





Tunisian banks are ineffective
at channeling resources to the
private sector



The financial sector is a critical component of the economy and its ability to create jobs. How well it works is a key factor in determining how the rest of the economy functions, as was clearly demonstrated when the recent financial crisis plunged economies into recession around the globe. What distinguishes the financial sector from other sectors of the economy is that, while the direct impact of financial institutions on the real economy (in terms of direct employment or GDP) is relatively minor, the indirect impact of financial markets and institutions on economic performance is extraordinarily important. The financial sector mobilizes savings and allocates credit across space and time, optimizing the allocation of capital. It therefore plays a pivotal role in enhancing the productivity of the economy, and therefore its ability to generate higher income and create more and better jobs (Herring and Santomero 1991) ¹.

The financial sector in Tunisia suffers from deep dysfunctions and has been unable to channel resources towards the most productive activities and projects ². The Tunisian financial sector is small and dominated by public-controlled banks but also presents a significant number of private banks, both large and small, and a substantial foreign presence (box 6.1). The ability to provide credit to the economy remains weak, especially when compared to banks in neighboring economies such as Morocco. As discussed in this chapter, the weak credit intermediation is a brake to economic performance in Tunisia. Further, while ordinary businesses struggle to gain access to finance, cronies have had easy access to finance (at convenient rates and low collateral or guarantees). As a result banks have accumulated large liabilities (which will have to be repaid by taxing economic performance in Tunisia) and have undermined competition (by favoring crony firms), thereby entrenching the misallocation of resources and contributing to the weak performance of the economy. In parallel the nonbank financial sector remains small and does not play its critical role in fostering investment and innovation.

This chapter discusses how to make the financial sector support faster economic growth in Tunisia. It argues that, just as the rest of the economy, the financial sector suffers from limited competition and weak governance, in large part as a result of the problems affecting the large state-owned banks. The chapter does not discuss the problems with innovation and risk—financing instruments in Tunisia, as this issue was already discussed in the 2010 Development Policy Review “Towards Innovation-Driven Growth in Tunisia” (World Bank 2010a).

6.1 / The Feeble Performance of the Financial Sector

Persistent Inefficiency, Especially in State-Owned Banks

An analysis of net-interest margins suggests that Tunisian banks remain relatively inefficient. The net-interest margins are a measure of competition and efficiency of the banking sector. The margin declined in recent years to reach 2.5 percent in 2010 (figure 6.1). This level is somewhat better than Morocco and Turkey, and is comparable to the Arab Republic of Egypt and to Jordan (figure 6.2), but remains higher than in developed countries where the ratio is generally below two percent. As discussed below, the decrease in net-interest margin in recent years is explained by the decline in overhead cost over total assets (except in large state-owned banks). This suggests that banks have been improving their efficiency and therefore need less interest margin to cover their overhead costs. In fact as discussed below this is driven by the performance of the middle-size and small-size private banks.

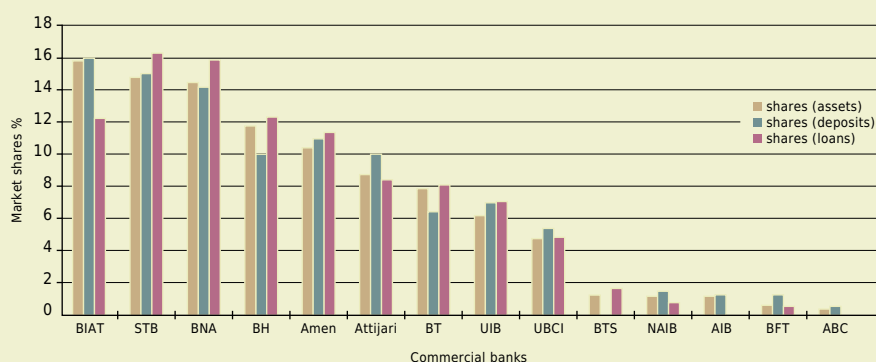
Box 6.1: The Structure of the Tunisian Financial System

In 2012, the Tunisian financial sector was small and dominated by banks, with assets equal to about 115 percent of GDP. This figure is somewhat lower than that of its regional peers such as Jordan, Lebanon, and Morocco.

Tunisia's banking sector is dominated by public-controlled banks, but also presents a significant number of private banks, both large and small, and a substantial foreign presence. As of 2012, there were 21 onshore credit institutions divided between five state-owned commercial banks (accounting for 39 percent of total banking assets in June 2011), ten private commercial banks (33 percent of assets), and six foreign banks (28 percent of assets). The three largest state-owned banks account for 37 percent of banking sector assets, namely the *Société Tunisienne de Banque* (STB), with 52.5 percent of public capital; the *Banque Nationale Agricole* (BNA), with 66.2 percent of public capital; and the *Banque de l'Habitat* (BH), with 57 percent of public capital. Similarly the three large private domestic banks account for 28 percent of total assets (*Banque Internationale Arabe de Tunisie*, BIAT; *Amen*; and *Banque de Tunisie*, BT). Three of the largest foreign banks (from France, Jordan, and Morocco) are former state-owned banks, only one of which appears to have completed its restructuring. There are five small banks set up as development banks, partially with funds from the Gulf States, which enjoy universal banking licenses. No major changes in the number of market players have occurred during the last five years except the setting up of a second Islamic bank (*Zitouna* Bank).

This fragmentation leads to a division of market shares with no institution having a market share greater than 14 percent in terms of total assets or loans and 16 percent in terms of deposits. The three largest banks—BIAT, BNA and STB—concentrate almost 50 percent of total assets with approximately equal weight. This situation is unusual in the Middle East and North Africa region (MENA), where the concentration of the banking sector is generally much higher. In Morocco, for example, the top three banks accounted for 62 percent of loans to the economy while the first five concentrated 81 percent in 2012.

Figure B6.1.1 Market Shares of Largest Fourteen Tunisian Banks in 2010



Source: Bankscope database.

