Mohammed Laksaci: Banking sector reform and financial stability in Algeria

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Introduction

After being strongly involved since 2008 in addressing the liquidity crisis through massive liquidity support and expansion of their balance sheets, central banks in advanced countries must now pay more attention to monitoring systemic risk, in a context of interaction between banking and sovereign risks. Seven years after the burst of the international economic and financial crisis, the global financial sector reform agenda remains incomplete, while it is now important to also face the issues related to the difficult situation of the global economy transition.

This calls for strong efforts to accelerate the repair of banks' balance sheets in the euro zone and the early establishment of a unique and independent mechanism of crisis resolution. The prospects of monetary policies normalization (in particular in the United States) and its negative effects on emerging economies through capital flows require sustained attention.

Like other central banks, the Bank of Algeria had to face the need of further strengthening systemic risk monitoring. This requires the deepening of the banking system reforms.

1. Banking sector reform: efforts made prior to the strengthening of the legal framework in 2010

Within the broad framework of the economic reforms undertaken in the late 1980s (overall reform of the economic regulation, including that of price systems), the banking reform has been implemented since 1990, following the enactment of the law on money and credit (1990) establishing a two-tier banking system. This major monetary reform reemphasized the role of money and monetary policy- through indirect tools- in macro-financial regulation, thereby enabling a gradual shift from the "financial repression" paradigm.

Since the year 1990, and after assessing the vulnerabilities of the Algerian public banking system, a number of reforms have been undertaken to improve the functioning of public banks, reinforce the banking activity operating framework- especially through the opening of the sector to private investors- and promote the development of non-bank financial institutions.

Based on institutional audits, action plans aiming at improving public banks functions have been launched during the first half of the 1990s and pursued during the 2000s. In order to improve their governance, performance contracts between the public banks' managers and the State as the owner, took effect in the beginning of 2007.

At the same time, and on the basis of their financial statements audits undertaken by international firms, cleaning up operations of the public banks' balance sheet started in the beginning of 1991 with the repurchase of non- performing loans (NPLs) and capital increases. The public banks restructuring cost, in terms of non-performing loans repurchased by the Treasury (excluding interests owed by the Treasury, materialized in bonds), accounted for 2.38% of GDP for the decade 1991–2000. For the same period, when including the amount of foreign exchange losses and interest rate spreads paid by the Treasury on account of public banks earlier external borrowing to support the balance of payments, the overall cost reached 3.26% of GDP.

Improvement in public finances during the 2000s enabled further restructuring of public banks' balance sheets, with part of the NPLs consisting this time of bad loans to the private sector. For the period 2001–2010, repurchases by the Treasury through issuance of securities, essentially with regard NPLs to public enterprises, reached about 1.30% of the decade's GDP. Finally, in 2011–2012, repurchase by the Treasury of loans to public and private enterprises accounted for 235.7 billion dinars, representing 0.77% of GDP.

Along with NPLs repurchase operations, public banks received financial support from the Treasury to increase their equity capital. The overall amount in this regard reached 238.8 billion dinars, of which 107.7 billion dinars in cash and 131.1 billion dinars in equity securities. Part of these securities was subsequently repurchased by the Treasury, bringing their outstanding amount to 56.2 billion dinars by end 2010. It is worth noting that, during the 2000s, public banks provisioned significantly and benefitted from additional financial support from the Treasury to further increase their equity capital. This important and costly bailout program enabled public banks to meet the prudential regulation requirements in terms of solvency ratios and risk-distribution, in line with international standards.

With the sustained implementation of the new banking regulatory framework for banks and financial institutions during the 1990s, especially with regard the rules and conditions for the establishment of new banks and financial institutions, the second half of the 1990s recorded the first phase of effective opening of the banking activity to the private sector. However, violations and breaches in some private banks led the Banking Commission – the supervisory authority – to withdraw the licenses of seven banks and two financial institutions between 2003 and 2009, a number of which being in bankruptcy conditions between 2003 and 2006 and having risks concentrated on entities of their group. Against this background, the deposit guarantee scheme was activated in 2003 in accordance with the prevailing regulatory framework.

In August 2003 and in light of these failures, the 1990 banking law was revised to strengthen the licensing conditions, increase the minimum capital requirement, which also became fully due in cash, and strengthen the Banking Commission missions. In particular, the Commission was given exclusive competence to exceptionally extend the deadline for the publication of banks and financial institutions' financial statements.

