FSAP Financial Sector Assessment Program
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Tunisia

FSA | Financial Sector Assessment

OVERVIEW

1. The Tunisian economy registered a strong performance over the past decade. With average real growth rates of 5 percent since 2000, real per capita income increased by 20 percent in a context of macroeconomic stability.

2. The banking sector plays a predominant role in financing the economy. New equity issues remain modest (TD 204 million in 2004, equivalent to 0.8 percent of GDP and 3.7 percent of private investment), in line with low stock market capitalization (about 9 percent of GDP in 2004). Asset growth of venture capital companies (SICAR) in 2004 was lackluster (approximately TD 40 million) with their total assets (TD 550 million) equal to 1.5 percent of GDP. However, leasing has developed successfully, with assets growing 50 percent between 2000 and 2004, reaching 11 percent of private investment financing.

3. The authorities are aware that pursuit of growth, necessary to create employment, requires strong banking sector support. Presently, although NPLs have declined (21 percent of total loans at end-2005, compared to 24 percent at end-2004) , there remains a need to accelerate their reduction that continue to be high for the system as a whole and strengthen provisioning.

4. To strengthen the banking sector the authorities have established a provisioning ratio target of 70 percent by 2009. Building on their awareness that a reduction in the NPL level is essential to restore the effectiveness of the banking sector, the mission has recommended that they adopt a second objective of reaching a NPL target of 10 percent by 2009. However Tunisian authorities have adopted a progressive approach by fixing a NPL target of 15% by 2009 and 12% by 2011.

5. Attainment of this latter goal would yield significant savings in provisioning and could reduce the need for capital increases, particularly in state-owned institutions. A set of regulatory, judicial, and tax measures have to be designed to create appropriate incentives for banks to attain this goal. The principal regulatory, tax and judicial measures[1] should aim at:

- Improving the quality of new loans so as to ensure that the stock of nonperforming loans (NPLs) does not increase again. For new loans, no more than 30 percent of the loan loss provisioning should be met through collateral, consistently with the goal of achieving at least 70 percent provisioning of all non-performing loans by 2009.

- Eliminating the legal and tax obstacles currently preventing a reduction in the non-performing loan burden, particularly through partial write-offs. These measures should also encourage recourse to out-of-court settlements.

6. The mission estimates that these measures should encourage vigorous prosecution of recalcitrant debtors and restructuring arrangements that are fair to both creditors and debtors and thus help reduce the moral hazard resulting from total or partial nonpayment of loans.

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[1] Box 1 on page 13 summarizes the main policy recommendations.

7. In order to achieve the proposed strategy, it is important that regulatory authorities monitor closely the implementation by banks of the new measures taken to promote the restructuring of NPLs, including their compliance with the new provisioning rules. Authorities should monitor the effectiveness of the instruments deployed to reduce the NPL stock and, if necessary, quickly adapt the regulatory incentives to support them.

I. Introduction and Recent Measures

8. The joint International Monetary Fund/World Bank mission[2] that visited Tunis from January 16 – 31 and March 27 – 31, 2006 as part of the Financial Sector Assessment Program (FSAP) update for Tunisia carried out a detailed analysis of the ability of the Tunisian banking sector to support the country's development objectives. Upon invitation of the Governor of the Central Bank of Tunisia (BCT), the mission organized three well-attended workshops on: the restructuring of nonperforming loans; management of public banks; and the use of information for financing SMEs and individuals.

9. The Tunisian economy registered a strong performance over the past decade. With average real growth rates of 5 percent since 2000, real per capita income increased by 20 percent in a context of macroeconomic stability. In 2005, the rate of inflation declined to 2 percent and the fiscal deficit was brought down to around 3 percent. The current account deficit on the balance of payments narrowed considerably since 2000, to reach 1.3 percent of GDP in 2005 in spite of further progress in trade liberalization.

10. The authorities acknowledge that the continued economic growth hinges on improved effectiveness of the banking system and this, in turn, requires a reduction of non-performing loans in the banks' portfolio (20.9 percent of total loans at end-2005). This burden increased between 2000 and 2003, mainly as a result of the decline in tourist sector activity following the events of September 11, 2001 and in Djerba in 2002. Although a marked decrease in the non-performing loans ratio took place in 2005, it remains high and considerably above the level of comparable countries.

11. To address these challenges, the authorities have embarked on a comprehensive strategy which is based on the following regulatory actions:

Strengthening of the credit culture and good governance

- A major element is the law 2005-96 of October 18, 2005 on the security of financial relations. This law strengthens companies' financial governance through improved allocation of responsibilities among corporate officials and

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[2] The mission was co-led by Luigi Passamonti (WB, FSE) and Emilio Sacerdoti (IMF, MFD). Mission members were: Guillaume Almeras (WB, SME Lending consultant), Pauline Aranda (WB-LEG), Marie-Therese Camilleri (IMF-MFD), Jean-Philippe Couëtoux (Banque de France), Didier Debals (WB-MNISF), Marianne El-Khoury (IMF, MFD), Eric Haythorne (WB-LEG), Oscar Madeddu (IFC), Rodolfo Maino (IMF-MFD), Cedric Mousset (WB-FSE), Jean Pesme (WB-FSE), Michael Pomerleano (WB-FSE), Isabelle Schoonwater (WB-FSE), Emile Van der Does (WB-FSE), David Welch (IFC retiree). Sadok Rouai (IMF), Senior Advisor to Executive Director for Tunisia, has attended all meetings.

control structures, and ensures more transparency through communication to the markets of credible financial data.

- It is also to be noted that in 2001 bank regulations have imposed stricter requirements on banks regarding financial information on their clients, in particular the obligation to obtain financial statements certified by the external auditors if total exposure on a client exceeds TD 5 million, and a recent rating from a rating agency if exposure exceeds TD 25 million.

Addressing the stock of nonperforming loans

- Within the framework of the efforts under way to limit the risks arising from the nonperforming loans, the tax deductibility of provisions has been gradually increased to attain 100 percent of profits starting in 2005.

