may be registered in the name of the central depository, who acts as trustee for the investor. Some civil code jurisdictions, such as Japan, the province of Quebec, and the state of Louisiana, have attempted to overcome these problems by superimposing separate trust laws on the civil code. France has adopted two laws setting up collective savings schemes as trust. And the European Community is now working on a trust treaty so that countries can simply ratify the treaty. (The relevant laws in Mauritius, Acts 25-28, all issued in 1989, are as follows: the Trusts Act, the Unit Trust Act, the Public Trustee Act, and the Trust Companies Act.)

2 Before granting a loan based on a security, a bank asks for a search by the Conservator of Mortgages to see whether the security has already been used and, if not, registers that security. In the case of nonpayment, the bank has the lien on that property fully recorded, and a receiver manager is appointed who can arrange for seizure of property without a court appearance, dispose of the property, and turn the proceeds over to the bank.

3 In the last five years, Mauritius has made major efforts to update its legal framework to cope with the growing complexity of the financial sector: revisions to the Companies Act (1984); the Insurance Act (1987); the Banking Act, the Stock Exchange Act, and the Bankruptcy Act (all 1988); and the 1989 trust acts cited in note 1, are examples of these efforts.
3.4 The most pressing legal and regulatory challenge facing Mauritius concerns the capital market, which is in its infancy but is a key to the ability of the country to expand its savings and investment. The development of the capital market must be addressed through comprehensive legislation covering the market's institutional and regulatory framework. That framework is weak—many stockbrokers represent special interests, and the stock market attracts little interest from issuers and investors. Tax breaks and a "desire to do what the government wants" have encouraged some listing on the "official" (major-market) list, and avoidance of the transfer tax of 13.2 percent drives the over-the-counter (OTC) market.

3.5 Support of comprehensive legislation for the capital market does not, however, extend to an all-encompassing financial services act, for the following reasons. First, an adequate legal framework already covers banking, insurance, and pensions and, if properly implemented, would provide regulation in those areas. Second, a comprehensive financial services law does not exist in most countries and may provide less flexibility than would the enactment of separate laws when needed. Finally, an attempt to draft such a law now would divert resources from the urgent task of enacting the laws required to reform the capital market.

3.6 Overall approach to regulation. The Stock Exchange Act of 1988, which created the Securities Exchange Commission (SEC), covers neither unit-trust schemes nor the primary market for issuing equity or bonds. A company that wishes to issue securities to the public must apply to the Registrar of Companies and fulfill the limited obligations set out in the Company Law; the SEC looks at the application only in an informal way. A key element in the strengthening of the capital market would be comprehensive legislation that establishes strict, thorough licensing and prudential regulation over the issuance and trading of equity and debt instruments. In keeping with developments throughout the world, the legislation should place licensing and regulatory powers in one semi-independent agency; the logical agency for Mauritius would be the SEC.

3.7 The government recognizes that improving the capital market will take much work. The broad need is to set rules and regulations that would not stifle the development of the market yet

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4 See chapter 2 for a discussion of the SEC's oversight of the Stock Exchange of Mauritius under the Stock Exchange Act of 1988. Brokerage for financial and other activities is covered in the Brokers Act of 1945 as amended. However, stockbrokers/dealers who operate on the stock exchange are now required under the Stock Exchange Act of 1988 to be licensed by the SEC. Thus, the Brokers Act and the Stock Exchange Act clearly overlap. Other matters involving the capital market have been left either to the general provisions of the Companies Act, the Unit Trust Act 1989, or to other laws.

Brokerage especially points up the need to distinguish between money market and capital market activities because of the fine line that may exist between these activities. Money market and foreign exchange brokerage will become important activities as these markets are liberalized. Such activities as currency swaps, foreign exchange forward and futures, short-term money market brokering and underwriting of such instruments are examples.

5 In general, the SEC would have authority over the capital market activities of individuals and firms whose non-capital-market activities might be regulated by other agencies: If, for example, a bank sets up a securities company subsidiary or a fund management company, the licensing and supervision of that subsidiary and the requirements for the stockbrokers and investment analysts should be set out by the SEC. If a lawyer or auditor wishes to be involved in capital market activities, he/she should abide by the rules set forth by the SEC. And if a public company is involved in a merger, it should meet the requirements of the SEC over and above those of the Registrar of Companies.
would bring transparency, clarity, and public confidence to its operations. A principle critical to this strategy is that the government will require full disclosure by companies without thereby implying any "guarantee" of the securities market. That is, the government must demand that all public companies, not only those that list on the stock exchange, make full information available to the investing public and also demand that the public take responsibility for its own investment decisions thereafter. Such a stance should be clearly evident in any government promotion of the capital markets.

3.8 **Legislative elements.** First, the legislation, by amending the Companies' Act, should cover public offerings whether they will be listed on the stock exchange or not. Such offerings should come under the direct purview of the SEC and be part of a highly transparent process. All companies planning public offerings should be required to go through a primary offering process and prepare a prospectus, and the SEC should be formally charged with examining it. (Limited information may continue to be registered with the Registrar of Companies.) With the appropriate disclaimer, prospectuses should be released to the public only if they state that the SEC has found no material errors in it and has found the disclosure satisfactory. The issuer of securities and all professionals supporting the issue--accountants, legal advisors, auditors, and underwriters--should be legally liable in the preparation of the prospectus. The SEC must receive adequate enforcement powers to carry out all its responsibilities; and it must receive the requisite staff-building to apply sufficient skills and resources to all the new tasks discussed here.

3.9 Second, the capital market legislation should cover the licensing and regulation of "unit trust" schemes, with an appropriate distinction between so-called open-end and closed-end funds. The encouragement of such collective funds would be facilitated by legal requirements that would help ensure the protection of the small investor; such requirements include measures that would keep management at arm's length from fund assets and require independent custodians to handle the assets; establish the minimum qualifications and licensing of fund managers; and require the accurate measurement of the value of the fund.

3.10 Third, the SEC should oversee, and give approval to, the rules and regulations of the formal stock exchange and over-the-counter market and license and supervise stockbrokers/dealers and underwriters for both bond and equity issues.