In parallel, the supervisory capacities of the Bank of Algeria have been significantly reinforced since the beginning of the 2000s; Bank of Algeria's corps of inspectors being legally in charge of implementing the supervisory program set up by the Banking Commission. The financial sector assessment program jointly carried out by the IMF and the World Bank in 2003 and updated in 2007, together with the associated technical assistance, contributed to strengthening Bank of Algeria's supervisory tools.

As of 2002, the supervisory framework also benefited from the adoption of a regulation on internal control of banks and financial institutions, which requires them to establish an internal control system for their activities and associated risks in order to improve risk assessment, management, and control. The emergence of excess liquidity in the money market since 2002 led to the introduction of new monetary policy tools in order to mop it up effectively.

Based on a comprehensive regulation adopted by the Council on Money and Credit in 2005, important progress was achieved in 2006 in modernizing the payment systems, including the real-time gross settlement system for large value and urgent payments and the clearing system for retail payments. The efficiency and safety of transactions occurring through these systems have been strengthened since then, in line with international standards.

To improve bank financing of private enterprises, especially SMEs, the government initiated reforms regarding loan guarantees in the 2000s. These include an increase in the level of guarantee (from 50 to 250 million dinars) provided by the Guarantee Fund for Investment Credits (CGCI), the creation of the national investment fund and regional investment agencies, and the introduction of an interest rate subsidy on investment loans. These measures have substantially contributed to increasing the share of credit to the private sector in total credit, which rose by 24 percentage points (from 31.3% to 55.3%) over the last decade.

As a non-bank source of investment financing, financial market financing- mainly bond issuance – has significantly increased since 2002 in response to new financing needs related to private and public enterprises investment programs. As a percentage of nonhydrocarbon GDP, the financing of public and private enterprises through bond issuance reached 3.5% in 2006, up from 1.5% in 2004.

2. Macroeconomic stability and recent strengthening of the financial stability framework

The return to macroeconomic stability in 2000 and the financial performance achieved between 2001 and 2008, allowed the domestic economy to weather the global crisis well. In particular, sustained accumulation of foreign reserves between 2000 and 2008 and early repayment of the external public debt in the mid-2000s put Algeria in a position of net creditor vis-à-vis the rest of the world. Its net external position reached 91% of GDP in 2013, in a context of continued prudent management of foreign reserves by the Bank of Algeria.

This external financial stability is supported by Bank of Algeria's active exchange rate management through its interventions in the interbank foreign exchange market aiming at stabilizing the real effective exchange rate of the dinar close to its medium term equilibrium level. In the first half of 2014, real effective exchange rate slightly appreciated, in a context of disinflation. The inflation performance over the last twelve years, except for the year 2012, is an anchor to monetary stability in Algeria, despite structural excess liquidity in the money market. After a surge in 2012, the disinflation process started in February 2013 and continued through 2014, with inflation declining to an annual average of 1.49% in July. The contribution of monetary policy to preserving financial stability in Algeria remains crucial, given the predominance of the banking sector in the Algerian financial system and banks' potentially important role in the development of financial intermediation.

At the same time, the financial capacity built during the period 2000–2008 enabled the Budget to mitigate the impact of the 2009 external shock, while avoiding any crowding out effect. This financing capacity remains significant and accounts for 34% of GDP at the end of 2013, in a situation of very low domestic public debt (8% of GDP in 2013) and implementation of fiscal consolidation.

In contrast with the case of several emerging and developing countries, credit expansion in Algeria continued at the pre-global financial crisis pace, and even at a higher rate since 2010, in particular as regards credit to the private sector. The strong growth of credit to the economy in 2013 (20.3% against 15.1% in 2012 and 14% in 2011), driven by medium and long term credit dynamics (27.6%), was a key determinant of monetary expansion in 2013. As regards the private sector, the credit growth rate over the last thirteen years averaged 19.4%.

The revision of the 2003 banking law through the Ordinance on Money and Credit of August 2010 extended the missions of the central bank to include an explicit objective of financial stability in addition to the price stability mandate.