- In addition, since 2004 the central bank has forced banks that record inadequate provisions to allocate the totality of their operating income to the coverage of this shortfall (and foregoing dividends, if necessary), until it is fully reabsorbed.

- Other measures aim to facilitate the judicial recovery of bank credits, in particular the reform concerning the rehabilitation of enterprises in difficulty, so as to prevent recalcitrant debtors from using the law for delays, and the law which facilitates the judicial sales of goods, and limits undue delays in the recovery of claims.

Restructuring of the banking system

- Restructuring has taken mainly the form of the privatization of two banks, the *Union Internationale des Banques* (UIB) and the *Banque du Sud* (BS), which account for 13.5 percent of banking system assets. These two sales have led to a reduction of government equity participation in the banking system from 36 percent at end-2004 to 32.5 percent at end 2005 and to an increase in foreign participation to 34 percent in 2005.

Reform of the regulatory framework

- In the context of the modernization of the banking sector, the authorities have revised the law on the central bank and the law on credit institutions.

12. Regarding the insurance sector, the legal and prudential framework was strengthened by amending the insurance code, which aligns prudential rules with international standards, triples minimum capital requirements, establishes new supervisory arrangements, and broadens the scope of off-site and on-site inspections.

13. A summary of recommendations of the 2002 FSAP, and the status of their implementation is presented in Table A.

14. Although this set of measures represents an important regulatory effort to strengthen the banking and financial system, and although headway was made in 2005 in reducing and provisioning nonperforming loans, the FSAP mission has recommended additional measures to reduce the NPL stock and hence improve the efficiency of financial intermediation.

II. Objectives, Strategies, and Instruments for Strengthening the Financial Sector

A. Main features of the strategy

15. The Tunisian banking system has reached a watershed in its long strengthening process. In order to withstand the shocks to which an outward-oriented economy is inevitably exposed while financing new growth-oriented activities—particularly those involving intangible assets—the banking system must strengthen its efforts to reduce the stock of nonperforming loans.

16. Today, a sizable proportion of the equity base of the banking system is earmarked for covering under-provisioned NPL risks. If a meaningful reduction in NPLs is achieved, it would be possible to allocate the largest part of the system's equity base to protect against unexpected losses, thereby bolstering the financial system's support for economic growth.

17. The mission conveyed the opinion to the authorities that the banking system should focus on achieving an NPL target level of 10 percent or less by 2009. This would put Tunisia on a par with other emerging countries. Attainment of this target would allow for substantial loan loss provision savings, and could minimize the need for potential equity capital injections, particularly from public shareholders. A package of regulatory, judicial, and tax-related measures to provide banks with appropriate incentives should be assembled.

18. A powerful tool for scaling back NPLs—and the related provisioning requirement—would involve restructuring loans to debtors, whose situation might be sustainably improved, including through partial debt cancellation. This strategy could be much less costly in terms of provision build-up than that presently pursued by the authorities which is to reach 70 percent provisioning target on presently outstanding NPLs.

19. However, a prerequisite for any partial restructuring is to reduce moral hazard resulting from full or partial nonpayment of debt. This can be achieved through vigorous enforcement action against defaulting debtors. It is to be noted that NPLs older than one year have a high concentration of large debtors, and that only 1/3 of NPLs older than 5 years are in litigation based on end-2003 data. Moral hazard results not only from the partial write-off of claims, but also from delayed payments on a temporary basis.

20. To limit moral hazard, partial debt cancellation should be accompanied by a dilution of control by the borrower through debt-equity swaps. Banks could then transfer these equity participations to investment companies such as the SICARs. Debt restructuring operations (extension of terms, extended grace period, stepped-up amortization) should be conducted on the basis of a rigorous analysis of actual ability to repay, to ensure that restructured loans can rapidly be reclassified as performing (which is seldom the case today).

21. A 25 percent reduction of the present NPL stock would be sufficient to put Tunisia on a par with other emerging countries that is, achieving an NPL ratio below 10 percent[3] and a provisioning rate, in line with the authorities' objectives, of 70 percent. To achieve this goal, the banking system should reduce its NPL stock by 300 million dinars per year for three years. Mission estimates show that this target could be achieved with the following indicative modalities: (i) full collection of about 100 million dinars (equivalent to 3 percent of NPLs older than 1 year); (ii) partial write-offs (average 25 percent of face value) of about 300 million dinars (equivalent to 8 percent respectively), and (iii) total write-offs of about 400 million dinars (12 percent respectively).

22. It is to be noted that this dynamic strategy, which associates a provisioning effort with a reduction of NPLs, would imply, if successful, a provisioning cost for the banking system substantially lower than that resulting from the provisioning-only strategy currently pursued by the authorities. The Table below indicates that the cost savings would be in the order of 500 million, i.e. about one third of the provisioning cost. A detailed worksheet has been made available to the BCT.

COST OF 70% PROVISIONING STRATEGY	Millions	
A) Without NPL Stock Reduction	**1,550**	
B) With NPL Stock Reduction	**1,000**	
I) Financing NPL write-offs	490	
Full Write-Offs		420
Partial Write-Offs		70
II) To reach 70% on outstanding NPLs	510	
Saving (B-A)	**550**	
(% A Strategy)	35%	

23. Presently, debt restructuring is penalized by the absence of tax deductibility for partial write-offs. It is important that the fiscal treatment be neutral in relation to the amount of write-off provided, and that the rules for eligibility of tax exemption for write-offs be simplified. In fact, write-offs have accounted for just TD 287 million over the past six years.

24. With respect to the recovery of claims through judicial channels, although reforms in favor of creditors were made in 2003, major delays in court-ordered payment procedures are still encountered. Thus, it will be important to develop extrajudicial procedures.