3.11 Fourth, the SEC should have oversight over mergers and acquisitions involving public companies.

3.12 Last, clearing and settlement should be streamlined before trading volume becomes so large as to overwhelm the current system and thereby cause serious problems for the stock exchange and the rest of the financial system. The Transfer of Shares and Debentures Act of 1953 excludes listed companies from its requirements, which is an essential part of such streamlining, but more needs to be done. It appears that shares must be registered in the books of the issuing company before legal title of ownership can be sent to the investor, a requirement that is a substantial practical

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6 The Unit Trust Act of 1989 states that application to set up such a trust must be made to the SEC. However there is no provision for the setup or supervision of such funds in the powers of the SEC in the Stock Exchange Act of 1988. Such powers should be so stated. On the other hand, the law allows that the units issued under a unit-trust scheme approved by the Minister "may be traded or dealt with on the Stock Exchange." The use of the term "unit trust" in Mauritius seems to refer to both open-ended and closed-ended funds, with no distinction being made in the law. Furthermore the use of the word "trust" is unfortunate in that such funds might be set up as companies.
obstacle to trading. The comprehensive capital markets act should establish a central clearinghouse with at least a degree of automation; the clearinghouse should be allowed to hold accounts of customers and brokers, and the system should become scriptless as soon as possible. Technical assistance is needed in this area.

3.13 The government should also consider certain laws that may be obstructing the development of new financial instruments and thereby impeding the quest for a more dynamic financial sector. The provisions of the civil code concerning mortgages, for example, may make it impossible to issue mortgage-backed securities; the Company Law may affect the beneficiaries of tax free bond issues; and the legal feasibility of repurchase agreements needs to be examined.

Pension Funds, Insurance Companies, and Other Nonbank Financial Institutions

3.14 The setup and supervision of pensions lack a well-coordinated legal framework; the supervision of the insurance industry contains certain gaps; and certain financial activities, such as leasing, factoring, and special financing for housing, are not specifically regulated at all. The Mauritian government intends to improve the legal framework in these areas.

3.15 Pensions. The Insurance Act of 1988 covers the pension business and puts its supervision with the Controller of Insurance. However, inconsistencies and gaps in the regulation of pensions arise because many pension schemes in Mauritius are set up by separate laws that specify varying supervisory agencies. Moreover, pensions not managed by insurance companies are not clearly the responsibility of the Controller of Insurance.

3.16 Insurance companies. All domestic and offshore insurers and reinsurers doing business in Mauritius must be registered with the Controller of Insurance and cannot carry out any activity not connected with the insurance business. The Controller of Insurance has extensive authority in registration, investigation, examination, and enforcement.

3.17 Weaknesses in the regulatory system for insurance appear to be the long delay in reporting (eight months after close of the fiscal year) and the absence of substantial surveillance of the products offered by individual companies. These weaknesses should be addressed legislatively. Also, the Sugar Insurance Fund, established to meet the extreme losses to the sugar industry that often come with the periodic cyclones, should be brought under the purview of the Controller of

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7 The Statutory Bodies Pension Funds Act of 1978 is administered by SICOM, and the National Pensions Act of 1976, which set up the National Pension Funds Scheme, is under the purview of the Ministry of Social Security. Also, many private "superannuation schemes" have been set up by employers for their employees—and appear to come under no specific act or agency. A basic step would be to collect data distinguishing insurance from pension funds; the two categories are often combined in data from the Controller of Insurance.

8 For example, the Controller sets the deposit level (article 19), minimum margin of solvency (article 20 (1)), percentage of relevant risks which must be ceded to a statutory reinsurer (article 22(1)), and minimum reserve fund level. Policyholders must receive at least 90 percent of an established surplus (article 24(2)). Only 20 percent of the reserve fund must be in prescribed securities (article 26(6); the Controller could, however, apply conditions and restrictions on investments (article 26(7)). At present, the investments are mostly in deposits and government securities. An insurer must have prior written authority of the Controller to wind up, and the winding up must be done in consultation with the Controller (articles 35-40). A registered insurer does not have to maintain any assets in Mauritius in respect of his business which is not conducted in, or from within, Mauritius. All accounts must be audited annually by qualified auditors.
Insurance. Finally, the large scale reinsurance needed from outside Mauritius necessitates more careful monitoring of the foreign and offshore companies taking on this risk.

3.18 Other nonbank financial institutions. As described in chapter 2, institutions that make loans, but take no deposits, are nonbank financial intermediaries. More significant in the Mauritius economy will be credit institutions that fund themselves through commercial bills, long-term bonds, and equity capital and draw on lines of credit. These entities are critical sources of long-term and lease financing, yet no special legal or regulatory framework exists for any of their activities.

3.19 As the government begins to widen the market for the supply of such financing, it should set up a licensing/supervision department within the Ministry of Finance; its goals should be to assure that companies adhere to their licensed activities, that they do not commit fraud, and that they meet at least minimum standards. This department should be ready to cooperate with, and report to, the regulatory agencies of parent companies such as banks. Audited reports for these companies should be required within three months of the end of the fiscal year.

Prudential Supervision and Regulation

3.20 Prudential supervision and regulation protects the payments system and the small saver/investor by preventing risky behavior, or fraudulent behavior, or both, depending on the context. Companies that are funded by mobilizing funds from the public—banks, insurance companies, and pension funds—should be supervised stringently to prevent imprudent behavior as well as regulated for adherence to law. Other financial institutions, such as nonbank lenders and stockbrokerages, should be supervised more lightly regarding risk but regulated to prevent fraud and to prevent them from transmitting their risks unduly to the more supervised sectors of banking, insurance, and pensions. When banks, insurance companies, and pension funds engage in riskier activities more typical of other types of financial firms, therefore, they should be required to operate through subsidiaries, preferably in joint ventures with other companies. Requiring subsidiaries in such cases would allow for easier supervision by function, separate out the risk for bank depositors and policyholders to some extent, and clearly identify conflicts of interest.

3.21 Prudential supervision depends on skilled and ethical professionals. In the furtherance of prudential supervision, associations of professionals should draw up codes of conduct that they

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9 Practically speaking, the category of nonbank financial intermediary excludes banks, insurance companies, pension funds, investment funds ("unit trusts"), and the stock market. Some countries include venture capital companies in this category, but it is not recommended that such firms be regulated as financial companies.