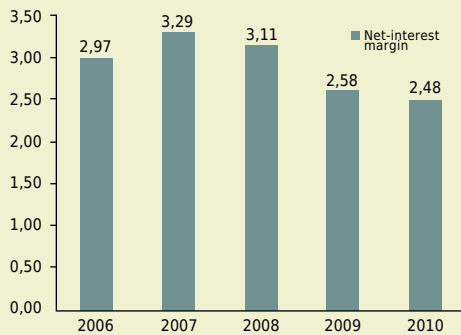
The nonbank financial sector is small and accounts for only about 20 percent of all financial system assets. Tunisia has a nascent insurance sector, with 19 companies primarily focused on nonlife activities (85 percent of premiums) and annual premiums to GDP of about 2 percent. The equity and fixed-income markets are still relatively modest, with a market capitalization equal to 24 percent of GDP, lower than in regional peer countries such as Jordan (112 percent) and Morocco (76 percent). Private equity remains small and the leasing sector, with nine institutions, accounted for 15.5 percent of private gross fixed capital formation in 2010.

Source: World Bank and IMF 2012; Khanfir 2013

The analysis of overheads indicates that large banks in particular are not very efficient and have been shielded from competition. Overhead costs of Tunisian banks are higher than those in other MENA countries, with the exception of Turkey (figure 6.3). On the one hand, the high overheads reflect the atomized structure of the Tunisian banking sector that may limit scale economies. On the other hand, the large banks (which are mostly state-owned banks—see box 6.1) do not have the lowest overhead costs (figure 6.4)—which reflects the weak performance of the large state-owned banks. The persistently high level of overheads in large banks indicates limited efficiency, which would be consistent with low competition in the banking sector. Middle-size and smaller banks, however, have been reducing their overheads quite substantially (figure 6.4), suggesting that there is competitive pressure in this segment of the market. Overheads for small banks have decreased the most over the period but remain the largest—suggesting that smaller banks may not be able to realize scale economies.

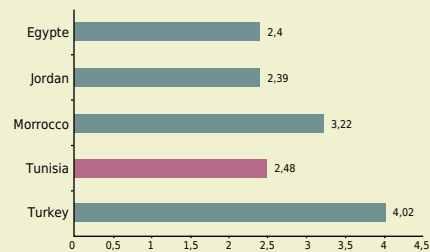
Overall, medium-sized banks have the best financial performance in Tunisia. Higher overheads in large banks are mainly driven by higher wages per employee, which reflects the generally higher pay offered by the public banks (figure 6.5). The income-to-overhead costs ratio has been highest for the medium-sized banks (figure 6.6). These findings

Figure 6.1: Net-Interest Margin in Tunisia, 2006-2012 (%)



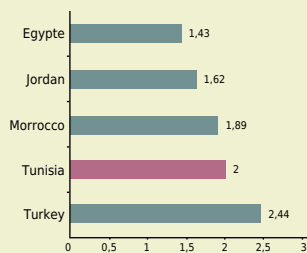
Source: The Global Finance Database (World Bank, 2012).

Figure 6.2: Net-Interest Margin in Various Countries in 2010 (%)



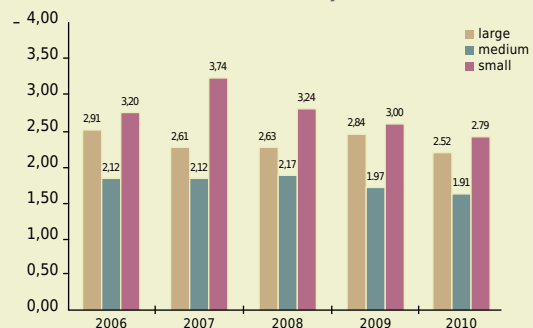
Source: The Global Finance Database (World Bank, 2012).

Figure 6.3: Overhead Costs to Total Assets in 2010 (%)



Source: The Global Finance Database (World Bank, 2012).

Figure 6.4: Overhead Costs to Total Assets by Bank Size, 2006–2010 (%)

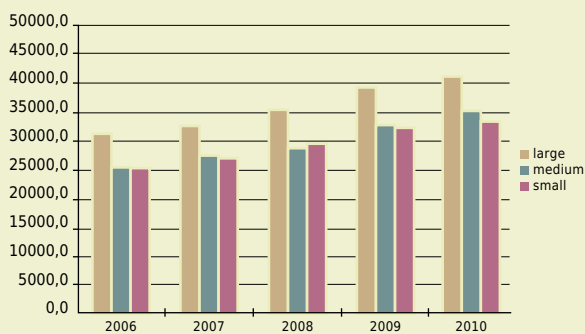


Source: Bankscope
 Note: ATB is dropped out due to lack of data (missing values for some items for years 2009 and 2010).

suggest that medium-sized banks are the best performers in Tunisia—they are not afflicted by the corporate governance problems affecting large state-owned banks (see below) and they appear to be driving efficiency gains, possibly because they are large enough to realize scale economies.

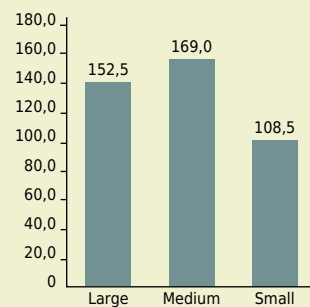
Reflecting the inefficiency of the sector, the profitability of banks in Tunisia is lower than in comparator countries. It is worth clarifying that we are interested in the profitability of the banking sector in as much as it may be indicative of the efficiency and performance of the sector—that is, to assess how efficiently financial services allocate resources to productive projects that can create wealth and jobs for Tunisians. The average return on assets (ROA) was 0.9 percent and

Figure 6.5: Wages per Employee by Bank Size, 2006-2010 (TND)



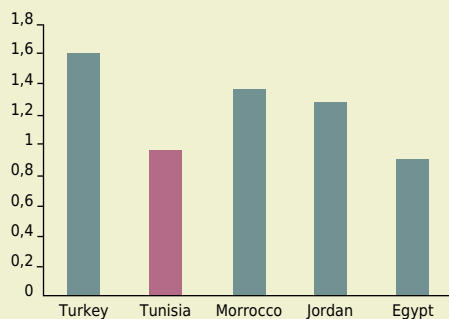
Source: Bankscope
 Note: Large banks = BIAT, STB, BNA; Medium banks = BH, Amen, Attijari, BT; Small banks = UIB, UBCI. NAIB and ATB are left out due to lack of data.

Figure 6.6: Income to Overhead Costs by Bank Size in 2010 (%)



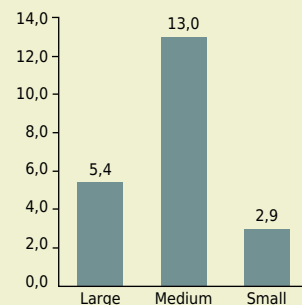
Source: Bankscope
 Note: ATB is dropped out due to lack of data (missing values for some items for years 2009 and 2010).