25. In the area of prudential regulations, incentives for rapid recovery of non-performing claims need to be strengthened. Thus, in accordance with the government's strategy to raise the provisioning rate for nonperforming claims to at least 70 percent by 2009, the regulatory

[3] As calculated, according to international standards, net of non-accrual interest which Bank of Tunisia presently adds to the NPL stock.

authorities should take steps to ensure that, for new NPLs, no more than 30 percent of the provisioning requirement is met by eligible collateral.[4]

B. Financial restructuring in the tourism sector

26. The tourism sector, of which 40 percent of claims are classified, could be the pilot case for this renewed effort to reduce NPLs. Indeed, this sector has some favorable features: the number of operators is relatively limited (800 hotels), economic prospects for the latter are favorable, except in isolated segments, cash flow projections are expected to pick up, foreign investors are interested in bringing in considerable amounts of capital and skills, and an investment restructuring program is underway. The Minister of Tourism has expressed interest in preparing a comprehensive financial restructuring plan that could provide a reference for the Tunisian banking sector as it considers funding requests from individual hotel operators. This plan should quantify the overall resources needed by the tourism sector from existing and new shareholders and the banking system in order to successfully complete its restructuring. It should provide an estimate of how much equity is required to reduce the level of indebtedness and the new financing from international and local banks and include quantification of possible extensions of terms and loan write-offs. It should also include plans for stock exchange listing of tourism real estate firms and the establishment of dedicated institutional investors.

27. If it were to be successful, a more disciplined financial restructuring of the tourism sector would enable the largest public bank to significantly reduce its non performing portfolio, to strengthen its financial base while limiting potential equity increases from its main shareholder. Ministry of Finance data indicate that out of 235 tourism projects that benefited from the provisions of the 2004 Budget (cancellation of late interest, transfer to principal of part of the unpaid obligations, restructuring of the debt over 25 years, tax exemption for efforts to write-off debts), no recovery was effected for 77 of the projects, for 33 the rate of recovery was less than 50 percent and only the remaining 125 projects were recovered by more than 50 percent.

C. Strengthening the management of public banks

28. The share of the public banks in the system (42.9 percent of total assets[5] end-2005) remains high. It is crucial that their operating results remain at least as good as those of their private sector competitors so as to avoid the establishment of a banking system with differentiated performance capabilities along ownership lines. In 2004-05 the bank specialized in housing financing seems to have reached performance levels comparable to those of the private sector banks. For the other public banks, a broad strengthening program (strategic, financial, operational and institutional) will have to be drawn up to ensure that their performance does not weaken further, which would be costly for the government. This

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[4] This would imply that the average provisions for class 2 and class 3 NPLs (older respectively of 90 and 180 days) would not be less than 14 and 35 percent, respectively, so as to penalize the accumulation of new NPLs. In 2004, the corresponding data were 7 and 21 percent respectively.

[5] The government share in the total equity of the system is 32.5% because of private sector minority interests in public banks (para 11).

program should include action plans directed, above all, towards improving risk management (loan procedures, information on borrowers, and risk appraisal), the handling of nonperforming loans, and rationalization of activities and personnel.

29. The reference shareholder should formalize a contract program with management of the public banks based on achieving a certain number of quantitatively defined and precisely scheduled targets (NPL ratios, cost income ratios, claims recovery, write-offs, fees and commissions as a percentage of operating income, evolution of interest margins, etc.). Implementation of this plan should be periodically verified by the BCT and the government. It should be complemented by a series of measures related to governance, transparency, and human resource management:

- To make the Board of Directors free from external influence, ensuring it is partly composed of non-executive members, to implement the strategic plan;
- Appointment of internationally recognized auditing firms;
- Insistence on all loans being granted solely on the basis of strict financial criteria;
- Judicious management of human resources, including appropriate mandates for senior managers;
- Prompt estimates of prospects for recovery nonperforming loans based on financial audits, drawing appropriate conclusions from the latter in terms of provisioning requirements and capital injections from shareholders.
- A commitment to a dynamic policy of NPL resolution, with quantitative targets for their reduction and deadlines to limit potential capital increases.

III. CONSTRAINTS, CHALLENGES, AND VULNERABILITY OF THE BANKING SECTOR

A. Credit quality

30. Loan portfolio quality has declined across all commercial banks since 2000, as a result of the combined impact of the crisis in the tourism sector (mainly in 2002 and 2003), drought, and business cycle difficulties in the distribution sector. Thus, NPLs as a ratio of total lending rose from 21.6 percent in 2000 to 23.7 percent in 2004. However, a significant decline to 20.9 percent was registered in 2005.

31. The provisioning rate for NPLs was 46.4 percent at end-2005 (36.2 percent net of interest in suspense), compared to 40.2 percent at end-2000. Tunisia’s NPL and provisioning ratios do not compare favorably in an international benchmarking context. The balance, corresponding to non-provisioned NPLs, is covered by collateral, 85 percent of which is real estate. Due to the high ratio of NPL to total loans, this low level of provisioning leads to a ratio of non-provisioned NPLs to capital that is greater than 100 percent.

B. Solvency ratios

32. The solvency of commercial banks, as measured by the reported risk-weighted capital adequacy ratio (CAR), has deteriorated between 2001 and 2003 with a decline from 11.1% to 9.9%, but started improving in the second half of 2004 and more substantially in 2005, with aggregate CAR rising to 10.7%.

33. Current prudential regulations allow real estate and financial collateral to be taken into account in determining the amount of provisions required against NPLs. Taking real estate collateral into consideration on insufficiently prudent terms (prices in thin-volume markets may not be representative) could lead to under-provisioning of non-performing loans. In line with good international practice, Tunisian authorities are recommending a higher NPL provisioning target (to reach 70% by 2009). This would address the risk arising from the high ratio of non-provisioned NPLs to capital which stood at 124 percent in 2005 (an increase of 10 percent from the 2000 level).

C. Profitability and liquidity

34. The spread between average lending and deposit rates declined from 4.6 percent in 2000 to 3.1 percent in 2004. This development stems from the decline in interest rates and partly from the decline in the interest-bearing claims portfolio in view of the increase in NPLs.