The MPOSB is specifically excluded from coverage of the Banking Act. It collects savings deposits only. Its "investments," determined directly by the Minister of Finance, are entirely in government securities.

10 The Bank of Mauritius Act (articles 2, 17(10), and 18(6)) gives the BOM the right to designate a company giving credit as a credit institution over which it can impose and enforce requirements for cash balances and liquid assets. This provision does not seem to be implemented at present, but it could cause an overlap of authority if nonbank credit-giving companies are to be supervised by the Ministry of Finance or other authorities.

11 Truth-in-lending regulations should be developed for these activities and monitored by this department. Information on effective interest rates and conditions for credit should be made available to the public.
consider binding on their behavior. In addition, the government should actively encourage such organizations to provide education, training, and information to the public to promote fair competition and full disclosure.

3.22 The number of well-trained auditors in Mauritius is impressive for a country of its size. Auditors can be qualified only through acceptance by such organizations as the Institute of Chartered Accountants of England and Wales. For the most part, accounting and auditing standards for financial institutions and at least for the larger nonfinancial firms are sufficient. The number of actuaries in Mauritius, however, is insufficient for the needs of pension funds and insurance companies, which tend to use foreign actuaries. The government should consider funding the training of several Mauritians as actuaries abroad, to create a local core of experts.

3.23 Another area requiring development in the face of prospective economic change is the authorities’ ability to oversee foreign exchange transactions. As direct controls over such transactions are relaxed, it is important the regulators have the appropriate training to be able to monitor the more sophisticated transactions that will begin to develop, especially off-balance-sheet transactions.

**Current and Proposed Licensing and Supervision Structure**

3.24 Table 3.1 shows the current structure of licensing and supervision of financial institutions in Mauritius. It also shows a proposed new structure, based on the discussions in this chapter.
4. INSTITUTIONAL STRUCTURE AND FINANCIAL GROWTH

4.1 The government of Mauritius intends to accelerate the growth of financial assets relative to GDP over the next decade and thereby expand the resources available for growth-enhancing investments. While financial assets in Mauritius are likely to increase faster than GDP in the coming years, the pace of growth will depend in part on the policies shaping the institutional structure of the evolving financial system.

Alternative Emphases in Sectoral Development

4.2 To achieve its goal of significant financial deepening, the government has announced its intentions to reduce direct controls over the banking system, move to indirect instruments of monetary policy working through well-functioning money markets, and encourage the development of the capital markets, all initiatives that this report supports. Assuming the full implementation of the government's plans for the encouragement of financial deepening, it is not unreasonable to expect that the Mauritian economy by the year 2000 will allow financial choices to be guided by relatively stable market prices, including the price of foreign exchange, and that the financial system will offer a much broader range of financial services and instruments. However, within this overall framework, the Mauritian government can shape the institutional structure of the financial sector in different ways, depending on the policy mix it will use.

4.3 Today, the commercial banks are the dominant financial institutions in Mauritius. On one hand, the government could plan for financial diversification and deepening by conferring on banks a continuation of their dominant role through their direct expansion into new activities. On the other hand, while allowing banks more scope for competition with each other, the government could choose to emphasize the growth of assets of nonbank financial institutions (including specialized bank subsidiaries). This chapter discusses these two broad alternative emphases—a banking-centered strategy and a diversified-financial-system strategy—and considers their implications for the attainment of the government's goals.

4.4 The potential evolution of the Mauritius financial system has been considered in the context of growth and structural change from 1982 to 1989 in Korea, Singapore, and Malaysia, countries with certain important structural features in common with Mauritius. The histories of their institutional evolution do not, of course, determine the possibilities for Mauritius; but their histories do represent some plausible outcomes.

Prospects for Financial Growth

4.5 From 1984 to 1990 the growth of commercial bank assets accounted for much of the growth of the financial sector of Mauritius. Broad money, or M2, grew from 39 percent to 60 percent of GDP.1 Total commercial bank assets, especially capital, grew even more rapidly than did M2, from 41 percent of GDP in 1984 to 72 percent in 1990—a rise of about 75 percent. By 1990, all financial assets amounted to approximately 100 percent of GDP.

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1 Narrow money, or M1, grew at roughly the same rate as GDP and held a constant ratio of 12 percent. M1, consisting of currency plus demand deposits, is the transactions portion of the money supply and usually maintains a fairly constant ratio to GDP under severe inflation.
4.6 Over the coming decade, however, bank deposits (M2) in Mauritius are not likely to maintain their share of total financial assets. As economies develop, the demands for financial services become more diversified and specialized and shift increasingly from shorter-term deposits of liquid savings to liquid holdings of longer-term commitments of various sorts (for example, stocks and bonds tradable on an active stock exchange).

4.7 The need for the liberalization initiatives planned by the government of Mauritius can be illustrated by the recent history of Korea, whose per capita income in 1982 was close to that of Mauritius today. Korea is an export-oriented country that over the past decade has had financial policies similar to current ones in Mauritius—relatively tight controls over domestic financial institutions and foreign exchange transactions.

4.8 In Korea, the total assets of financial institutions in the 1982-89 period grew by 29 percent, to 213 percent of GDP. The ratio of assets to GDP for the commercial banks, the specialized banks, and the development institutions like the Korea Development Bank fell, while assets grew sharply at investment companies, savings institutions, and insurance companies. In addition, the total market value of stocks and bonds grew to about 100 percent of GDP in 1989; securities plus assets of financial institutions equaled more than 300 percent of GDP in 1989.

4.9 This outcome, in which nonbank financial institutions and the securities markets have had to carry much of the responsibility for mobilizing savings, financing investment, and overall financial deepening and in which the pace of overall financial deepening is not surprising for a country that, like Mauritius today, suppresses its banking system with strong government controls over interest rates, credit, and foreign exchange transactions.

The Banking-Centered Approach

4.10 A banking-centered strategy would free up many of the existing controls on banking activity. It would allow the existing and possibly additional banks to provide a broader range of services, along the lines of universal banking, and to operate directly, rather than through subsidiaries, in many different financial markets. In this strategy, the other financial institutions would not be constrained; they would be allowed to find their niches of specialization and survive as best they could in competition with the larger, more powerful multiservice banking institutions.