Figure 6.7: Return on Average Assets for Some MENA Countries in 2010 (%)



Source: Bankscope
 Note: Large banks = BIAT, STB, BNA; Medium banks = BH, Amen, Attijari, BT; Small banks = UIB, UBCI, NAIB. ATB is dropped out due to lack of data (missing values for some items for years 2009 and 2010).

Figure 6.8: Return on Average Capital (ROAC) by Bank Size in 2010 (%)



Source: Bankscope
 Note: Large banks = BIAT, STB, BNA; Medium banks = BH, Amen, Attijari, BT; Small banks = UIB, UBCI, NAIB. ATB is dropped out due to lack of data (missing values for some items for years 2009 and 2010).

the average return on equity (ROE) was 9.9 percent in 2012, which are low compared to returns observed in comparator countries (figure 6.7) ³. Profitability has been highest in medium-sized banks (as shown by the return on average capital, ROAC), reflecting their lower overhead costs and higher income (figure 6.8). In principle, in line with our discussion in Chapter Two, the low profit margins could be indicative of a high level of competition. However, as we have seen, the relatively low profitability is the result of relatively high margins and persistently high overheads in large banks. This suggests that low profit margins are not the result of high competition driving efficiency—rather the problem in the banking sector seems to be that low competition allows inefficiency in large banks to continue.

Weak Intermediation of the Banking Sector, Both in Quantity and in the Selection of Projects

The level of intermediation in Tunisia remains very low, and an international benchmarking signals significant potential to increase the quantity of financing available to the private sector for investments. Consistent with their feeble financial performance and limited efficiency, Tunisian banks are ineffective at channeling resources to the private sector. The share of credit to GDP remained almost constant at around 60 percent throughout the past decade and, despite an increase in recent years ⁴, the level of private credit to GDP remains below the potential for Tunisia (figure 6.9) ⁵. Credit to the private sector as a percentage of GDP remains much below high-income Organization for Economic Cooperation and Development (OECD) countries and also well below neighbouring Jordan and Morocco (figure 6.10). The low level of intermediation of the Tunisian financial sector has significant implications. An increase in the share of credit to GDP from the current 70 percent to its potential level of 80 to 90 percent could generate in excess of US\$10 billion in additional credits that could be injected in the economy, over say a period of 10 years, to finance private investment. Such an increase in investment corresponds roughly to an additional 380,000 jobs in total (that is, approximately 38,000 additional jobs per year).

Figure 6.9: Actual vs. “Benchmark” Private Credit to GDP, 2000-2010 (%)

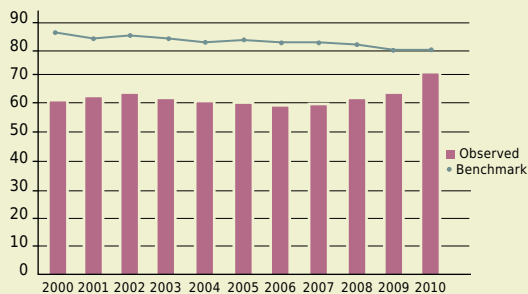
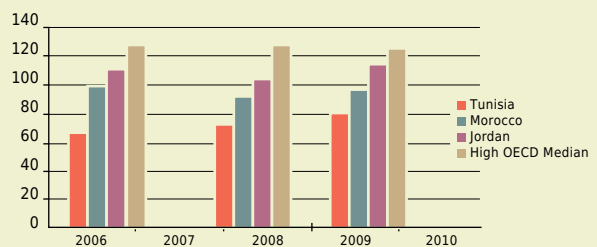


Figure 6.10: Credit to Private and Public Sector as Percent of GDP in Jordan, Morocco, Tunisia, and High-Income OECD Countries, 2009 to 2011



Source: World Development Indicators (WDI).

Note: Benchmark values of private credit to GDP are obtained following the methodology of the ‘benchmark’ model as developed by Beck et al. (2008). Indeed, ‘benchmark’ values are obtained from the estimation of a pooled Ordinary Least Squares (OLS) regression for the period 1985-2010 where the dependent variable is the log of domestic credit to GDP. The explanatory variables include the logs of GDP per capita, population size and density, the value of fuel exports to merchandise exports, the poverty gap, and an interaction variable which is the product of GDP per capita and population size.

In fact firms’ complain that access to finance is a major constraint in Tunisia. According to the World Bank 2012 Enterprise Survey (see annex 4.4), approximately 55 percent of firms have a loan, which is high by regional standards. Nevertheless access to finance was indicated as a major or severe constraint by 34 percent of Tunisian firms in the survey, which is also high by regional comparison (Investment Climate

Assessment, World Bank 2014e). The problem is greatest for medium-size firms, which flag it as their most important constraint. These data pose somewhat of a paradox, as access to finance is perceived to be restricted, while in fact most firms have had access to bank loans ⁶. The perceived difficulty in access to credit may reflect the extreme prudence of banks in Tunisia, which results in an over-collateralization of the loan (which at 177 percent is the highest in the entire MENA region). Also the length of time required to get a loan from a bank is very high. These aspects of weak performance of the banks can be attributed to the lack of competition ⁷. The result is that many small entrepreneurs who have a great project are unable to create it or to expand because of difficulties in finding access to finance (box 6.2).

Box 6.2: Cautious Lending a Hurdle for Tunisian Startups

BEN AROUS, northern Tunisia—On a greenfield site south of the capital, this medium-sized company produces plastic granules for some of the hundreds of firms across Tunisia that work with injection molding. They will transform the plastics into anything from garden furniture (the omnipresent white plastic chairs of village cafés) to auto parts or electrical components for sophisticated European manufacturers.

The business's founder and chief executive derives some satisfaction from having introduced a new industrial process into Tunisia. Until he started the company, all those manufacturers had to source their polymer granules from abroad. After five years in operation, his plant is still the only one of its kind in the country. Sales have risen eightfold to 7.3 million dinars (about 3.3 million euros), and in 2014 are expected to approach 13.5 million dinars with the help of two more production lines. The workforce—around 30 people at present, mainly graduates—is set to increase.

