R Basant Roi: Overview of recent economic and financial developments in Mauritius

Address by Mr R Basant Roi, Governor of the Bank of Mauritius, at the Bank of Mauritius' Annual Dinner with major economic stakeholders, Flic en Flac, 27 November 2015.

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Hon Senior Puisne Judge, Eddy Balancy

Distinguished Guests

Ladies and gentlemen

Nine years ago, I gave what was my last address to this august gathering of businessmen, bankers and professionals at the Sugar Beach Hotel in this very neighbourhood. It never ever crossed my mind that I would be back to the Bank of Mauritius someday. It's a tryst with destiny. I am back and am pleased to address you on an occasion that has become an established tradition.

Decades ago, when I was trying to decide on a subject for my dissertation, a famous professor advised me that if I wanted to maximize the probability of success I should be guided by two principles: one was to make sure to cover issues where I knew more than those who would be evaluating my work; and the other was to make sure, while putting together everything I needed, to travel from dialectics to such a logical conclusion that no one in their right mind would ever think of doing. I did not listen to the professor's counsel. I remembered this counsel while I started writing this address a few days ago. This evening, I have decided to be somewhat guided by his counsel. In so doing, I hope not to cross the delicate line that every speaker fears and faces: the line that separates courage and stupidity.

We, at the Bank of Mauritius, do not claim to have incandescent intellect whose every idle utterance is brilliant. We are certainly not gifted with cosmic wisdom for spinning regularly in public. We are just a team of modest central bankers who happen to be the powerhouse of information. The Bank is not omniscient though. One paradox in this age of near-perfect communication system is that nobody can claim to know what is actually happening. Given the nature of the functions we are called upon to fulfill, not all the information held by the Bank can be made public. We, too, like all the citizens of this country have to be law-abiding. We have the best interests of Mauritius as a very well-regulated and supervised jurisdiction at heart. I have ensured that the Bank's decisions, in particular those regarding regulation and supervision of deposit-taking institutions, are not guided by prejudices. I want to be open. I want to be frank. I want to be candid. I want to be straightforward. I find no better audience than this gathering of businessmen and professionals to express freely some concerns of the Bank of Mauritius.

For over 300 years, central banking policies have been guided by the ultimate objective of achieving sustainable economic growth. Central banks support sustainable growth through the pursuit of price stability and financial stability. Far from a desire to lecture on the meaning of price stability, I need to touch upon it since it keeps being variously misinterpreted after every MPC meeting. There does not exist a universally accepted rigorous definition of price stability. It is, however, generally meant to be a condition in which the rate of inflation is low – not far away from zero – and sustained over a period long enough such that expectation of changes in the general price level does not alter business and household decision making. In other words, people do not find the general price level a matter of concern in their day-to-day decision making. For the purpose of this audience, put in its simplest possible form, financial stability, on the other hand, is a state in which our financial system, that is, all the financial intermediaries, markets, and market infrastructures, can withstand internal and external shocks without any consequential disruption to financial intermediation and to the efficient allocation of savings to investment. Price stability and financial stability are the pre-requisites of sustainable growth.

Economic, cultural and political pressures have, over the years, dictated emphases on central banks' policy goals. In fact, the balance between policy goals has not always been the same. Most central banks had multiple policy goals in the decades before the 1980s. In the decades before the 2008 financial crisis, the policy pendulum swung strongly to price stability as the goal. Inflation rates dropped dramatically. Some central banks were even asking for a little higher rate of inflation to grease the growth process. Who would have ever imagined in the 1980s that there would come a time when some central banks would wish inflation rates to pick up a little? In the years after the crisis, against a backdrop of deflationary forces, the policy pendulum of central banks again swung and this time to achieving financial stability. Inflation stopped being an overriding policy concern for central banks. As many of you must be aware, many central banks have been pursuing aggressive unconventional policy action. Collectively, central bank policies since the outbreak of the crisis have made a crucial contribution to restoring financial stability. Given the depressed economic conditions and various challenges that have emerged, we, at the Bank of Mauritius, are expected not to lose sight of financial stability while formulating policies; it's a dragon that we cannot afford to leave out of our policy calculations.