4.11 The principal arguments in favor of the banking-centered strategy are that the banks in Mauritius are already well-established, with many skilled personnel and strong linkages both internally and internationally, and that their resources are underutilized in the currently over-constrained banking system. Freeing up of credit ceilings, interest rates, foreign capital movements, liquidity ratios, and credit allocations would permit these institutions to expand rapidly by mobilizing additional domestic deposits and foreign funds and channeling them to the broad needs of the economy and society.

4.12 Singapore, which has become an important exporting country and an international financial center, is an example of a bank-dominated financial center. Its level of per capita income in 1982 (US$ 4430) was well above that of Mauritius today (US$ 2300). The ratio of financial-institution assets to GDP in Singapore was high at the beginning of the 1980s—240 percent—but by 1989 the ratio still increased by half, to 364 percent. Assets of all categories of financial institutions grew relative to GDP. Relative to the assets of the financial sector itself, however, the assets of
commercial banks and the Post Office Saving Bank held steady, the assets of merchant banks and insurance companies rose, and those of the finance companies and the Central Provident Fund, a government-run pension program for all employed persons in the country and the second largest category of financial institution, fell.

4.13 The main arguments against the bank-centered strategy for Mauritius is that, unlike the situation in Singapore at the outset of the 1980s the surrounding financial system is not sufficiently developed: The systems of indirect monetary and foreign capital control in Mauritius are not yet in place, the money and foreign exchange markets are not operating effectively, and the monetary authorities may not be prepared to remove direct controls over domestic credit and foreign capital movements for a long time. Also, the Mauritius banking system is currently dominated by two large institutions, making it prone to practices that undermine free markets.

4.14 Bank-dominated financial systems tend to lead to the suppression of capital markets and other long-term financial services that are not part of traditional banking activities or the customary concerns of monetary authorities. An additional problem can arise in a bank-centered system when the monetary authorities become concerned about inflationary or exchange rate pressures and are not confident of the restraining effects of higher interest rates. In such circumstances, the authorities may be inclined to revert to direct controls to constrain the total level of bank financing, a move that would dry up all types of financing. In contrast, if the banks are just one part of a broader financial system, the authorities may be more willing to restrict the liquidity of banks and raise interest rates generally throughout the financial system because they would not thereby be stopping all financial growth based on increases in real saving.

The Diversified-Financial-System Strategy

4.15 A diversified-financial-system strategy would limit the banks to their current sphere of activity—operation of the payments system and intermediation between short- to medium-term deposits and loans. Other types of financial institutions and the stock market, including specialized subsidiaries of the banks, would be expected to provide most other types of financial services, including the intermediation of longer-term savings and investment demands.

4.16 The arguments in favor of the diversified-financial-system strategy are largely the counterpart of the arguments against the banking-centered strategy: It will yield more diversity and specialization, less danger of oligopoly, and therefore better chances for competitive markets. The monetary authorities can concentrate on prudential regulation of the banks and control of the money supply; they can influence interest rates throughout the economy but not directly control the total supply of credit. Market forces would then work to allocate the higher-cost financing to the most productive uses. Banks need not, and should not, be precluded from engaging in nontraditional banking activities, such as equity investing, insurance, and leasing, but they would be required to do so through wholly or jointly owned subsidiaries. This helps to differentiate supervisory and regulatory controls according to the requirements of specific types of institutions.

4.17 Malaysia, an exporter of raw materials that moved into the export of manufactures, has followed relatively liberal, market-oriented financial policies, although it has maintained some restrictions on entry of new banks and on some aspects of foreign exchange transfers. The ratios of financial institution assets to GDP and per capita income in Malaysia in 1982 were not very different from the current ratios in Mauritius (table 4.2). Over the 1982-89 period, financial assets as a proportion of GNP grew by 54 percent in Malaysia, about the same pace as in Singapore; but unlike
Singapore, Malaysia had relatively balanced growth in all types of financial institutions, including an Employees Provident Fund similar to Singapore’s Central Provident Fund. Capital markets have also been developing very rapidly in Malaysia.

4.18 The major argument against the diversified financial system, especially for a small economy, is that it may reduce the efficiency of the financial system by precluding economies of scale that may exist in some types of financial services. The importance of this argument is very difficult to evaluate for the financial system as a whole. Also, it needs to be weighed against the potential inefficiencies from oligopolistic practices, or from the retention of direct controls to limit oligopolistic practices by a few large, multiservice banks. The current pattern of setting up quasi-governmental institutions in selected financial areas, either to promote competition or to pioneer new activities, seems promising, provided that the pioneering companies will not prevent entry of new private institutions as the market grows and the potential for profitable activity becomes clear.

International Transactions

4.19 Another strategic question concerns the role of domestic institutions in international transactions. The government of Mauritius has committed itself to a separation between domestic and offshore operations. Such separation eases the administration of direct controls, but it reduces the efficiency of the financial system.

4.20 Singapore followed the path of restriction on domestic activity, requiring the establishment of separate Asian Currency Units that were based in Singapore but could not do business with Singapore customers. In contrast, Hong Kong allowed all banks to conduct both domestic and international business. Over time, however, Singapore has eliminated many of the distinctions between domestic and offshore banking, so now it is much like Hong Kong. Thus, the issue may be mainly one of timing or sequencing. The government of Mauritius might declare that domestic financial institutions eventually will have the same liberal rules as offshore institutions and then proceed to decontrol domestic institutions as rapidly as seems prudent. This approach would tend to limit over-investment and subsequent demands for protection by the new offshore institutions.

Conclusion

4.21 The financial deepening that Mauritius is seeking over the next decade will probably be best served, by policies intended to produce a diversified financial system: The banking system would be liberalized, and domestic money markets and the debt and equity markets would be strongly developed. Banks would engage directly in traditional banking activities and international transactions; they would also be permitted and encouraged to establish or invest in subsidiaries engaging in other types of financial activity with proper prudential controls.
5. AGENDA FOR REFORM

5.1 This chapter discusses the suggested reforms for the financial sector. It also briefly addresses other avenues in which the financial sector can contribute to the promotion of economic diversification, and deals briefly with the question of taxation.

Banks

5.2 The commercial banks in Mauritius are well equipped to provide banking services, especially short-term credit, to the country's businesses; and the branch network required to provide services to the household sector is in place. But the effectiveness of the banks in serving these sectors is hampered by restrictions on their competitive behavior.