35. The second trend affecting the profitability of the banking system as a whole, is the marked deterioration in operating cost[6]-income ratios (including depreciation), from 54.5 percent in 2000 to 61.4 percent in 2005. The difference between banks is significant, since two public banks registered a ratio of approximately 70 percent, while two private banks had rates of 40 and 50 percent, respectively, comparing favorably with international standards. Reversing the trend for banks suffering from high ratios requires (apart from increasing income) a meticulous cost control. However, the strategy of most banks to open new branches and the resulting need for completely overhauling their information systems to cope with the development of new market segments, such as consumer credit, and risk management will increase overheads and amortization costs.

D. The former development banks

36. The five former development banks (the shareholding of which held jointly by the government of Tunisia, and the governments of four Gulf states and Libya) have restructured their loan portfolios in 2002 and 2004 by making provisions and transferring claims to their asset recovery companies. After acquiring universal bank status in 2005, they will henceforth be required to compete in what is increasingly appearing to be an over-banked system. It would thus be beneficial to consider associations or mergers.

E. Financing SMEs and individuals: opportunities and risks

37. The Tunisian productive sector will be undergoing major transformations as it will face increasing international competition. To support new or fast-growth enterprises, the banks will need to rely less on historical relations and traditional collateral. The mission considers that further improvements in banks' organizational and lending practices are required. In parallel, competitive pressures may push banks to engage in new product and

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[6] Depreciation of fixed assets is included in operating costs.

client segments without adequate instruments for assessing risks and appropriate control systems. It is important to underscore that the establishment of a credit bureau would be an essential instrument for improving the quality of credit extended to small- and medium scale enterprises and households.

38. The development of electronic banking is likely to bring about changes in forms of financing which, are currently based mainly on collateral and available for a small share of the potential client base. Guarantees will become less important for evaluating risks in favor of more sophisticated techniques, based on beneficiaries' repayment capacity. The BCT could greatly contribute to this new development phase by making the data collected for the consumer credit module of its centralized information service available to a private credit bureau which, under its oversight, would provide a service to banks by giving them data adapted to their needs in terms of retail lending (credit scoring).

39. While broadening access to finance hinges on a better understanding of the client base, the BCT will also need to ensure that banks increasing their exposure to new markets have internal systems that allow them to identify, measure and manage risk properly. Weaker banks will be those more exposed to an increase in default risk. As in the case of SME lending, the BCT will play a crucial role in promoting the upgrading of banks' technological and professional capabilities.

F. Improvements in the prudential framework

40. Since the 2002 FSAP several regulations of relevance to bank supervision were adopted, most notably the banking law that has established new rules on licensing and investment. New regulations have also been adopted to strengthen the compilation of financial information prior to the extension of credit to enterprises. As at early 2006, the banking law was under revision and a draft circular on internal control reached its final stages; their enactment will strengthen the legal and prudential frameworks, a task for which the BCT has devoted considerable efforts. The BCT has also refined its analytical approach, developed the expertise of its inspectors and reinforced its supervision of the banking system, particularly the monitoring of credit risk.

41. The weaknesses highlighted by the assessment lie essentially in the management of credit risk and provisioning, the absence of prudential ratios on a consolidated basis, sanction procedures, and rules for connected lending.

42. With regard to the rehabilitation of the non performing portfolio of the banking sector, it would be beneficial for the BCT to closely monitor the classified claims of each bank, particularly those with high NPL ratios, as well as progress in terms of recovery. Regular studies should be carried out, such as those of end-2001 and 2003 on claims classified in category 4, to follow up on the situation in the banking sector and ensure that the objectives of reducing classified claims and increasing the rate of provisioning can be achieved.

G. Scenarios through to 2009 and vulnerability analysis

43. The mission developed a commercial bank performance simulation model, distinguishing between private and public banks, in order to assess the ability to reach the target of 70 percent provisioning by 2009.

Baseline scenario

44. This scenario is based on maintenance of the current situation. The results of this exercise confirm a split in the Tunisian banking system between private and public banks. Whereas private banks achieve the 70 percent provisioning target and observe the standard CAR of 8 percent, public banks achieve only 58 percent provisioning in 2009.

Pessimistic scenario

45. This scenario is based on continued deterioration of the current situation (average spread between lending and deposit rates would further shrink[7] and the cost income ratio would increase). The whole of the banking system fails to reach the 70 percent provisioning target by 2009 because the overall provisioning coefficient is 54.5 percent. In this scenario, private banks do better (60.5 percent) than public banks (46.4 percent).

IV. Legal and Judicial environment for Credit

46. The legal and judicial framework for credit in Tunisia has recently undergone a series of reforms designed to facilitate the recovery of nonperforming loans. However, these changes do not appear to have altered the behavior of economic actors, nor have they led to a significant improvement in the still low rate of recovery, particularly of loans in litigation.

47. Because of that, special attention needs to be paid to the rehabilitation and liquidation of enterprises in difficulties, to claims recovery procedures, to execution of collateral, and to guarantees in the form of securities and real estate.

48. It is generally recognized, internationally, that the restructuring of enterprises is more effective "in the shadow of the law", that is to say, especially when there is market discipline, a reliable judicial system, and effective liquidation procedures. Opinions differ regarding the extent to which these conditions exist in Tunisia today.

49. The recovery of claims and execution of guarantees have been commented upon by financial institutions, particularly in connection with the privileges accorded to certain creditors. It is essential that the existence and amount of the "super privileges" enjoyed by the Treasury, the National Social Security Fund (CNSS), and, albeit to a lesser extent, by employees, be published to enable banks to gauge their risks and the advisability of filing a collection action to preclude challenges from third parties.

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[7] A lower interest rate spread would adversely affect the stability of an under-capitalized banking system while representing a benefit to financial service users from an efficiency perspective.

50. The time it takes to recover claims in the courts is variously described as "lengthy" or "reasonable." The mission was told that there is no control over requests for adjournment of hearings. Hence the importance, in this context, of amicable and discreet proceedings, which could be handled by professional mediators and supported by business information bureaus.

51. The establishment, reporting, and execution of guarantees in Tunisia is somewhat precarious, a state of affairs that impairs banks' ability to recover their loans as well as the possibility and terms of access to credit. The scope for collateral in the form of securities is limited, in particular, by a restrictive list of assets that can qualify as collateral without dispossession. In more advanced guarantees systems, any security can be put up as collateral, with no major restrictions. Furthermore, existing mechanisms are particularly restrictive.[8] The rules governing the constitution, reporting, and execution of guarantees are specific to each guarantee, with no regard for a harmonized system.