Soundness and robustness of banks as well as financial stability are not a novel policy concern for Mauritius. Mauritius is one of the rare countries in the free world that has known free banking in the 17th and 19th centuries. Bank failures were as common a feature in Mauritius as in the US and elsewhere. A few years after Independence in 1968, more specifically after the breakdown of the Bretton Woods system in September 1971 that had rendered the international monetary system unstable, the Bank established a division that eventually evolved into what is known today as the Bank Supervision Department. Its objective was and still is to regulate banks and ensure financial stability. The Bank has hitherto not lost sight of the critical importance of financial stability to the economy.

We have a bank-centred financial system. Total assets of our financial system are currently estimated at around 385 per cent of GDP. The banking sector alone accounts for around 300 per cent of GDP which goes to say that banking accounts for 80 per cent of the total assets of our financial system. Total assets of the most domestic systemically important bank in the country are nearly 70 per cent. The assets of the insurance sector are equivalent to 33 per cent of GDP while those of the pension sector stand at 25 per cent of GDP. The non-bank deposit taking sector, inclusive of leasing companies and finance companies, have assets equivalent to 16 per cent of GDP. These ratios suggest that the importance of banks in our financial system cannot be understated. If Government ever had to bail out banks in order to protect the economy from collapsing, our debt-to-GDP would fly through the roof. It goes to say that regulation and supervision of banks is a function of the Bank of Mauritius that cannot be taken lightly and politicians should stay out of the regulatory and supervisory arena. In particular, licensing of financial institutions should be free of political influence in the first place.

However effective and robust the regulatory and supervisory framework in place, banks do fail. And they fail due to a variety of reasons. There is no magic elixir that grants immortality to banks. In the last 46 years, the Bank of Mauritius revoked the banking licences of five banks. The funeral list of banks has not been so long as to suggest that the Bank of Mauritius has been ineffective as a regulatory authority of banks.

The US Controller of Currency wrote a letter of guidance to banks way back in December 1863. Three short lines in the letter give an idea as to why the five banks lost their banking licences. The lines read as follows: "Pursue a straightforward, upright, legitimate banking business. Never be tempted by the prospect of large returns to do anything but what may be properly done under the National Currency Act. 'Splendid financiering' is not legitimate banking, and 'splendid financiers' in banking are generally rascals or humbugs."

In 1996, the Bank of Mauritius had revoked the Banking Licence of the Mauritius Co-operative Central Bank Ltd (MCCB). The MCCB, as the bank was popularly known, suffered from serious capital deficiency. The bank had a scheme to attract deposits at the mind-boggling rates of interest of over 15 per cent. The rates were of course far higher than the then prevailing market rates. When the chicken had come to roost, the bank did not have liquidity. The bank's shareholders and staff as well as informed depositors had started withdrawing funds. The bank barrelled towards failure and dashed around like a panicked headless chicken. The shareholders of the bank, representatives from the small-planters community and those personalities who were politically well connected clamoured for the Bank of Mauritius intervention. The then Bank of Mauritius was not yet independent. As per the Bank of Mauritius Act 1971, the Minister of Finance was fully empowered to issue directives to the Bank. Reluctantly, the Bank of Mauritius had intervened by way of capital and liquidity injection. Already, public trust in the bank was lost and irrecoverable. The death sentence of the bank was readable on the wall for quite some time. Yet, the Bank of Mauritius was asked to revive a clinically dead bank. The Bank of Mauritius had yet to learn a fundamentally important lesson when dealing with banks in trouble: a troubled bank can survive without capital for some time. But without liquidity, that bank is bound to collapse within hours. No amount of liquidity injection by tax-payers would be sufficient to rescue such a troubled bank. Once public confidence in a troubled bank is lost more so in a small gossip-ridden society like ours, it stays lost. This sad story and other equally sad stories about bank failures in Mauritius remind me of Hemingway's conversation between Bill Gorton and Mike Campbell. Bill asks: "How did you go bankrupt?" Mike answers: Two ways. Gradually. Then, suddenly," Final outcome: MCCB was put on liquidation. A large chunk of the funds injected by the Bank of Mauritius into the ailing bank has not yet been recovered; it never will be. Tax-payers lost what was then a colossal sum of about Rs375 million. In financial markets lexicon, it's said, bulls made money, bears made money and the pigs got slaughtered. And the smart guys cleverly got away with criminal offences. Fortunately, the MCCB was not part of a bigger corporate group resembling a galaxy loaded with loss making planets of all sizes and orbits. The aftertaste of the MCCB episode – a low-intensity tremor in our banking industry though – still lingers in the soul of the Bank of Mauritius.