5.3 Credit controls. The ceiling on credit applied to each bank is the core of the central bank's monetary control but is also a major impediment to competition among banks. Even with the stringent reserve and liquidity ratios, loanable funds at banks exceed the credit ceiling, so banks have no reason to compete for deposits. Thus, banks often have to turn depositors away because of lack of opportunity to gainfully exploit the additional funds.

5.4 The BOM requirement for a concessionary rate of interest on loans to firms in the EPZ implies that relatively risky projects or companies there may be unable to obtain credit, despite their potential to be very profitable, because the maximum interest rate allowed may not compensate the banks for the higher risks involved. Yet risky borrowers may be the smaller and fast-growing ventures with the greatest potential for adding to economic growth. The limits on lending to the low-priority sector (III) imply that only well-established companies have access to credits although at comparatively high interest rates. The high cost of finance and the resulting limitations to the entry of new firms may be a cause of higher prices for certain sector-III goods and services, including imports, which the government is ineffectively trying to restrain by imposing price controls.

5.5 The distinction between categories may create a problem for non-priority companies which are essential for the successful development of priority sector ventures, by providing services or subcontracting to them. Modern industrial activity is by far too complex to allow a simple classification.

5.6 The individual bank credit ceilings also prevent changes in the structure of the banking sector, including changes in the relative size of banks. The smaller banks, especially those backed up by large international banking groups, presumably would try to increase their market share by offering competitively priced services, but credit ceilings block the growth of market share. The inability of banks to improve market share is a major reason for noncompetitive pricing of many bank services, including spreads on foreign currency exchange and charges on international transactions. The limit on market share also explains the success of the bankers' association in coordinating fees and commissions.

5.7 Foreign currency controls. According to the declared policy, all current account transactions are liberalized. In reality the commercial banks are allowed to keep with foreign correspondent banks only very small deposits and are expected to sell daily to the BOM any holdings of foreign currency above their immediate needs. The large and growing foreign currency reserves of Mauritius are held exclusively by the BOM.
5.8 The BOM prohibits exporters from keeping deposits with foreign banks and prohibits the local banks from paying interest on the exporters' foreign currency deposits, which must be kept small and for only a very short period. Exporters are also prohibited from converting foreign-currency receipts into another foreign currency for payments (for imported materials) without first converting to the local currency, thus forcing them to pay the local banks' large conversion fees twice.

5.9 Reforms. The costs and inefficiencies of credit controls are expected to abate once open market operations replace credit ceilings as the main tool of monetary control. Such a change will, however, take years to accomplish. Therefore, the following actions, achievable in the near term, are recommended with a view to increase competition in the banking industry and benefit the real sectors.¹

1. Eliminate specific directives on interest rates for deposits and for lending.

2. Eliminate the ceilings on the percentage of credit that may be extended to the low-priority sector (III).

3. Liberalize foreign exchange transactions on current account: Allow exporters to convert between foreign currencies without converting first into the local currency. Allow banks and exporters to hold reasonable sums of foreign currency in foreign banks, and allow the local banks to offer all foreign exchange services to exporters, including interest bearing accounts and hedging instruments. Banks would thereby be allowed to manage some of the country's foreign exchange reserves.

4. Eliminate entirely the individual credit ceilings on banks, a step that can be accomplished in the near term. The liquidity ratio can then be an interim tool of monetary control until open market operations can be efficiently used.

5.10 By enlarging the scope for competition in the banking industry, such reforms can be expected to lead to higher interest rates on deposits (encouraging savings); lower interest rates for borrowers in the low-priority sector (thus dampening the cost-push on the prices of their goods and services); and higher interest rates to borrowers in the high-priority sector (thus making credit available also to the higher-risk borrowers).

5.11 As banks compete for a larger share of the market, fees for financial services and spreads on foreign currency conversions can be expected to decrease. Therefore, banks probably will lose some income both from interest margins and from fees and foreign exchange transactions. The reforms therefore should be accompanied by new opportunities for banks to earn fees lest their profitability be eroded. One promising area is instruments for hedging between foreign currencies. Another is leasing (currently monopolized by the Mauritius Leasing Company). The mobilization of long-term deposits for long-term lending, through subsidiaries, is a third area of expansion for the banks, for their own benefit as well as for that of the whole economy, and will be discussed later in this chapter.

¹ Companion measures that will allow the commercial banks, through subsidiaries, to compete in the medium- and long-term credit markets are presented later in this chapter, in the section on long-term credit institutions.
5.12 Longer-run monetary management. With the elimination of bank-specific credit ceilings and of controls on deposit and loan rates, the BOM can rely in the near term on the adjustment of the liquidity ratio to control overall bank credit and monetary growth. As the tools of indirect monetary management are developed over the next several years, the central bank can shift to the adjustment of the cash-reserve ratio and to open market operations to conduct monetary policy.

5.13 Offshore banking. It is recommended that the offshore banks be consolidated into their related local banks, which in turn would themselves be allowed to provide offshore banking services to foreign customers. This move will save operating expenses, make better use of the expertise in international transactions that can be gained from offshore operations, and ease the supervision task for the BOM.

Capital Markets

5.14 The reforms required to make the capital market a more effective instrument for the stimulation of savings and for the channelling of savings into investment through equity and other long-term securities are much more extensive than the reforms suggested for the banks. The broad recommendations are as follows:

1. Enact legislation to fill gaps in the current legislative framework and facilitate smooth functioning of the market.

2. Develop an efficient securities clearing system.

3. Facilitate (i) the supply of securities and (ii) demand for securities.

5.15 Comprehensive legislation. As described in chapter 3, legislation for the capital market should include legislation to clarify and strengthen the responsibilities and authority of the SEC, enabling it to effectively regulate the issuance of securities, securities trading, and to license stockbrokers/dealers. The legislation would also grant appropriate enforcement powers to the SEC. However, as also noted in chapter 3, it is recommended not to develop now an all-encompassing financial services act, which would be an unnecessary distraction from the urgent work required on the capital market legislation and entails potential inherent disadvantages.