The 2010 banking law emphasized the role of the Bank of Algeria in ensuring banking system stability, safety and soundness. In this regard, it has been endowed with larger prerogatives to carry out any investigation at the level of banks or financial institutions, thereby enabling greater capacity for early detection of vulnerabilities in the system. Accordingly, the Bank of Algeria intensified micro-prudential controls, including with regard banks' anti money laundering and financing of terrorism mechanisms. Improved efficiency of these controls enables an orderly development of the banking system. For a comprehensive monitoring of the banking sector stability, the Bank of Algeria periodically assesses its soundness, based on stress tests which have been developed since 2007 and strengthened in 2013–2014.

In addition, existing micro-prudential regulation tools – such as loan to value ratios, minimum reserve requirement (also a monetary policy instrument), and the ratio of debt service to revenue – have been revisited and could be adjusted as needed to face potential systemic risks. Furthermore, a strengthening of macro-prudential tools is underway since early 2013, especially through the introduction of new tools enabling horizontal analysis of risks and the introduction of resilience tests.

To further develop the operational framework for financial stability, and following the implementation in 2010 of the new accounting rules, in line with international standards, as well as those related to the assessment of the risks associated with new financial products, a regulation on the identification, measurement, and management and control of the liquidity risk was enacted by the Council on Money and Credit in May 2011. This regulation introduces a minimum short-term liquidity ratio which must be met by banks and financial institutions at all times. In the same vein, the Council on Money and Credit has also enacted in May 2011 a second regulation establishing an internal surveillance system and a ceiling by counterpart regarding interbank outstanding lending and borrowing, especially those occurring in the money market. The assessment made by the Bank of Algeria for 2013 suggests that all banks meet the liquidity ratio requirements (169.87% at the end of 2013), despite the relative stabilization of banking liquidity over the past year.

In terms of banking sector depth, it is worth noting that the ratio of collected resources (demand and term deposits excluding hydrocarbon deposits) to nonhydrocarbon GDP increased in 2012 and 2013 (62.73%) after a stabilization at 61.44% in 2011. The upward trend between 2008 and 2013 of the credit to the private sector as a proportion of private sector deposits in local currency, in a context of increased financial transformation, is another relevant indicator of the banking system depth. Moreover, the ratio of total credit to nonhydrocarbon GDP remained stable, whereas credit to the private sector/nonhydrocarbon GDP increased somewhat in 2013 to reach 23.45% (21.35% in 2011).

In 2013, while pursuing their provisioning efforts, banks consolidated their financial soundness indicators. Solvency ratios remain high, much higher than required under the prevailing regulation and in line with the recommended level under Basel III. The banking sector soundness is anchored to high capital adequacy ratios and high profitability and liquidity. The solvency ratios are in line with those of comparable emerging market economies.

In 2013, an assessment of the banking sector carried out by the International Monetary Fund and the World Bank has helped define further directions in deepening banking sector reforms and strengthening banking system stability in Algeria. Effective implementation has started in the first quarter of 2014 with the enactment by the Council on Money and Credit of three regulations related to the solvency ratios, large exposures and participations, and loans classification and provisioning. The minimum Tier 1 capital ratio has now been set at 9.5%, higher than recommended by the Basel Committee, and the regulatory capital ratio has been set at 12%. Moreover, as regards the strengthening of the capacity in assessing the banking sector risk, Bank of Algeria will rely, as of the beginning of 2015, on the effective use of the new stress test model, and on the generalization of the bank rating system.

Furthermore, within the larger prerogatives scope provided by the 2010 law, encompassing the functioning, surveillance, and security of the payment systems, the Bank of Algeria is currently updating the payment systems infrastructure (real-time gross settlement system for large value payments and urgent payments and clearing system) established in 2006, in line with international standards.

The completion in 2014 of the modernization of the existing credit bureau and the establishment of a new infrastructure for the development of a broader credit bureau will provide an important tool to monitor credit risk as of the second half of 2015.

The new risk-based, forward-looking supervision approach will be focusing on the banks' credit allocation process in order to avoid the reemergence of credit risk concentration. Anchored within a framework of strengthened stability, the deepening of the financial sector reform as of 2014 will form the basis for a better allocation of national savings to foster productive investments and financing of nonhydrocarbon inclusive and job-creating growth, that is less dependent on the budget and is driven by SMEs development. In this regard, a series of recommendations has been formulated at the end of 2012 by a working group chaired by the Bank of Algeria, with a view of improving the financing of SMEs development, especially through better access to credit and banking services. These efforts should be sustained. For their part, banks are expected to diversify their SMEs financing tools, while continuing to improve the assessment, analysis, and management of credit risks.