One more dramatic episode. Same play, different acts. In 2001, the Bank of Mauritius was made aware by whistleblowers of several frauds totalling hundreds of millions of rupees in a bank. There were more policemen than bankers at the bank's annual shareholders meeting. This was a bank that had obtained a form of Bank of Mauritius subsidy after its acquisition of the defunct Union Bank Ltd in 1996. A Bank of Mauritius subsidy means a subsidy granted by taxpayers. This is a phenomenon not easily grasped by the public at large. The Chairperson of the Board of Directors who was also the majority shareholder was unseated as chairperson in May 2001 and was respectfully asked to inject capital into his bank. Without the capital injection, the bank had no legal right to exist. The unseated Chairperson hurriedly left the country without injecting the capital and refused to show up in Mauritius despite repeated calls. That bank did not meet the deadline for capital injection. The Bank of Mauritius revoked the banking licence of the bank in early 2002. Still, he had refused to show up. But he battled from afar to win back his enterprise the liabilities of which had far exceeded its assets. The battle was just a public show; he abandoned the game - eventually. The bank was Delphis Bank Ltd and Chairperson's name, just in case you have forgotten, was Ketan Somaia, a brilliantly nefarious thespian who finally failed to malinger his way out of prison in Kenya and the UK, just over a year after the revocation of the banking licence of his bank in Mauritius. The Bank of Mauritius did not receive a felicitous remark for its bold and pre-emptive decision to close the bank though it was profusely castigated by some politicians and a specific section of the population.

These two banks and all the others in the funeral list of defunct banks were given a fair trial – and a fair hanging – by the regulatory authority. The Bank of Mauritius always ensured that depositors never lost their money in the bargains that followed.

No single career officer of the Bank of Mauritius derives sadistic pleasures out of the revocation of banking licences because the aftertaste is known to be very unpleasant. The Bank of Mauritius does hold a licence to kill an ailing bank as many of you have been made to believe. The power to revoke a banking licence must never be construed as the itchy finger of a depressed man at the trigger of a loaded pistol. It is rather the equivalent to having a gun hanging on the wall. The Bank knows that once a while it shoots off, but it does not know when. The gun is there but the Bank has no pre-commitment to use it. Revocation of a banking licence is a very last recourse decision. May I emphatically state that the primary responsibility of a regulatory and supervisory authority is to rescue banks in trouble, not to act as a gunslinger. Financial stability is indeed an overpowering consideration for any responsible regulatory authority. The Bank of Mauritius as the regulatory authority of deposit-taking institutions in the country is not guided by prejudices.

Several reasons have motivated me to come up with narratives regarding the revocation of the banking licences of the two banks in quite a distant past. One of the reasons is particularly important. I have to share it with you this evening. The tension between the regulator and the shareholders of the defunct banks engenders some kind of a social electricity. Every voice suddenly becomes a digital loudspeaker. People react to the revocation of banking licences with all kinds of biases and irrational impulses. They overreact to illusory threats and underreact to real threats. Some of them seem to instantly develop the deep torments of a retarded poet in a broken marriage. Revocation of the banking licences of the two banks had attracted unjustified criticisms. Aspersions were violently cast on the Bank of Mauritius by a specific section of the population for not having done enough to bail out the two banks and let down that ethnic group having affinity to those two banks. Extending liquidity to a very badly managed bank owned by almost a single person was tantamount to giving more liquor to an alcoholic to soothe his tremors – a short-term fix that does not do anything to solve the problem. Make him feel good enough, and soon he won't feel anything again. In one of the three cases, an ailing bank needed a massive amount of liquidity from the Bank of Mauritius. The Bank of Mauritius does not lend to ailing banks, however desperate the situation, against fake collaterals – collaterals that have been already and secretly sold by the ailing bank. It is totally irresponsible to express vociferous opinion on a subject when you suffer from ignorance-cultivated diseases. In the Delphis Bank ltd case, I was left with an impression that I ought to have given sympathetic considerations, at whatever the cost to taxpayers. One of my family members was even physically attacked. It requires enormous emotional stability not to allow personal misfortunes or sufferings to affect one's judgment.

Ladies and gentlemen, I need not underscore that there are some things you cannot learn from others. You have to pass through the fire. Everyone sees your exterior but few can discern what you store in the heart.