52. Certain gaps in the system make it more difficult to constitute and register mortgages on real estate property. A sizeable portion of Tunisian territory is not registered and, despite the political will to expedite this process, proceedings before the real estate tribunals are especially long-drawn-out (three to five years). Financial institutions are also conscious of the long time it takes to obtain title deeds, be they for land, lots in Tunisia's industrial zones, or city apartments (operations involving misappropriation of the title deed). Registering transfers and mortgages with the land registry--which affects the ranking assigned to mortgage-holder creditors--is criticized for its slowness and excessive protocols, which leads to numerous rejections of applications.[9]

V. Assessment of AML/CFT

53. Tunisia ratified all the relevant international and regional instruments relating to AML/CFT and adopted in December 2003 a comprehensive AML-CFT Law, which goes a long way toward meeting international standards. Criminalization of money laundering and the financing of terrorism in particular are generally in line with current international standards. Key remaining weaknesses in the legal framework include the legal basis for freezing funds in accordance with United Nations Security Council Resolutions 1267 and 1373, the inability of the financial and the insurance sectors supervisors to engage in international cooperation, the requirements for identification of beneficial owners, and ambiguities in the STR system and in the coverage of DNFBPs. The Tunisian authorities should quickly address these weaknesses, particularly those related to their UN-related obligations and to the STR system, as these are central to an effective AML-CFT system.

54. Overall, the implementation of the AML/CFT Law is still at an initial phase. The prosecutorial authorities have begun using the CFT component of the law, but on a limited basis. Beyond this, the Tunisian authorities should lay out a criminal policy on their fight against money –laundering, based on a more comprehensive risk-assessment and analysis of criminal patterns in the country. A FIU has been formally set up within the CBT, but only a

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[8] For instance, the pledging of equipment (without dispossession) is only allowed in connection with its purchase, not in other circumstances.

[9] Approximately 30 percent of requests for registration are rejected.

handful of STRs have been filed with the FIU in more than two years. The key challenge going forward lies therefore in implementation and enforcement, in particular through a more active supervision of compliance of the financial sector with their AML-CFT requirements. The adoption of two directives in April 2006 by the FIU (one on the STR template and the other detailing implementation requirements for credit institutions, off-shore banks and the Postal Office) is in that regard a welcome step forward. The second directives details requirements on due diligence, internal controls, and suspicious transactions reporting obligations. It needs to be complemented in the short term by circulars to be issued by the central bank.

Box 1. Main FSAP Update Recommendations

Main recommendations (by area)	Timeframe
A. Banking sector issues	
• Require 70 percent provisioning for all NPLs, without regard of existing collateral**.**	ST
• Reduce by 2009 the ratio of NPLs to total loans to no more than 10 percent of loans through a proactive policy of loan restructuring, including partial write-offs, accompanied by dilution of control of debtors' assets to avoid moral hazard	MT
• Accelerate restructuring of bank loans to the tourism sector, on the basis of a realistic assessment of debt repayment capacity of the borrowers	ST
• Ensure that partial write-offs benefit of tax deductibility	ST
• Promote extrajudicial procedures for bank debt restructuring	ST
• Strengthen management of public commercial banks, ensuring full independence of management, tighter risk management procedures, and improved estimate of NPLs recovery prospects	ST
• Maintain prohibition of dividend distribution for banks which have inadequate NPL provisioning	ST
• Speed-up privatization and mergers of former development banks that have recently received universal banking licenses	ST
• Improve information system for lending to SMEs and households by promoting establishment of private credit bureaus.	ST
B. Prudential Supervision and Regulation	
• Ensure implementation of new rules on management of credit risk, envisaged by new circular on internal controls	ST
• Assess the quality of banks internal audit functions	MT
• Establish prudential ratios on a consolidated basis	ST
• Enter in information sharing agreements with other Tunisian financial supervisors and foreign supervisors	ST
• Tighten regulations regarding equity investments, and strengthen enforcement	ST
• Revisit the disciplinary sanction regimes by vesting the power to impose sanctions in the Banking Commission envisaged in the banking law, rather than in the governor of the central bank, to promote transparency	ST
C. Central Bank Policy, Systemic Liquidity Management, and Foreign Exchange Markets	
• Disclose more clearly in the BCT publications the monetary framework in terms of ultimate, intermediate and operational objectives	ST
• Deepen interbank markets by widening central bank narrow interest rate corridor	ST
• Publicize more widely newly established bond yield curve	ST
• Repeal the current foreign exchange surrender requirement on banks	ST
• Relax restrictions on forward foreign exchange cover for commercial operators.	ST
D. Corporate debt restructuring	
• Promote use of expert workout specialists in judicial reorganizations	ST
• Ensure that judicial proceedings for companies restructuring are not hampered by excessive delays,	ST
• Promote extra judicial procedures, with preset rules for creditors and debtors to speed up agreements	ST
• Review the superseniority of tax authorities and social security agency claims	ST
E. Collateral registration and realization	
• Standardize rules for movable collateral	ST
• Speed- up real estate titles registration, registration of changes in property, and registration of mortgages	ST