However, he is less happy with the banking system. Its mindset on lending to startups needs some fresh air, he believes. "A bank needs to understand the nature of a business so that when it is asked to invest further, it's ready to lend." Some banks that lent to him in the past never even made a site visit.

His company initially secured funding from FOPRODI, an official industrial development fund, and took on the relatively high level of borrowing that was tolerated by banks in those days. Banks are now showing a new cautiousness in their lending, plus the lack of engagement with start-ups continues, he says.

Working in plastics, a low-margin area of manufacturing, the business has needed successive top-ups to working capital for investments that have allowed it to comply with the requirements of its European end users. Car assemblers working round the clock require suppliers to have a back-up production line, for example. This is not something Tunisian bank managers always understand. "Why does the company need a second production line if the first is not yet used at full capacity?" they ask. Another major investment has been a water sprinkler system for fire protection in its warehousing facility, as required by International Organization for Standardization (ISO) standards.

The business has found a more understanding partner in private equity firm Tuninvest, which supplied crucial cash in the form of successive capital increases, leaving Tuninvest with a 72-percent stake in the business. "They believed in the project," says the chief executive. "They know that in this line of business you don't get a return on investment in just six months."

Other Tunisian entrepreneurs, however, possessive of their start-ups and failing to secure bank loans, choose not to grow rather than accept new shareholders, he says. "They have the ideas, competence, a little bit of know-how and the enthusiasm to throw themselves into a project." But they don't find banks that understand their needs: "For many of our bank managers, a loan is just a file. It's a set of papers. It's movements of cash through an account. They still think like civil servants."

Source: Interview with chief executive, April 2014.

Performance is also quite disappointing in terms of credit quality as measured by the rate of non-performing loans and provisioning rates. Between 2006 and 2011, the official non-performing loans (NPL) ratio improved from 19.3 percent to 13.3 percent, which however remains high by international standards⁸. The weak performance of the loan portfolio reflects corporate governance failures that result in the inability of banks to select good performing investment projects. It also reflects a bankruptcy regime that favors debtors at the expense of creditors, hampering competition as well as hindering the efficient operation of the banking sector.

Mounting Fiscal Liabilities in the Public Banks: The Price of Inefficiency and Crony Privileges

The banking sector has been a tool for privileged access to finance by cronies. Instead of allocating resources toward the most productive projects, the banking sector, and public banks in particular, have been providing financing to the cronies and well connected. While there is abundant anecdotal information, the most visible evidence of these practices regards the loans granted to the family of Ben Ali. Tunisian banks funded businesses linked to the family of President Ben Ali to the tune of TND1.75 billion (or approximately 2.5 percent of GDP), the equivalent of five percent of all financing by the Tunisian banking sector, and nearly 30 percent of the cash was provided with no guarantees of repayment⁹. Beyond Ben Ali, connections play a very large role in gaining access to credit in Tunisia. As a result, Tunisian banks (mainly, but not only, the public banks) have imposed a significant cost on the economy both directly as they have accumulated significant losses such that they now require recapitalization from the state budget (see below) and indirectly by reinforcing the anticompetitive environment for private sector (as discussed in Chapter two and Chapter Three).

Beyond the weak financial performance and weak intermediation, the vulnerabilities in the banking sector have translated into a large fiscal liability. The results of stress tests carried out in January 2012 indicate that the banking sector has accumulated large recapitalization needs even to meet the current eight percent regulatory minimum (which is below international norms) (World Bank and IMF, 2012). The solvency tests simulated bank performance under a baseline scenario and an adverse scenario for the period 2012 to 2014¹⁰. Even under the baseline scenario, there is a projected recapitalization need of almost three percent of GDP within two years, while under the adverse scenario it is projected at five percent of GDP¹¹.

The performance of public banks is much weaker than that of private banks. Another key aspect to consider is the role played by the large public ownership of the sector. As mentioned above, the financial performance and efficiency of the public banks appear to be much lower than of other banks. Indeed, the results of the stress test also highlight that the three largest public banks have an average solvency ratio of nine percent, an average official NPL ratio of about 15 percent, an average provisioning ratio of less than 50 percent, and an average ROE of about six percent. These figures are significantly worse than the comparable averages for the private banks¹².

The large debt of the tourism sector is emblematic of the financial sector failures in Tunisia. Tourism deserves a special mention as it accounts for over 25 percent of total NPLs. The weakness of public banks tended to both mask the problems in the tourism sector but also contributed to them by channeling credit to less productive entrepreneurs and by freezing liquidity that would otherwise have circulated in the sector (box 6.3). Notably, under the prior regime, there was a high risk of directed and related credits to members of the ruling elite and their cronies. Several structural and governance issues magnified the level of financial distress in the tourism sector, notably the sector strategy that promoted overreliance on debt, the role of the state-owned banks, the lax central bank regulation, and the ineffective insolvency and creditor rights system.

Box 6.3: The Tourism Sector in Tunisia: Chronicle of a Death Foretold?

Tourism plays a major role in the Tunisian economy, accounting for at least seven percent of GDP (in 2010), about 14 percent of jobs (direct and indirect), and over 10 percent of total exports (and is therefore a major earner of foreign exchange). Over the last 25 years, however, multiple structural issues have undermined the competitiveness and financial soundness of the sector, such that tourism has witnessed a steady decline.

In the early 1980s, the Tunisian government launched an ambitious program to develop the tourism sector, with a strong emphasis on coastal development in a few select beach areas. As part of this effort, the government deeply engaged the public banking system to subsidize the expansion of the tourism sector. The Tunisian government, like many others in the 1980s, decided to help overcome the size limitations of the domestic financial markets by setting up a series of subsidized financing mechanisms. Subsidies aimed at the tourism sector specifically included provision of below-market land, looser credit requirements, loan guarantees and preferential interest rates, as well as the directed support of the state-owned financial institutions.

Through the 1980s and 1990s, the effort seemed to succeed as Tunisian hotels tapped the European beach vacation market. Over two decades, the effort tripled hotel space while tourism revenues grew twentyfold and Tunisia became a major mass tourism destination.

However, as the initial low-cost all-inclusive model became saturated, the sector started suffering from critical rigidity. In the early 2000s, at a time when new and more sophisticated competitors were entering the market, the “beds only” strategy became less and less relevant. The abundance of hotel beds (now over 250,000 in over 850 hotels, creating a total capacity of over 91 million bed nights) and the pressure on their owners (most of whom have monthly debt to service and bills and salaries to pay) to sell this perishable product gave gradually more market power to a handful of large tour operators (with access to markets) and put them in a position to dictate room rates and market positioning to hotel owners.