It's easy to take the role of victim, since we live in a world where most are looking for the shortest and fastest way out of a situation. In a society of instant gratification where we want it all and want it now, the default mechanism is to claim to be a "victim." It's a quick and dirty way to get it over with. Where the regulatory authority is involved, you just point a finger. The Bank of Mauritius told the truths with evangelistic fervour. No one believed in the truths. The shareholders told vociferous lies. People believed in their vociferous lies. It is said that power corrupts. We hardly realize that weakness also corrupts. Power corrupts a few. Weakness corrupts the many. George Orwell knew what he was talking about when he had described political language as "designed to make lies sound truthful and murder respectable, and to give an appearance of solidity to pure winds." Today, the Bank of Mauritius has become accustomed to the distortions of political speak. People who wear victimhood as a badge of courage get lots of attention. There are interpersonal and sociological components to this that run very deep in our society. Perhaps our society merits ecclesiastical review by common sense.

Three of the five banks whose banking licences the Bank of Mauritius has revoked in its history have a common thread that runs through to their demise. Like a piece of an Indian classical *raga*, a theme plays throughout in different variations, tempos and pitch. In small, heavily politicized, clan-based societies, relations between politics, banking and business tend to become too cozy, not to say incestuous. The politically well-connected CEOs or the politically well-connected biggest shareholders have had a domineering influence in their respective banks. They found it difficult to imagine that anything bad could happen – a phenomenon known as 'disaster myopia" – which makes them develop an infallible instinct to self-destroy and ruin their own banks. Another striking feature of the three defunct banks under reference is specific management weakness, particularly in the lending area, a frequent initial cause of financial distress known even to the most stupid external auditor of banks. By the way, external auditors generally have the right nose. Tragedy! They pretend to have sniffing deficiency. Bad lending practices, often motivated by considerations other than normal, opened the door to credit weaknesses and left the banks vulnerable to adverse economic cycles. One of our latest discoveries was massive lending to sister companies having fantasy science fiction balance sheets or no balance sheet at all. The tantalized regulator wondered whether he or she should believe in astrologists or physicists in astronomy. Non-performing loans and associated problems accumulated rapidly. The attitude and behaviour of top management permeated middle management and other organizational layers. A bad management culture is very difficult to change. The change for the better may take as long as the change for the worse. The regulator finds himself in an impossible position. From technical mismanagement, the defunct banks shifted to cosmetic management and then to desperate management. And finally, to fraud. It's a sobering reminder of man's capacity for folly.

Ladies and gentlemen, this year a distressed insurance group involved in shadow banking fell tragically. At least Rs25 billion, that is, as big as 6 per cent of our 2014 GDP, passed through the shadow bank like the proverbial "dose of salts" to elsewhere. The insanity underlying the mind-boggling interest rates set to deceptively attract funds drove savers to fateful 'sweet dreams'. A profile of the holders of the funds in the shadow bank reveals that they were mostly households, not necessarily low income households. Those who held the funds as part of their portfolio of savings were of course merry and felt wealthy. The 'wealth effect' on consumption expenditure, particularly on non-essential items, appears to have been significant. The loss of wealth seems to have had a dampening effect on consumption of non-essential items this year and is likely to last in the months ahead. Along with other developments, this dampening effect should be reflected in a narrowing of the current account deficit of our balance of payments.

In the wake of the 2008 financial crisis, financial stability has assumed much more importance than before. Monetary policy transmission mechanism is severely disrupted when a financial system is crippled by instability. This is not news to most of you; financial papers are replete with discussions on this issue. Regulatory authorities are rightly placing greater emphasis on quality human capital in the financial services industry. They have come up with stringent requirements for appointment and accountability of senior officers and board directors. In some countries, the UK for instance, appointment for senior positions including appointment of board directors has to go through regulatory authorities. In the selection process, in-depth interviews of candidates are conducted by the regulatory authorities. This appointment procedure is now binding for the financial services industry. Shareholders, board directors and senior management are being called to assume greater responsibility than before. Failure of a bank does not happen overnight. The politics of credit decision making and other decisions detrimental to a bank are known to the insiders. Over time they build up to a point where the bank finally discovers that its capital is seriously impaired, its liquidity position is perilous and finally it is insolvent. The question is: should such a bank be bailed out without any accountability of the senior officers, directors of the board and shareholders? The latest trend is a set of new norms of conduct and accountability for senior officers and directors. They are being made personally liable in the event of malfeasance. A major improvement in the culture of banks is now an economic necessity.