ST= Short Term; MT=Medium Term

Table A. Implementation of 2002 FSAP recommendations		
Main recommendations	**Measures adopted for implementation**	**Measures underway or still outstanding**
A. Monetary policy transparency and bank supervision		
Revise the BCT Law to establish price stability as the principal objective.	The draft amendments to the BCT Law submitted to parliament establishes price stability as the principal objective.	
Publicly explain and disclose the factors underlying monetary policy decisions.	Monthly communiqués from the board of directors are published, setting out the factors underlying monetary policy decisions.	
The professional qualifications required of the Governor and deputy Governor should be specified, as well as the grounds for their dismissal. The three-year term of the advisors should be lengthened.		The professional qualifications required of the Governor and deputy Governor are missing from the draft amendments to the BCT Law, as well as the grounds for their dismissal. The three-year term of the advisors was maintained.
Define the role of the BCT in the formulation and implementation of exchange rate policy.		The draft amendments to the BCT Law do not clarify the institutional allocation of responsibilities over exchange rate policy.
Subject the BCT financial statements to an external audit.	The draft amendments to the BCT Law require external auditing.	
Publish a regular BCT report on bank supervision.		No reports on bank supervision have been published by the BCT to date.
Clarify the institutional relationship between the BCT and other financial supervisory agencies.	The draft amendments to the BCT Law enable the BCT to cooperate with other financial supervisory agencies. This cooperation is carried out through joint inspections and the exchange of information.	
B. Bank supervision		
Reinforce banks' credit policies, the weaknesses of which are reflected in high levels of NPLs.	Law 2005-96 contains important measures on the transparency and reliability of financial information. The draft Banking Law requires financial institutions to establish an executive credit committee. The draft BCT circular on internal control sets out the rules governing credit risk management. The level of NPLs declined in 2005, but remains high.	

Provisioning should reflect real prospects for recovery within a reasonable time frame.	To stimulate provisioning, the tax exemption on provisions has gradually been increased to reach 100percent in 2005. However, the recovery of long standing NPLs and provisioning levels remain weak, equivalent to 46.4percent of NPLs end-2005.	A rapid increase of provisions, especially on long standing NPLs, should be envisaged.
Banks' recovery procedures should be strengthened.	Amendments to the civil code and commercial procedures in Law 2005-79 facilitated judicial auctions of real estate collateral. Amendments to Law 1995-34 on the restructuring of enterprises facing difficulties offer greater protection for creditor rights.	Out of court procedures for the recovery of classified claims should be developed.
Legal and regulatory texts against money laundering should be adopted.	The directives and circulars that establish appropriate procedures against money laundering were adopted in April 2006.	
Corrective measures should be applied in a more coherent manner.		The framework for corrective measures established in Law 2001-65 on credit institutions should attribute the power of imposing sanctions to the banking commission on a permanent basis, procedures for appeal and modalities for recourse should be specified.
New accounting standards and the draft Banking law should provide for financial control on a consolidated basis.	The national accounting council adopted standards on the preparation of financial statements on a consolidated basis in 2003. From 2005 onwards the consolidated methodology should be applied by all financial or non-financial subsidiaries to which exclusive control criteria apply.	
There are no formal procedures for information sharing with foreign supervisory agencies.	The draft amendments to the BCT Law will allow the BCT to sign bilateral cooperation agreements with foreign supervisory agencies.	
C. Credit policies and corporate financing		
Banks should not finance projects in the tourism sector if they have insufficient own funds.	The financial restructuring of enterprises in the tourism sector is underway, with the support of foreign capital.	
NPLs should be transferred to claims recovery agencies. Banks should find external partners for	The majority of banks have established asset recovery companies. However, performance, in	A more systematic approach to recovery, restructuring and the cancellation of classified

their asset recovery companies.	terms of effective recovery remains modest.	loans should be pursued, including operational restructuring of debtor firms, sales of non-essential assets, cost cutting measures, the formulation of quantified plans with target dates, and capital injection.
The financial structure of enterprises should be strengthened and indebtedness reduced.	The restructuring program covered around 2000 enterprises. The rapid development of SICAR brought in new risk capital. However, these amounts remain modest when set against bank credit.	Strengthening the financial structure of enterprises might require greater inflows of funds from external sources.
D. Development, regulation and supervision of capital markets		
Regulation of financial markets should be more rigorously enforced, the information disclosure requirements should be tightened, and control and sanction powers of the CMF (Commission des Marchés Financiers) should be increased.	The CMF has increased its control and sanction powers. The 2005 law on financial security requires auditors to notify any factor likely to weaken the solidity of the audited company to the CMF. Lags for publication of financial information have been reduced.	
The financial statements of the CMF should be published in its Annual Report.	The CMF 2004 Annual Report contains the financial statements of the CMF.	
Promote the number of listed firms by reducing the asymmetry in information and transparency requirements between these firms and others.	The 2005 law on financial security reduces the asymmetry in information and transparency requirements by reinforcing financial transparency and good governance across all enterprises.	
Firms' financial statements should be drawn up on a consolidated basis.	The national accounting council has adopted a series of norms, enacted by decree of the Ministry of Finance in December 2003, on the preparation of annual accounts on a consolidated basis.	
Develop the primary market for government securities and secondary markets.	Adoption of a new law on repos in 2004 and drawing up of a master repurchase agreement. Concentration of BTA issuance on defined maturities, to increase liquidity of issues. Establishment of a yield curve in 2005 on the basis of recent emissions, estimated on the basis of actuarial valuations.	Publicly disclose the yield curve to increase price transparency.

E. Supervision and regulation of insurance companies		
Supervision and regulation of insurance companies should be strengthened, with a clear mandate for on-site inspections and greater powers to impose sanctions. The directorate general for insurance (DGA) should become an autonomous institution.	Separating the inspection function from that of regulation, the DGA was transformed into a general committee on insurance (CGA) which is mainly responsible for ongoing supervision of insurance companies and related firms. However, it is not an independent entity. The CGA has increased its staff and the frequency of on-site inspections and has greater sanction powers.	Complete the transformation of the GCI in an independent entity.
The DGA should have the authority to refuse insurance companies applications for a license or changes in shareholding.	The legal and prudential framework was revised through the amendments to the insurance code in law 2002-37. The license of one insurance firm was withdrawn in 2003.	
The DGA should align the prudential rules on solvency margins, adequacy of technical provisions and other management criteria to international standards.	The new insurance code strengthened prudential criteria, including the minimum capital requirement that was increased from 3 to 10 million dinars. Supervision over provisions and asset/liability management was strengthened.	
The DGA should promote the strengthening of insurance firms' financial structure.	Based on audits carried out in 2000-01 the CGA has formulated restructuring plans for insurance firms covering the period 2002-05. A strategic partner is being sought so as to strengthen the capital of one of the largest firms, a process which should be concluded end 2006. The restructuring plan for a further three firms is underway. The CGA is encouraging firms to merge. It has prohibited certain firms from distributing dividends.	Further measures should be adopted to encourage further market consolidation.
The DGA should establish governance rules for insurance firms.	Governance provisions will be included in the amended insurance code that will be submitted to parliament in 2006.	
F. Payment systems		
Establish a large value payment system that meets international best practice criteria.	A large value payment system is in the final testing stage and will be implemented shortly.	
G. Liquidity management and monetary policy		
Increase the reliance on open market operations and eliminate the conditionality of access to	As of 2003, the BCT has steadily increased its reliance on open market operations based on	

