Recent Reforms in Banking Regulation, Supervision and Prudential Accounting in Mauritius

Address by Mr Rameswurlall Basant Roi, G.C.S.K., Governor of the Bank of Mauritius, at the Seminar on International Financial Reporting Standard 9, organised by the IMF AFRITAC South, Ebène, Mauritius, 7 April 2017

Ladies and gentlemen

Good morning

I am happy to be here with you this morning. Thank you Mr Ravi Mohan, Resident Advisor to the IMF's AFRITAC South, for inviting me to share my views on recent reforms in the area of banking regulation and supervision, including on prudential accounting, in Mauritius.

In 2012, the BCBS released the revised Core Principles for Effective Banking Supervision to address weaknesses that came to light during the 2007-08 global financial crisis. In recent years, supervisors around the world – including the Bank of Mauritius – have taken radical steps to improve the regulatory and supervisory framework by drawing lessons from the crisis and by raising standards in line with the revised core principles and other internationally-accepted norms.

The 2007-08 crisis demonstrated how easily a failed financial institution – in particular, systemically important ones – could send tremors across jurisdictions worldwide. Shockwaves can be transmitted, for instance, directly via the liquidity channel by way of severe constraints to access funding or indirectly via second-round effects resulting from an economic slowdown. It is thus important that financial institutions build up resilience to be able to absorb both internal as well as external shocks.

Many regulators have made stress testing an integral component of the capital planning exercise for financial institutions. The Bank of Mauritius has recently developed stress testing models to independently assess the resilience of banks to shocks, both at macro and micro levels. Banks are being required to implement an internal capital adequacy assessment by conducting stress testing for key risks at least once a year.

In line with international trends, the Bank of Mauritius issued guidelines on capital conservation buffer back in June 2014. Domestic systemically important banks are called upon to build adequate capital buffers that can be used in the event of stressed financial and economic conditions.

Whereas some supervisory authorities have already developed a risk based supervisory framework, a good number of authorities are still in the process of constructing their own framework to ensure that resources and compliance requirements are commensurate with the risk levels as well as the systemic importance of financial institutions. The Bank of Mauritius has initiated a phased roll out of a robust risk-based supervisory framework.

One of the BCBS core principles for Effective Banking Supervision is consolidated supervision. Financial conglomerates can be faced with various risks, unknown to regulators looking only at one segment of their operations. Further, large financial groups may operate across jurisdictions, with possibly differing regulatory regimes. The core principles emphasise an effective framework for consolidated and cross-border supervision with appropriate home-host coordination.

The Bank of Mauritius has been working on these recommendations and not later than last year the banking legislation was amended to allow for consolidated supervision of banking groups. The Bank of Mauritius actively engages with the host regulator of subsidiaries of local banking groups as well as with home regulators of foreign groups through regular supervisory colleges. The Bank of Mauritius has also entered into Memoranda of Understanding with other regulators for the purpose of fostering exchange of information and facilitating regulation and supervision of entities with affiliates falling under the purview of other regulators.

A strong liquidity base is key to ensuring robustness of a regulatory and supervisory framework. The BCBS has reviewed liquidity standards, including the need for High Quality Liquid Assets to safeguard survival under stressed scenarios and a Net Stable Funding Ratio to guarantee that banks have appropriate level of stable funding. The Bank of Mauritius has lately released its upgraded liquidity guidelines, which are presently under consultation and are expected to be finalised in 2017.

Another Core Principle for Effective Banking Supervision requires an appropriate crisis management and resolution regime to minimize disruption in the financial system as well as the reduces both the impact and probability of failures. This also requires adequate collaboration across regulators to ensure that responsibilities are discharged in a coordinated approach. The Bank of Mauritius is currently reviewing the existing regime with assistance from the IMF to cater for an effective resolution and crisis management regime.

The establishment of a deposit insurance scheme is one of a series of reforms initiated with a view to preserving financial stability. The Deposit Insurance Scheme Bill has been finalised by the Bank of Mauritius and sent to government to be enacted.

Nine years after the global financial crisis, loan loss provisioning and asset quality remain key issues for banks and regulators. Accounting standards around the world are currently based upon the incurred-loss impairment model. This approach permits recognition of impairment losses centred on "objective evidence" – which basically means that loan loss provisions are computed on *ex post* losses. The existing model is, in many cases, applied by banks so that impairment is only recognised just before the default of a loan. The existing standards for provisioning thus do not meet supervisory requisites.

IFRS 9 is a complex accounting standard relating to financial instruments. The key reform with IFRS 9 is that provisions for loan losses will be based on an expected loss model for credit losses. This is a distinct improvement as it will make it difficult for banks to hide problem assets on their balance sheet. I don't need to dwell at length on this topic knowing that you have just participated in the course.

The Bank of Mauritius has engaged with external auditors and banks as from March 2016 to ensure smooth implementation of IRFS 9. Banks have been requested to submit the implementation plans to the central bank and are required to make quarterly presentations on progress achieved and roadmap to complete implementation. The Bank of Mauritius has already conducted a first round of discussion with most banks to better understand their plans and challenges as well as guide them in terms of our expectations.

The Bank of Mauritius is envisaging parallel runs by financial institutions to allow for a good transition as well as provide management and the regulator and external auditors with sufficient time to verify the reliability of the models and the assumptions. In addition, the Bank of Mauritius has issued several guidelines which would be assisting in ensuring the safety and soundness of the banking sector during the implementation phase.

In April 2016, the Bank of Mauritius added prudential norms for credit classification and provisioning requirements to the existing Guideline on Impairment Measurement and Income Recognition. This was in response to difficulties in comparing information across banks, given that there could be significant differences on how banks identify and report their asset quality. In addition, as highlighted earlier, the global financial crisis revealed that the existing accounting framework resulted in “too little and too late” provisions.

The Guideline Impairment Measurement and Income Recognition prescribes rules for valuation of collateral given that that proper valuation of collateral is important for an accurate estimate of expected losses. The Bank of Mauritius has included provisions for the treatment of restructured loans to address the risk of ‘cosmetic’ restructuring to postpone expected losses and the setting aside of adequate provisions.

As regards loan loss data, credit profiles currently available on the Mauritius Credit Information Bureau, which is hosted by the Bank of Mauritius, is in the process of being upgraded to provide default history. The new information would then be used in assessing expected losses.

The Banking Act 2004 sets out the duties of external auditors which, among others, requires them to report any breach of regulations and or material issues to the Bank as well as to certify that the financial statements represent a true and fair picture of the affairs of the financial institutions.

Sound credit risk management is a key factor in the accuracy of expected loss models. The Bank of Mauritius issued a Guideline on Credit Risk Management back in 2003 which establishes sound principles of credit risk management whilst at the same time establishing the responsibilities and accountabilities of senior management and the board of directors. There are several other regulations regarding credit risk management and adequacy of provisions which in addition to the ones I have just stated will assist in the maintenance of the safety and soundness of banks and other deposit taking institutions through the transition period.

Will the new standards on IFRS 9 help to avoid the next crisis?

The concept of expected credit loss model aims to recognise losses adequately and in time. It will address the ‘too little and too late’ provisioning problem. However, the model itself will be largely dependent on underlying data, expert judgement, subjective estimates of macroeconomic parameters as well as adequacy of the internal control framework notwithstanding the IT infrastructure and analytics.

Subject to these challenges being effectively addressed, boards and senior management of banks will take informed decisions to proactively manage provisions. Banks' senior management, board of directors, external auditors as well as supervisors all have a critical role to play in the smooth transition and implementation of the new prudential accounting regime.

Thank you.