To the external auditors of banks, I have a few remarks that I do not believe should be restricted to private room conversations. When you make errors, make sure they are errors of judgment, not errors of principle. I do not intend to sermonize. We, as regulator, have noted that moral compasses of people in the business have been spinning erratically. I would like to share with you a piece from *Lectures on Jurisprudence* by the father of Economics, Adam Smith. "Whenever commerce is introduced into any country, probity and punctuality always accompany it . . . "When people seldom deal with one another, we find that they are somewhat disposed to cheat, because they can gain more by a smart trick than they can lose by the injury that it does to their character . . . "Wherever dealings are frequent, a man does not expect to gain so much by any one contract as by probity and punctuality in the whole, and a prudent dealer, who is sensible of his real interest, would rather choose to lose what he has a right to than give any ground for suspicion . . . "When the greater part of people are merchants they always bring probity and punctuality into fashion, and these therefore are the principle virtues of a commercial nation." This was said 240 years ago in Scotland. Someone I know of at Brunel University came up with a researched finding that we are undergoing a "cultural shift" in our attitudes to honesty. Jurors hold widely different views as to what constitutes dishonest behaviour. There is little consistency in the outcome of trials. A defendant could find himself convicted by one jury and acquitted by another. Jurors are asked to decide whether a defendant's actions are "honest according to the standards of reasonable people". That always seemed to work well enough in the past, but not now. The difference is that we no longer have a universal standard for honesty. Firms of Accountants do have a universal standard of conduct. Like a reckless and non-performing schoolboy who did not do his homework, an external auditor has no right to say at trilateral meetings with the regulator that his family dog ate his homework. Lately, I personally noted unethical behaviour and signs of rivalries that breached professional decency between what appeared to be gangs of external auditors. One firm turned into a guerrilla game player in order to grab an even bigger piece of the pie. It was an ugly sight. You might not like your neighbour across the street. But is it in your best interest to cause his property value to plummet? When external auditors fail in their duties because of greed and recklessness, they put an entire financial industry in jeopardy. Greed is good only if it leads to honest wealth creation.

Take due cognizance of what's happening the world over and in the country. Over the past three years, there has been a significant decline in correspondent banking facilities. The regions that have been the hardest hit are the Caribbean, Eastern Europe, Central Asia, East Asia and especially small jurisdictions with significant offshore banking activities and high-risk jurisdictions. The threats posed by the decline in correspondent banking are serious. Regulators, including the Bank of Mauritius, the Financial Services Commission, the Financial Intelligence Unit and most importantly external auditors of financial institutions have to be extraordinarily diligent in tracking the nature of financial flows failing which the economy could be seriously affected. The realities and challenges have been mutating fast due to cross-currents of forces in recent years. I ask external auditors to wake up and smell the coffee; it's a far different coffee.

I would have very much liked to end this address right now. But I would feel something missing if I resume to my seat without highlighting an issue. Our bank supervisors have observed that one of the key reasons for loan delinquency and rising non-performing loans is due to borrowers diverting funds from the main activity for which funds are directed. The ease with which a client in arrears opens another operating account with a new bank with a view to diverting funds for financing non-business related activities is a serious concern from the standpoint of financial stability. Disaster lies in wait for bankers who smoke the same hashish they give out to other bankers. It is no doubt the duty of a banking industry to put a stop to such diversion of funds. Any well-meaning and competent association of bankers with a sense of purpose for the promotion of a robust banking industry ought to have resolved this issue already. An effective association of bankers has to be representative of all the banks, not to be a representative of one or two persons. In 1982, I happened to be in the campus of l'Université de Bordeaux, France. I was asked by a friend why the guy from Belgium goes to sleep with one glass full of water and one empty glass next to his bed. I could not give the correct reply. And I was then told that the Belgian guy never knows if he'll be thirsty or not when he wakes up in the night. When an association of bankers start resembling the Belgian guy, I believe it has no *raison d'être* in our banking industry, more so if issues affecting its own members are not resolved in-house. I have been open. I have been frank. I have been candid. I have been straightforward. You have choices to make. The Bank of Mauritius, too, has choices to make.

Ladies and gentlemen, on behalf of the Board of Directors, Members of the Monetary Policy Committee, the staff of the Bank and my wife, I extend to you all and your families Happy Holidays.

Thank you. God Bless You.