The terrorist attacks of September 2001 in the United States and April 2002 in Tunisia (at the synagogue in Djerba) led to severe revenue shocks that revealed these mounting structural weaknesses. While it was clear that policy reforms were needed to encourage innovation, diversify, and improve quality, nevertheless the government continued to subsidize less qualified investors and to add undifferentiated additional capacity, resulting in a further downward economic and financial spiral. As a result room rates have been declining over the past 10 years. Economic benefits to the country, particularly employment, are low relative to the number of tourists and the number of hotel rooms.

As of the end of 2010, the outstanding credit to the sector amounted to TND 4 billion (or almost six percent of GDP), and total tourism sector NPLs amount to an estimated TND 1.5 to 2 billion (or approximately 2.5 percent of GDP) but this figure may significantly understate the problem. State-owned banks are by far the largest providers of credit to the tourism industry, but the problem is widespread with 15 out of the 21 commercial banks operating in Tunisia exposed to the tourism sector.

The heavy weight of debt on many hotel borrowers has led them to give short shrift to renovation and to operational necessities, further continuing the downward spiral in quality and prices that has hurt the whole sector. More recently, political instability and security concerns have pushed the sector into a severe recession with tourism revenues falling by about 40 percent in 2011. Indeed, out of the 850 hotels, it is reported that over one-third went into severe financial distress in 2011. As a result tourism NPLs have increased further at a very fast pace since the revolution.

6.2 / Challenges affecting the financial sector: Limited competition and weak corporate governance of State Owned Banks

The analysis above has highlighted the poor performance of the Tunisian banking sector in terms of profitability, efficiency, intermediation, and financial stability¹³. Overall it is clear that the financial sector has not played the role of “lubricator” in the economy to effectively channel resources to the most profitable activities. On the contrary it appears to be misdirecting the resources, favoring cronies, and as a result it has accumulated large liabilities that undermine the economic performance of Tunisia. We now turn to explore the factors that may explain such poor performance.

The Paradox of the Tunisian Financial Sector: Many Banks, but Little Competition

Despite the large number of banks, several indicators suggest that the Tunisian banking sector suffers from low competition. The fragmentation of the Tunisian banking system and the small size of many Tunisian banks could explain the disappointing performance of the sector, as they prevent the efficiencies associated with scale economies. Nevertheless, a previous World Bank study has argued that the fragmentation does not by itself explain this disappointing performance and that, on the contrary, weak competitive pressure is at the root of the feeble performance of the Tunisian banking sector (Anzoategui, Martinez Peria, and Rocha 2010)¹⁴. A formal Ross-Panzar test for Tunisia indicates an H-coefficient of 0.32, suggesting that indeed the banking sector operates under “monopolistic competition¹⁵.” Comparing this result with the available data for the region shows that Tunisia performs rather poorly: Egypt has an H coefficient of 0.62 in 2010; Morocco of 0.59, indicating much greater competition; Turkey of 0.61; and only Jordan exhibits an H of 0.32, which is the same as Tunisia. Two additional indicators of competition, the Lerner index and the Boone indicator, suggest broadly similar conclusions (table 6.1)¹⁶. Hence it seems that the Tunisian financial sector suffers from low competition, despite the larger number of banks. As discussed below, several factors explain the low level of competition in Tunisia.¹⁷

Table 6.1: Competition Indicators for Some MENA Countries

Country	H-Statistic	Lerner index	Boone indicator
Egypt	0.62*	0.19*	-0.08
Jordan	0.32	0.34	-0.05
Morocco	0.59*	0.69	-0.07
Tunisia	0.32	0.29	0.01
Turkey	0.61	0.27	-0.01

Source: The Global Finance Database (World Bank, 2012).
Note: Figures with * come from Anzoategui et al. (2010) for the year 2008.

An Inadequate Regulatory and Supervision Framework

The lack of control and sanctions for violations undermines fair competition between banks, as those banks that strive to comply with the prudential rules are disadvantaged compared to the others. The 2012 Financial Sector Assessment Program (FSAP) report noted that banking supervision is inadequate, particularly with regard to public banks (IMF and World Bank 2012). Despite recent progress, the regulatory framework remains short of international standards. In

addition, infringements of prudential rules have so far not resulted in sanctions by the Central Bank ¹⁸. In extreme cases non-viable banks can continue to operate even in violation of the rules and generating credit losses. Such situations lead to significant distortions of competition because experience shows that such institutions in trouble cannot survive in the market by exercising a downward pressure on tariffs, lowering their selection criteria and management risk and using funding guaranteed by the state or granted by the Central Bank.

Weak standards also lead to systematic underestimation of risk, which has contributed to the high rate of bad debts. In addition to weak financial soundness, some prudential rules have also led to distorted lending policies, as illustrated by the example of the overreliance of banks on mortgage collateral (see below) ¹⁹. In addition, the weakness of the prudential framework and supervisory system does not encourage banks to focus on their comparative advantage and to invest in innovation.

Limitations on Interest Rate Artificially Restrict Competition and Access to Finance

Further, the CBT regulations on interest rates restrict banks' ability to compete. The Central Bank has long established a maximum limit on lending interest rates (at 1.2 times the average lending rate observed during the last semester) ²⁰, which results in undesirable effects. First, the cap excludes otherwise viable companies, mostly small and medium-sized enterprises that do not have adequate collateral. Second, loans with longer maturities must carry more or less the same price tag as short-term loans ²¹. These restrictions limit competition and at the same time prevent banks from pricing credit according to the level of risk (by clients or by maturity). As a result Tunisian banks compete only for a limited pool of clients (low risk, high collateral)—as reflected by the fact that interest rates charged are fairly low and that banks do not seek higher-risk profitable projects. In fact they would not be able to charge them for the higher risks. The cap on bank interest rates imposed by the Central Bank aims to protect bank customers from possible abuse. In doing so, however, this cap excludes many companies, such as startups or businesses that do not have sufficient guarantees, and to whom banks cannot offer rates that would allow them to cover their additional risk. Hence, there is a need to find other means to protect customers without limiting access to credit.