refinancing facilities on the basis of priority sectors.	Treasury bills. Since 2002 liquidity injection and withdrawal operations are carried out through deposit and credit auctions (*appel d'offres*), repurchase operations or outright purchases and sales of government securities or quality claims on the private sector.	
Eliminate the limit of BCT holdings of Treasury bills of 10 percent of government revenues.	The draft amendments to the BCT Law contain no such limit on BCT holdings of Treasury bills.	
H. Crisis management framework		
The modalities, in which the Governor can organize the support of the banking system to help a bank in difficulty on the basis of the powers given to him by the Banking Law, should be specified, as well as the manner in which the BCT would react in such an event. The BCT should prepare crisis management scenarios.		Further details should be provided on such modalities, and on the manner in which the BCT would intervene to address bank insolvency. The BCT should prepare crisis management scenarios.
A new deposit insurance mechanism should be established with the disclosure of further details on the extent of coverage depositors may benefit from and the contributions required from participating banks.	The Banking Law includes a provision according to which all banks are required to establish a deposit insurance mechanism. The BCT is currently evaluating the possibility of instituting the deposit insurance system as provided for in the law. However, the timing of this is subject to a number of prerequisites being met.	

Table 1. Tunisia: Selected Macroeconomic Indicators, 2000-2005

	2000	2001	2002	2003	2004	2005 (prov)
Production and income (percent change)						
Nominal GDP	8.2	7.8	4.1	7.6	8.8	6.2
Real GDP	4.7	4.9	1.7	5.6	6.0	4.3
GDP deflator	3.3	2.7	2.4	2.0	2.6	1.9
Consumer price index (CPI), average	3.0	1.9	2.8	2.8	3.6	2.0
Gross national savings (in percent of GDP)	23.1	23.7	22.2	22.0	21.9	22.1
Gross investment (in percent of GDP)	27.3	27.9	25.7	25.1	24.2	23.9
External sector (percent change)						
Trade balance (in percent of GDP)	-11.6	-11.8	-10.1	-9.1	-8.7	-7.9
Current account, excl. grants (in percent of GDP)	-4.2	-4.2	-3.5	-2.9	-2.0	-1.8
Foreign direct investment (percent of GDP)	...	2.2	3.8	2.2	2.2	2.3
Terms of trade (deterioration -)	-2.1	0.1	-0.7	-1.5	-0.5	
Real effective exchange rate (depreciation -) 1/	-1.7	-2.4	-1.1	-4.1	-3.9	
Central government (percent of GDP, unless otherwise indicated) 2/						
Central government balance, incl. grants, excl. privatization	-3.7	-3.5	-3.1	-3.2	-2.6	-2.9
Total government debt (foreign and domestic)	60.8	62.7	61.5	60.4	59.7	60.3
Foreign currency public debt (percent of total debt)	...	62.4	63.5	64.4	63.2	64.2
Money and credit (percent change)						
Credit to the economy	8.0	10.3	6.7	4.6	5.3	7.5
Broad money (M3) 3/	13.2	11.3	5.2	6.3	10.3	9.2
Velocity of circulation (GDP/M3, deposit money banks)	1.88	1.84	1.83	1.85	1.81	
Liquidity aggregate (M4)	4.47	6.41	3.92	5.64	9.5	
Velocity of circulation (GDP/M3)	1.71	1.65	1.64	1.66	1.64	1.6
Interest rate (money market rate, in percent, e.o.p)	5.88	5.94	5.91	5.00	5.00	5.00
Official reserves						
Gross official reserves (US$ billions, e.o.p)	1.8	2.0	2.3	3.0	4.0	4.4
In months of imports of goods & services, c.i.f.	2.4	2.3	2.7	3.0	3.5	3.6
Total external debt						
External debt (US$ billions)	11.4	11.6	13.7	17.9	19.8	19.2
External debt (in percent of GDP)	58.4	58.1	65.1	67.2	67.8	69.5
Debt service ratio (percent of exports of GNFS)	22.6	15.6	17.2	15.1	16.2	15.6
Financial market indicators						
Stock market index 4/	1443	1,267	1,119	1,250	1,332	
Memorandum items:						
GDP at current prices (TD millions)	26685	28,757	29,933	32,212	35,035	37,202
GDP at current prices (US$ billions)	19.5	20.0	21.1	25.0	28.1	28.8
GDP per capita (US$)	2036	2,068	2,152	2,531	2,833	2,867
Unemployment rate (in percent)	15.9	15.3	15.5	14.7	14.2	
Population (millions)	9.6	9.7	9.8	9.9	9.9	10.1
Exchange rate: dinar/US$ (average)	1.37	1.44	1.42	1.29	1.25	

Sources: Tunisian authorities and staff estimates and projections

1/ Information Notice System.
2/ Excludes the social security accounts.
3/ Financial system (Deposit money banks and Development banks)
4/ TUNINDEX. (1000 = 4/1/1998). 2005 data from November 1, 2005