5.16 Clearing system. The development of an efficient stock exchange with large volumes and frequent trading requires a modern clearing system. Once the legal basis for registering shares in the name of trust-companies is established, a computerized clearing system should be developed by the Stock Exchange, supervised by the SEC. Such system should be designed to conclude daily each day's transactions, making possible the sale of securities bought today in the next trading session.

5.17 Increasing the supply of securities. The existing small number of listed securities and the limited corporate interest in making new public offerings mean that measures to stimulate the supply of securities are a priority to develop the capital market. The government should take the following steps:

1. Introduce secondary trading in all government and corporate debt instruments.
2. Make the fiscal incentives for companies to list their issues on the stock exchange effective for all companies—currently, firms in the EPZ and other priority sectors do not benefit from the lower income tax for registered companies because they pay an even lower rate. This can be achieved by giving a percentage incentive on the tax instead of a fixed rate lower than the full tax rate.

3. Remove the current double taxation of dividends flowing from corporations to individuals (taxing corporate income at the corporate level and again as dividends at the shareholder level). This can be achieved by crediting individuals for the corporate tax paid by the corporation, e.g., at a 35 percent corporate tax rate, a 54 cent tax certificate would be given for each one rupee of cash dividend.

4. Explore the potential for establishing a commercial paper market, perhaps through the stock exchange, a step that could also help formalize the existing intercorporate debt market.

5. Encourage well-run, profitable companies in the public sector to fund appropriate expansion of or new activities through the issue of bonds/debentures at market rates without a government guarantee.

6. Carefully divest good-quality public sector companies through the public sale of new or existing shares; encourage the SIC to actively divest investments once its catalytic role of helping a new company become established has been completed.

5.18 Increasing the demand for securities. On the demand side, investors already show interest in buying and selling debt and equity securities, as indicated by the volume of activity on the OTC. The authorities could encourage the development of this interest, and thereby develop greater opportunities for the public to save, by enhancing the transparency, liquidity, and efficiency of the existing market. Strengthening the SEC and its control of the issuance and trading of securities, as discussed above, is essential to this process. Two more-immediate steps would be to (i) increase trading for the official and OTC markets to three days a week, as a step toward daily trading; and (ii) conduct OTC trading through a board, where all offers to buy and sell would be openly recorded by brokers as they occur for, say, one hour each trading day. In addition, as discussed immediately below, the government should, where possible, remove the tax benefits and other incentives on investments that distort the demand for tradable securities, help expand the quality and quantity of financial information available to the public, and support the introduction of new debt instruments with features that would protect investors from inflation or currency devaluations.

5.19 The complicated set of incentives that currently apply to the purchase of financial products frequently negates those provided by the government to encourage the purchase of debt and equity securities. The interest on bank deposits with maturities exceeding three years, for example, is tax free; so is the interest on the bonds of the Bank of Mauritius and of several other public entities, which can thus yield effective annual interest rates of more than 18 percent. It is difficult
for private-sector issues to compete with such yields. It is suggested that such incentives be reviewed with an eye toward the removal of those that discriminate against the development of the markets.  

5.20 Markets trade on information, and better information will strengthen investor interest. Both the SEC and the SEM have important roles in improving the quality of the information disclosed by firms and the ability of investors to understand it. First, any public issue, listed or not, should be accompanied by a comprehensive, publicly available, prospectus. Second, local accounting standards, which are relatively good, should require companies to provide more detail in their annual audited statements, to release the statements within three months rather than eight months after the close of the fiscal year, and to release brief interim statements (semi-annually or quarterly). Third, to remove a disincentive for companies to list shares on the exchange, the government should impose on all registered companies, whether listed or not, uniform requirements for the release of financial information.

5.21 Improvements in the public reporting of financial information will aid the understanding of investors and will be especially needed with the development of less supervised and more market oriented financial activities. In addition, data on the trading activity on the official list and OTC markets, as well as expert commentary, can educate the public, thus giving investors better information for decisionmaking.

5.22 Interest in securities can be further enhanced by permitting the introduction of new financial instruments that protect investors from the effects of inflation and exchange rate fluctuations. Examples are debt securities that link the principal, or principal and interest, to changes in the cost of living or changes in exchange rates. Other options include long-term floating interest rate bonds and convertible bonds issued by corporations. Legal issues may encumber some possibilities. Provisions in the civil code concerning mortgages, for example, may make it impossible to issue mortgage-backed securities. The government must consider such impediments in its quest for a more dynamic capital market.

5.23 Given the lack of supply of securities and the structural weaknesses discussed above, it is important that measures to increase supply be taken in step with demand enhancing measures.

Other Financial Institutions and Services

5.24 The government can take steps to improve the functioning of other important institutions and services in the financial sector. The insurance industry, long-term credit institutions, and the potential need for restructuring selected institutions are discussed below.

5.25 The insurance industry. The insurance industry, described earlier in detail, seems to be competitive and to provide all the necessary services. The only concern is with the timeliness and thoroughness of its supervision and with the capital standards for the industry.
5.26 The controller of insurance should review the products being offered by the individual companies and should insist that the companies release their annual financial reports within three months after the end of the year. The controller should also demand that the local companies submit information about their reinsurers—the large proportion of premiums that the Mauritius insurance firms have to allocate to the purchase of reinsurance from firms outside Mauritius requires more careful monitoring of which foreign companies are taking the risks.

5.27 Some of the firms in the Mauritius insurance industry are very small, more the size of insurance agencies than of insurance companies, and such firms may not be adequately capitalized. Because the importance of insurance cannot be over-emphasized in a country as prone to cyclones as Mauritius, a revision of minimum capital requirements may be beneficial.

5.28 Long-term credit institutions. The real sector of the economy would benefit from more competition among providers of such nonbank financial services as leasing, factoring, and long-term credits. The government should create the basis for such competition by exempting long-term loans from credit ceilings (until all credit ceilings are lifted). This would allow the commercial banks, through subsidiaries, to compete in the medium- and long-term credit markets. At the same time, the government should liberalize the licensing system for firms wishing to engage in these activities.

5.29 With the introduction of competition, however, must come government supervision, most logically by a new licensing/supervision department within the Ministry of Finance. The firms entering the field are subsidiaries of other regulated firms, such as banks, and therefore the new department should be ready to cooperate with, and report to, the parent firms’ regulatory agencies. The department would license firms and then ensure through supervision that the firms are actually engaged in the businesses for which they were licensed and that they meet some minimum standards. The department should also require audited reports from the companies within three months after the end of the fiscal year.