Poor Corporate Governance of State-Owned Banks

The weak performance of public banks reflects severe corporate governance failures. As mentioned above, there is significant evidence of abuse of public banks for the benefit of cronies, reflecting the fact that the governance arrangements of public banks do not provide independent management from political power. Beyond the role of corruption, however, the corporate governance environment for public banks is full of conflicts of interest. The state is a dominant player, the largest customer, and the regulator of the banking sector. These multiple roles generate conflicts of interest that interfere with normal market operation and limit competition between the players. For instance, as a shareholder the government has no interest to grant licenses to new players; as a lender it will seek the best price conditions at the expense of bank profitability; and as borrower it pursues the most flexible and least secure conditions for the banks. Hence the public banks have been subject for a long time to conflicting demands resulting in poor performance. They have been required to lend to cronies and to poorly performing state-owned enterprises (SOEs), to be profitable, to diversify, to compete with private banks, and to fulfill missions on behalf of the state (for which they might or might not be compensated).

The weak governance of public banks also contributes to reducing competition. As a result of the weak governance environment, public banks have felt no pressure to improve their management, their internal organization, or even their economic and financial performance. For instance, until

now, no public bank has implemented a rating system of its debtors. Similarly, accounting and risk management are poorly developed in public banks, even though such functions are at the heart of good management of any bank.

Further, state involvement in the banking sector has created additional competitive distortions. Notably, past recapitalization of public banks initiated by the state without changing their governance structure has created distortions vis-à-vis other commercial banks. Several times over the past two decades public banks received significant recapitalization without requirements in terms of restructuring and corporate governance—such as would be standard requirement in EU countries. Such unconditional transfers of public resources create significant distortions of competition and undermine the performance of good banks.

Structural Inefficiencies in the Bankruptcy and Collateral Regime

Tunisia suffers from very weak bankruptcy procedures, enabling inefficient and crony firms not to repay their debts and yet to survive instead of having to restructure or exit²². Tunisia's bankruptcy regime is fragmented with duplicate and overly lengthy processes for business rescue and business exit. The result is that it allows inefficient firms to survive instead of having to restructure or exit. Although some protection is necessary for companies in difficulty, an overprotective law, such as is the case in Tunisia, has perverse effects. It is harmful to economic actors because defaulters continue to operate their businesses and impose unfair competition to other actors. As discussed above, the tourism sector is a good example of this phenomenon of self-destruction. In addition, an effective bankruptcy framework is of critical importance for the smooth operation of the banking sector, and indeed the private sector as a whole, as it improves stakeholders' recovery, reduces creditor risk, and facilitates asset disposal. These elements determine banks' lending policy, and therefore an ineffective bankruptcy regime hinders access to finance. A weak bankruptcy system acts like a scarecrow for banks that have no other choice but to adopt an ultraconservative attitude with respect to the distribution of credit. Finally, beyond promoting unfair competition and discouraging banks from financing good projects, ineffective bankruptcy procedures also impede the rechanneling of resources toward more productive uses in the form of new loans and therefore prevent the development of more productive firms—thus contributing to the structural stagnation discussed in Chapter One. In fact a well-functioning bankruptcy system is at the heart of instilling efficiency in the economy via the process of creative destruction discussed in Chapter One.

A well-functioning bankruptcy framework could lead to very significant financial gains in Tunisia. Given the current aggregate level of NPLs of around US\$7 billion (in 2011) and using the Doing Business 2012 recovery rate of 0.52 cents on the dollar, we can calculate that stakeholders will recover only around US\$3.7 billion on existing outstanding loans, leaving less than half in unrecovered funds or value destroyed. A reform of the bankruptcy system could help improve the recovery rates. Based on international experience, the Impact Model for Insolvency Reforms used by the World Bank collectively tends to increase returns to creditors by an additional \$0.30 of recovery for four percent of stakeholders. Hence, assuming that a reform will improve recovery rates by \$0.30 (a recovery rate of \$0.82), this would bring an additional US\$2.1 billion (or 4.5 percent of GDP) in stakeholder-recovered funds from current NPLs, which if reinvested could generate around 80,000 new jobs. Assuming that the impact of the reform would extend beyond the existing NPLs (to approximately four percent of insolvent companies) would result in much larger benefits.

Tunisia's financial sector has also become hostage to a distorted collateral regime. The Tunisian credit institutions try to mitigate their lending activities, and the risks incurred by lending to cronies, by demanding a high level of coverage by collateral (mainly mortgage)²³. There are

multiple reasons for this overreliance, notably: (a) most banks are unable to evaluate project risks, and smaller banks do not even have the necessary databanks; (b) collateral enforcement is known to be very slow and costly (see discussion above on the ineffective bankruptcy procedures) so lenders have no incentive to take security that would be more sensitive to time delays and costs (which is the case for movable, tangible and intangible assets, which can fluctuate rapidly); (c) the legal framework on security is complex and based on the principle that parties could not agree contractually beyond what is expressly allowed by law; and (d) there is no centralized collateral registry. As a result Tunisia is the MENA country with the highest collateral requirements. This strategy (of overcollateralization) has proven to be insufficient to protect banks against defaulting borrowers, however, and it also tends to exclude from access to finance firms and entrepreneurs without the required collateral ²⁴.

The lack of information on the repayment capacity of bank customers (and future customers especially) is also an important barrier to the development of the financial sector. In many countries there are private credit bureaus. These are companies that collect, store, and compile information, mainly on payment incidents and the debts accumulated by economic agents (companies, individual entrepreneurs, or consumers). In the absence of such systems, banks lend only to well-known customers (those who have had credit or are well connected in the business community), to the detriment of new entrepreneurs, young people, or economic actors in regions underserved by banks. Hence it is critical for Tunisia to allow the establishment of credit bureaus.

Limited Alternative Sources of Finance

Banks face only limited competition from other financiers (capital markets, foreign players). The largest Tunisian firms made only limited use of international markets (primarily loan syndications) and stopped when the global financial crisis broke out. Domestic financial markets play only a marginal role in financing Tunisian companies ²⁵. In 2010 the share of capital raised on the domestic market accounted for only two percent of GDP, and market capitalization stood at 24 percent of GDP in 2012.