Table 2. Tunisia Financial System Structure, 2000 and 2004

	2000			2004		
Type of Institution	Institutions	Assets (MD)	% of GDP	Institutions	Assets (MD)	% of GDP
Commercial banks	13	19,613	73.5	16	31,138	88.9
State-controlled	5	11,676	43.8	3	...	...
Private	8	7,936	29.7	13	...	...
Development Banks	6	1,119	4.2	2	407	1.2
Offshore Banks	8	1,961	7.3	8	2,080	5.9
Centres de Cheques Postaux (CCP) 1/	1	1,000	3.7	1	1,150	3.3
Caisse d'Epargne Nationale Tunisienne (CENT) 1/	1	800	3.0	1	920	2.6
Leasing companies	9	861	3.2	11	1,275	3.6
Factoring companies	2	30	0.1	3	72	0.2
Société d'Investissement à Capital Variable (SICAV)	28	1,398	5.2	34	1,998	5.7
Sociéte d'Investissement à Capital Fixe (SICAF)	85	469	1.8	92	490	1.4
Société d'Investissement à Capital Risque (SICAR)	26	207	0.8	38	547	1.6
Insurance companies 1/	16	1,300	4.9	16	1,508	4.3
Pension funds 1/	2	2,500	9.4	2	2,900	8.3
Banque Tunisienne de Solidarite (BTS) 1/	1	143	0.5	1	180	0.5
Total	**198**	**31,399**	**117.7**	**225**	**44,665**	**127.5**

Sources: BCT
1/ Estimates for 2004

Table 3 - Tunisia - Commercial Banks- Financial Soundness Indicators, 2000-2005
(In percent, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
Capital adequacy						
Regulatory capital to risk-weighted assets	11.3	11.1	10.2	9.9	10.5	10.7
Regulatory tier I capital to risk-weighted assets	10.8	10.7	9.9	9.5	9.8	10.0
Capital to assets	8.1	7.5	7.7	7.6	7.5	7.7
Asset quality						
Nonperforming loans to total gross loans	21.6	19.2	20.9	24.0	23.7	20.9
Nonperforming loans net of provisions to capital	114.2	105.3	132.6	161.5	143.6	124.1
Provisioning ratio	49.2	47.4	43.9	43.1	45.8	46.4
Provisioning ratio (net of interest in suspense)	36.2	35.5	31.8	32.7	35.5	36.2
Foreign currency loans to total loans 1/	3.1	3.0	2.7	3.2	2.4	2.8
Large exposures to capital 2/	79.2	53.0	70.6	124.2	84.7	…
Sectorial distribution of total loans						
Total loans to residents	98.6	98.8	98.9	98.9	99.2	99.0
Loans to private sector	89.4	92.4	93.3	92.8	93.0	92.7
Households 3/	…	…	12.9	13.3	14.8	17.3
of which: housing loans	…	…	8.3	9.1	9.3	9.9
Enterprises	85.5	88.2	76.0	75.8	75.3	73.3
Financial institutions	3.9	4.3	4.4	3.7	3.0	2.1
Loans to public sector	9.2	6.4	5.7	6.0	6.1	6.3
Government	0.0	0.0	0.0	0.0	0.0	0.0
Public enterprises	9.2	6.4	5.7	6.0	6.1	6.3
Total loans to non-residents	1.4	1.2	1.1	1.1	0.8	1.0
Distribution of private sector loans by sector of economic activity						
Agriculture	7.9	7.1	6.6	6.9	6.3	6.0
Industry	40.6	38.4	37.0	36.6	36.6	35.6
Real estate 4/	11.4	11.8	14.0	15.0	14.8	15.6
Services	40.1	42.7	42.4	41.5	42.2	42.8
Tourism	13.8	13.3	13.5	13.7	13.2	11.9
Commerce	15.7	15.9	15.5	15.8	15.8	15.8
Other	10.6	13.5	13.4	12.0	13.2	15.1
Distribution of Nonperforming loans by sector of economic activity						
Agriculture	7.0	7.4	7.3	6.2	6.5	5.8
Industry	43.2	42.0	41.6	40.8	38.4	40.0
Real estate	3.0	4.2	4.9	5.8	6.1	5.8
Services	46.8	46.4	46.2	47.1	49.0	48.4
Tourism	28.4	24.1	23.2	24.2	26.1	21.9
Commerce	6.2	8.1	9.9	10.8	12.3	13.6
Other	12.2	14.3	13.1	12.2	10.5	12.9
Earnings and Profitability						
Return on Average Assets (ROAA) 5/ 6/	1.3	1.1	0.7	0.6	0.4	0.6
Return on Average Equity (ROAE)5/ 6/	14.5	13.2	7.6	7.3	5.1	6.9
Interest margin to gross income 7/	62.9	61.8	60.5	59.3	56.3	56.7
Noninterest expenses to gross income 7/	54.5	56.0	60.7	64.1	64.7	61.4
Personnel expenses to noninterest expenses	63.6	63.7	62.8	64.5	65.3	64.2
Net gains on bond portfolio and other financial instruments to gross income 7/	14.7	13.8	13.2	13.5	15.7	16.3
Average lending-deposit spreads	4.6	4.3	3.9	3.5	3.1	…
Liquidity						
Liquid assets to total assets 8/	…	31.0	27.8	27.5	28.3	29.3
Liquid assets to short-term liabilities	…	97.2	103.1	104.9	113.2	117.8
Customer deposits to total (noninterbank) loans	46.4	46.4	46.5	47.0	47.6	46.4
Foreign currency liabilities to total liabilities	8.2	7.3	7.6	6.8	7.3	8.5
Sensitivity to market risk						
Net open position in foreign exchange to capital	0.1	0.4	0.4	0.7	0.8	0.9

Source: Banque Centrale de Tunisie

1/ Total disbursed loans(excluding off- balance sheet commitments).
2/ Defined as total exposures greater than 25% of bank capital.
3/ Data on household loans are not available for 2000 and 2001. They are included in loans to enterprises.
4/ Excluding credit for social housing in 2000 and 2001.
5/ After tax
6/ Quarterly averages; average assets net of provisioning and interest in suspense.
7/ The calculation of gross income is made according to the accounting principle 21 on the presentation of banks published accounts. It is defined as interest income minus interest expenses plus net commissions ad fees plus net gains on bond portfolio and other financial instruments.
8/ Liquid assets and short term liabilites as defined in the BCT liquidity ratio regulation.