5.31 Housing finance is provided by MHC for low-income families and by insurance companies and to a limited extent by Banks. MHC has access to NPF funds, and as of last year to NWF funds. The government policy of improving low-income families’ housing conditions can be implemented through these existing channels. It may be counterproductive to increase too rapidly the housing finance schemes, as land use restrictions and the limited capacity of the construction industry may lead to cost increases, if demand is allowed to increase quickly.

Institutional Restructuring

5.32 Most companies operating in the financial sector are relatively sound, with reasonable profitability and adequate capital and reserves. A few companies, however, need closer scrutiny. Among all commercial banks, only one, which is currently being restructured, has problems both with raising enough capital and with attracting enough deposits. The BOM is evaluating that bank’s position and has already taken remedial action in the management area. In addition, the BOM could require the bank to raise more capital or suggest that it merge with another bank.

5.33 DBM is the only lender in Mauritius whose portfolio has a substantial proportion of nonperforming loans—approximately 44 percent. According to its management and its audited financial statements, the DBM is well secured for most of the nonperforming loans and has adequate
loan-loss reserves for the rest. Nonetheless, the percentage of nonperforming loans is unacceptable and harms the ability of the DBM to recycle its resources through loans to new ventures. DBM has reviewed its portfolio and its collection procedures and will need to consider very strong measures against nonperforming borrowers. The contribution of the DBM to financial intermediation will be positive only if it imposes on its borrowers a payment discipline in line with the banking industry average.

5.34 The DBM could contribute to the development of the Mauritius capital market through another potential strategy—acquiring a much larger percentage of its funds by issuing bonds instead of borrowing abroad.

Supporting the Diversification of Economic Activity

5.35 Financial institutions with the credit facilities and financial services essential for the expansion of the real sector already exist. Enhanced competition, not new institutions, will best improve the supply of financial services to the real sector. Therefore, most of the above reforms are concerned with the enhancement of competition through the liberalization of controls.

5.36 Even with better competition in the financial sector, however, a significant problem remains for the real sector of Mauritius, one common to the real sector of economies worldwide: improving the access of small or new businesses to funds needed for growth. Such firms usually pose high credit risks because of small capital, little credit history, and no collateral and thus are not appropriate customers for lending institutions. Yet an adequate supply of resources for small businesses is essential to the diversification of economic activity, a major policy objective of the government of Mauritius.

5.37 One line of action is for the government and private sector to help make key assets affordable by small business and startups. Such firms could benefit, for example, from the existence of small-business parks, where they could rent small spaces until the scope of their operations justifies the move to larger facilities. The ability to rent to others makes the ownership of industrial buildings a low-risk investment for the private sector. In turn, the ability to rent only the space they need allows small enterprises to reserve their limited financial resources, including their borrowing capacity, for working capital. Such small business industrial parks may follow the example of European high technology industrial parks. These are high standard industrial buildings, leased for a market rate rent. The main special features are flexibility in space rented with an ability to move to larger or smaller space as required, and the provision of various services on the premises. As an immediate step DBM should build a small-business park as soon as feasible. Private owners should be encouraged to follow.

5.38 Another support to diversification would come from the expansion of leasing possibilities for widely used types of equipment. Such leases are low-risk for the lessor so long as the leased equipment is in general use rather than specific to the operations of only a few enterprises. Such equipment includes general-use computers, motor vehicles, and some machine tools and common textile machinery. MLC should pioneer the implementation of such a program, and private sector encouraged to follow.

5.39 Such supports will not be useful to startups and small businesses unless they have a source of equity. Venture capital funds, which provide such equity in developed countries, do not exist in Mauritius. With the proper treatment of capital gains and losses by the income tax
authorities, however, the private sector should find it profitable to establish their own venture capital funds and even to invest directly in new ventures. One possibility for piloting such funds is to do it jointly with SIC.

A Note on Taxation

5.40 This review has not examined the tax system of Mauritius, but questions related to it have naturally come up in the course of the study. The main issue has been the large number of special rates, exemptions, and holidays available to different companies according to their sector affiliation, their market, or the number of years they have existed. Some of these benefits, such as a lower tax rate on companies whose shares are traded on the stock exchange, are nullified by others, such as the even-lower rate allowed for companies in the EPZ. Exploring a fundamentally different approach to government subsidization of favored sectors seems worthwhile.

5.41 Under the alternative, most of the tax concessions could be phased out and any desired special assistance to sectors would come from direct, budgeted, government expenditures. The elimination of tax preferences would permit the reduction of the general tax rate without loss of revenue; and the direct expenditures would have what tax preferences notably lack: the transparency and budgetary exposure that assure frequent reassessment of their need. This approach fits well the recommendation of chapter 1, that the government pursue a policy of budgetary surplus and fund investment incentives from that surplus. The reduction in general tax levels is in line with the purpose of encouraging diversification on economic activity, instead of concentrating industrialization in a few pre-selected industries.

5.42 Other tax-related problems that came up during the review are the double taxation on dividends paid to individuals and the treatment of capital gains and losses in the context of venture capital investment; indirect taxes, currently imposed mainly on imports; and the collection system.

5.43 How the solution to the problems of double taxation and of capital gains related to venture capital can contribute to the development of capital markets and the encouragement of small businesses, has been mentioned earlier in this chapter.

5.44 The indirect taxes on imports carry a variety of distortionary exemptions. A replacement of most indirect taxes by a value-added tax may remove most distortions.

5.45 The present collection system creates a full year's delay in the government's receipt of taxes on a year's income and imposes large seasonal fluctuations in the deposit levels at the banks. Withholding of taxes for wage earners and salaried employees, as well as more frequent installments for businesses, will solve the problem of deposit fluctuations and will also decrease the inflation-based windfall to taxpayers. Such a change in the collection method will create a large increase in revenue in the transition year, that can be used to decrease the liquidity of the public and of the public debt.
6. IMPLEMENTATION

6.1 This chapter discusses the sequencing, time horizon and the resources needed for effective implementation with respect to the proposals made earlier in this chapter.