The main reasons for the weakness of domestic capital markets have been identified in the FSAP report as weak domestic demand, lack of yield curve, and lax enforcement of prudential banking regulation. In this regard, the weak banking regulatory and supervision framework results in an underestimation of risk that allows Tunisian banks to provide companies financing conditions below those that would prevail in a healthy and competitive market where risk is properly assessed. In addition, Tunisia does not have effective financing windows or instruments for innovative (higher technology) investment projects and start-ups (box 6.4). The lack of a sovereign yield curve is a major impediment to the development of diversified capital markets because fixed-income instruments cannot be priced appropriately. Without a yield curve, monetary policy transmission is less efficient, asset prices are distorted, and investors are not properly protected. In several instances, the pricing of corporate bonds does not seem to reflect the risk or the rating of the issuer; shares of mutual funds are not marked to market but valued at historical cost which makes this product similar to a fixed-rate deposit. The lack of a yield curve (as well as the absence of a secondary market for treasury bills) make more difficult the differentiation of pricing between short- and long-term credit, thus also lowering the ability by financial institutions to finance longer-term projects.

There is a need to unleash the potential of venture capital in Tunisia. Venture capital (VC) helps firms meet their equity needs during various critical junctures of their life (startup, development, buyout). Since a significant number of Tunisian firms are run by aged owners who are ready to hand over, their buyout by other existing firms or individuals becomes an issue that needs to be

Box 6.4: Financing and Incentive Mechanisms for R&D and Innovation in Tunisia

According to official sources, Tunisia has invested about 1.25 percent of its GDP in R&D in 2009. In 2006, spending was 1.1 percent of GDP; and Tunisia was above Chile, Morocco, and Turkey but slightly under the MENA average.

Tunisia's financing of R&D and innovations is channeled through an elaborate system of support and incentives mechanisms, including sectoral technical centers, technoparks, and technopoles; numerous research centers (130 research laboratories and 600 research units); an agency for the promotion of research, innovation, and firm creation; an agency for industrial promotion (API); an agency for agricultural investment promotion (APIA); and the capital-risk companies (*Société d'Investissement à Capital Risque*, SICAR).

These institutions are complemented by a number of public programs, aimed at providing incentives for innovation, often among other objectives. These include the *mise à niveau* (upgrading) and industrial modernization programs that attempt to support investment in new technology and enhance organizational and managerial capacity of firms; the *Prime d'Investissement en Recherche et Développement* (research investment premium); the *Programme National de Recherche Intégrée* (a program that seek to link a research unit, a firm, and a technical center around a specific project); the *Programme de Valorisation des Résultats de la Recherche* (research development program); and the *Régime d'Incitation dans le Domaine des Technologies de l'Information* (a fund dedicated to innovative projects in the area of information technology).

Recent reviews of Tunisian innovation systems highlighted several inefficiencies in R&D and innovation financing and incentives, including the following:

1. R&D spending is scattered around a large number of themes and public institutions (World Bank 2010a). The criteria for distributing R&D spending are unclear, and no clear alignment with national priorities or any performance criteria is evident. They are not aligned with any apparent performance indicator either. As a result, budgets received by individual laboratories are limited, as is production. Furthermore, the incentive and reward framework for researchers is biased in favor of producing and publishing personal academic papers, not focusing on research topics directly utilizable by the private sector (Proceedings of the National Days of Scientific Research and Technological Innovation 2007).

2. The objectives of a large number of R&D programs overlap to the effect that some funds are underutilized, for example the research investment fund. This creates waste and inefficiencies (World Bank 2010a).

There is little collaboration between research centers and the private sector. In the ICTEQ 2010 enterprise survey, 40 percent of firms declared having invested in research but only 15 percent of those have collaborated with universities. Three factors play a key role in this poor outcome: (a) limited demand from the private sector due to its predominant specialization in low value-added sectors and sub-contracting; (b) a mismatch between the nature of public research and the needs of firms; and (c) complex bureaucratic procedures.

3. The contribution of capital-risk companies to financing innovation is limited. The existing mechanisms, especially the SICARs, predominantly finance firm creation and operate like classic banks by negotiating credit-like financing conditions (for example, most transactions take the form of a "portage" in which the SICAR gets back its funds at a specified time with a fixed interest rate). Risk taking is minimal in the SICAR system. The SICARs account for only 1.2 percent of total financing distributed by the financial sector. A small number of firms benefit, however, from international funds or lines of credit dedicated to supporting innovation (for example, European Investment Bank credit line).

Source: World Bank 2010a.

properly addressed. In 2011 Tunisian authorities established a sound institutional and regulatory framework in order to stimulate the development of private equity. The regulation appears to be comprehensive and clearly enabled the emergence of various types of funding vehicles, notably investment companies (SICAR), mutual funds dedicated to private equity activities (*Fonds Commun de Placement à Risque*, FCPR), and funds for startups (*Fonds d'Amorçage*). However, VC activity remains shallow in Tunisia due to a number of impediments that prevent investors from fully playing their role in the financing of the private sector. The government has not yet defined what measures it intends to adopt to facilitate the development of venture capital in Tunisia, but several possible measures are being explored²⁶.

The government has taken steps to promote SME financing, and additional measures are being discussed. Besides direct funding channels (such as VC), intermediated small and medium-sized enterprise (SME) financing remains a key element of the financial sector infrastructure in Tunisia to support job creations and spur innovation. As for venture capital, intermediated financing has a key role to play at all stages of firms' life: startup, development, restructuring, buyout. There is a need to improve the performance of the Tunisian Guarantee Society (*Société Tunisienne de Garantie*, SOTUGAR, a partial credit guaranty scheme aiming at providing collateral to entrepreneurs and SMEs applying for bank credits), and the SME Financing Bank (*Banque de Financement des Petites et Moyennes Entreprises*, BFPME), which is a financial institution specializing in financing startups and SMEs, by also allowing more actors to enter this market.

6.3 / A Reforms Agenda for the Financial Sector

The discussion above has highlighted the need to strengthen the regulation and supervision of the banking sector and adopt measures to enhance competition in the financial sector. A key aspect of this would be the restructure of the state-owned banks. In addition there is a need to review bankruptcy procedures and to take rapid action to address the high NPLs in the tourism sector. As mentioned at the onset, we do not discuss the financing of innovative or risky projects and/or microfinance, which also need to be addressed. Specific recommendations are discussed below.