6.2 Mauritius is in the fortunate position of having a large number of skilled professionals and most of the institutions necessary to provide advanced financial services. Therefore, it can embark simultaneously on the various tasks recommended below, with initial results after one year and the achievement of most of the suggested improvements within two to three years. Also because of its relative endowment with professionals, the country needs to only commit a relatively low level of resources to implement most of the suggested reforms. For some tasks, however, including those relating to the strengthening of the SEC, the most expedient approach will be the procurement of experienced international consultants.

The Banking System

6.3 The elimination of interest rates' directives, ceilings on lending to specific sectors, and the limitations on current account foreign exchange transactions can be acted upon immediately. The replacement of single-bank credit ceilings with liquidity ratios, as the interim tool of monetary control require some preparations, and can be accomplished in the time frame of six month.

6.4 The banks are well equipped to provide the expanded services and respond to the new competitive challenges that will result from these steps; and given the great importance of commercial banking in the financial sector of Mauritius, more competition can significantly improve saving in the household sector and reduce service costs to the business community.

The Capital Market

6.5 The steps required to make the capital market an effective tool for the financing of economic growth in Mauritius are more elaborate and will take longer to implement than the steps to liberalize the banking sector. Strengthening the capital markets involves legislation, strengthening of the SEC, the creation of a clearing system, and steps to promote the supply and the demand for securities.

6.6 A capable SEC is important to the development of a capital market, which is the principle mechanism by which investors can obtain long-term funds while savers can retain liquidity. To perform the tasks, the SEC needs to be strengthened through implementation of appropriate legislation and to acquire the qualified staff, expertise, and other tools necessary to succeed in its expanded role.

6.7 The legislation conferring new powers and responsibilities on the SEC can be drafted by adapting the comparable laws of other countries to the specific conditions of Mauritius. A combination of local and international legal experts is recommended to expedite the change in the Mauritian legal context and to avoid mistakes experienced elsewhere. If given high priority and the necessary resources, the legislative changes can be completed in one year; the buildup of SEC capabilities will take several years, but a major improvement can be achieved in two to three years.
6.8 The human resources to carry out the expanded mandate of the SEC include a staff of CPAs, financial experts, and lawyers plus the assistance of foreign consultants in all three professions. If possible, the consultants should all be from one foreign SEC to ensure the implementation of one consistent set of methods. Staff members could also be effectively trained by internships in foreign SECs. The assistance of foreign experts should be massive for the first year and continue on a smaller scale for at least another year.

6.9 The development of a clearing system and the implementation of a trust arrangement that will eliminate the need to register shares and to physically transfer securities are prerequisites to successful stock trading and should be attended to urgently. A modern, streamlined clearing system can be in operation within one to two years, including the time needed for legislative changes. The clearing system should be developed with the technical assistance of a major stock exchange in collaboration with a local software consulting company; such an approach will give Mauritius the benefit of international experience and at the same time create a local skill base for the further development of the system.

6.10 Two immediate steps can be taken to increase the volume of trading in the stock exchange: (i) increase trading frequency to two or three sessions per week with the intention of reaching daily trading sessions in two to three years, and (ii) introduce trading in government debt securities; the introduction of such trading is the single most important step in supplying borrowers with long-term funds while meeting the demand of savers for a liquid investment. Further steps in the expansion of supply and demand in securities have been detailed earlier.

Long-Term Finance

6.11 The required change in bank regulations is to exempt long-term deposits with banks' subsidiaries from reserve and liquidity requirements, and medium- and long-term loans provided by such subsidiaries from credit ceilings. Until all credit ceilings on individual banks are removed, this change will allow the commercial banks, through subsidiaries, to compete in the medium- and long-term credit markets.

6.12 The introduction of competition to the long-term financial market requires a liberalized licensing policy, and the creation of a supervisory agency, in the Ministry of Finance to oversee the institutions active in this market. The necessary legislation is straightforward, and the professional requirements for supervisors are not higher than those of CPAs. Given the high professional level of accounting and auditing in Mauritius, the regulatory changes and staff-building can be accomplished within eighteen months if the government accords them a high priority.

6.13 The task in the Ministry of Finance can probably be handled internally with no foreign assistance. It will require the recruitment of a small number of professionals lead by a high-level official with the necessary professional background.

Support for Industrial Diversification

6.14 The start of construction of small-firm industrial parks for rent could be realized within one year by DBM, which already has the necessary expertise (an additional year will be required for the actual construction of the first park).
6.15 Also within one year, MLC, which is already engaged in leasing, could begin leasing common types of equipment to small businesses. Liberalization of credit regulations should permit the banks to join MLC quickly in this market.

6.16 SIC could create a venture capital fund within one year with assistance from foreign consultants at the initial stage. If accompanied by supportive changes in the taxation of capital gains, the SIC initiative will be followed by private business groups.

The Tax System

6.17 Although not an integral part of the financial sector review, the Mauritius tax system has problems that affect the financial sector. The collection method creates seasonal fluctuations in deposits that effect the banks' liquidity, and the various incentives provided through the tax system may have counterproductive effects on savings and investment decisions. It appears therefore that the tax system may require a major overhaul.

6.18 Several suggestions relating to (i) the method of collection, (ii) the reconsideration of the incentives provided through the income tax system, and (iii) the streamlining of indirect taxes have been made in the note on taxation above. These require a major in-depth study and, should any such changes be adopted, a major legislative effort.

Summary

6.19 The following table summarizes the tasks recommended in this report and the resources necessary for their completion:

<table>
<thead>
<tr>
<th>TASK</th>
<th>RESPONSIBLE AGENCY</th>
<th>ESTIMATE OF RESOURCES NEEDED</th>
<th>DURATION (MONTHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>LOCAL</td>
<td>INTERNATIONAL</td>
</tr>
<tr>
<td>Liberalization of bank supervision</td>
<td>BOM</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Capital markets &amp; SEC development</td>
<td>SEC</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Nonbank financial institutions licensing &amp; supervision</td>
<td>Ministry of Finance</td>
<td>X</td>
<td></td>
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<tr>
<td>Small industrial parks</td>
<td>DBM</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Equipment leasing</td>
<td>MLC &amp; banks</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Venture capital funds</td>
<td>SIC &amp; private groups</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
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