Restructuring of the State-Owned Banks

It is critical to reconsider the role of the state in the banking sector and engage in the restructuring of public banks. Mindful of the ongoing problems in the public banks, the Minister of Finance, in agreement with the Central Bank, decided in June 2012 to launch full audits of the three largest state-owned banks. The audits will aim to provide a comprehensive picture of the strengths and vulnerabilities of the state-owned banks (including banking activities, branch network, internal control, organization, marketing, human resources, and IT system) as well as the actual needs for recapitalization²⁷. There is a wide range of restructuring options, spanning from privatization ("fix-and-sell" or direct sale) to the merger of the three state-owned banks into one major public entity. As a prerequisite to this decision, the government should revisit the rationale for being the ultimate owner of these three large public banks, which are essentially commercial, with limited activities formally conducted on behalf of the state. It should also stop using state-owned banks to support (even temporarily) state-owned enterprises and entities, and prefer direct and transparent support out of the budget and subject to parliamentary approval and oversight. It will be extremely difficult to engage the necessary modernization of these banks without this step, and as such restructuring could have a dramatic impact on the ability of state-owned enterprises and entities to operate.

As part of this process it will be important to improve the corporate governance of state-owned banks, which is at the root of the problem. The rationale and modes of intervention of the state in the economy need to be revised with a view to instill more transparency and accountability. As part of this decision the governance structure of state-owned commercial banks needs to be reconsidered. The main governance shortcomings include: (a) weak boards of directors with insufficient expertise; (b) a general lack of autonomy; (c) a heavy administrative control structure; and (d) the absence of an overall strategic framework or ownership policy. State-owned banks should be subject to the same rules and regulations as private banks²⁸. A first step therefore would be to exclude state-owned banks from the law on State Entities (Law 89-9) and to appoint a majority of seasoned board members from the private sector.

A related issue in Tunisia is the absence of institutions that can provide medium- and long-term capital for productive investment projects. In 2012 the authorities launched the *Caisse des Dépôts et Consignations* (CDC) precisely to increase investments for long-term growth²⁹. More recently the government has discussed the possibility of creating a new development bank tasked with making loans for specific national or regional projects to private or public bodies (possibly in conjunction with other financial institutions) to promote private investment opportunities. Before proceeding to establish a new development bank, however, Tunisia should take stock of the failed and costly experience with its own development banks in the 1980s and 1990s, and identify the lessons learnt from the few successful examples of development banks across the globe³⁰. The overarching lesson is that solid governance arrangements and adequate supervision are critical to the success of these projects.

Strengthen Regulation and Supervision over the Banking Sector

To improve the efficiency of the banking system, priority should be given to strictly enforcing bank regulation and to strengthening market contestability. To improve the efficiency of the Tunisian banking system, it is advisable to: (a) further strengthen regulation (in particular in loan classification and provisioning) and supervision for the Central Bank of Tunisia to effectively control all credit institutions and to impose stricter sanctions for violations of prudential rules³¹; (b) increase competition by removing the Law 99-64 that imposes limitations on the interest rates charged on loans, thereby artificially restricting access to credit; and, (c) strengthen market contestability by reviewing rules for entry (approvals) and exit of nonviable institutions. These measures are intended to promote the restructuring of the banking sector by facilitating the orderly exit of nonviable players and allowing the entry of new, more efficient, and better-managed players within a sound regulatory environment.

Measures to Enhance Competition in the Financial Sector

In addition to these measures, competition in the financial sector can also be enhanced by promoting the development of capital markets as alternative sources of finance to bank loans. Building a reliable yield curve is the first step to take, which will have a catalytic impact on all the other debt markets. In addition, there is a need to strengthen the rules and institutions on competition in the financial sector³². Notably measures to promote venture capital financing seem required. Also financing for SMEs remains especially difficult.

The Reform of Bankruptcy Procedures

The government is working on reforming and modernizing Tunisia's bankruptcy laws. The aim is to arrive at a single, streamlined new bankruptcy law that consolidates Chapter IV of the Commerce

Law and the Law N° 95-34 under one text in order to avoid duplication. The modernization of Tunisia's bankruptcy regime would improve debt recovery and thereby strengthen the credit environment and improve confidence between debtors and creditors. The new legal framework should improve efficiency and flexibility of the bankruptcy provisions, more effectively save viable enterprises (through restructuring), and enable fast and efficient exit from the market of non-viable enterprises (through liquidation).

In addition, parallel improvements in bank intermediation and modernization of infrastructures are also essential by having the Central Bank operate a credit registry (and other database, including on balance sheets) and allowing credit bureaus (as additional resources to develop information and tools and collection of information beyond credit institutions).

Addressing the High NPLs in the Tourism Sector

The government committed to establishing an asset management company (AMC) to resolve the NPLs accumulated in the tourism sector. After considering several options for reform, the government opted for the establishment of a centralized AMC to manage tourism restructuring. A dedicated law will provide the AMC with specific powers, aiming at expediting the restructuring of the problem loans in the tourism sector. The plan is for a significant share of the tourism sector NPLs to be transferred to an AMC and swapped against state-guaranteed AMC bonds. This represents between 150 and 300 hotel units. As a result, NPL ratios will decrease across the banking sector. To successfully restructure the bad loans, the AMC will have to buy the NPLs at a low price. If all these bad assets are transferred, the NPL ratio could decrease from the current 13.5 percent to 10.25 percent. Also, the possibility to repossess the AMC bonds would significantly improve the liquidity in the banking system, freeing up space for new loans to the public and private sectors. On the sector side, restructured hotels would be able to repay their loans. Those that cannot be restructured will be transformed into other projects (for example, offices, hospitals, residences, and so on) or closed down, such that they no longer undermine the operation of competitive hotels.

6.4 / Conclusions

This chapter has argued that the financial sector in Tunisia suffers from deep dysfunctions and has been unable to channel resources toward the most productive activities and projects, thereby entrenching the misallocation of resources and resulting in the weak economic performance and inadequate jobs creation. The Tunisian banking system is characterized by limited profitability, inefficiency, low credit intermediation, and significant vulnerabilities. In line with this, financial deepening has been limited over the past decade and remains well below potential, such that the provision of credit to the economy remains weak, especially when compared to banks in neighboring economies such as Morocco. The weak intermediation of credit to the economy is a brake to economic performance in Tunisia. Indeed 34 percent of Tunisian firms report that access to finance is a major constraint to them. Although ordinary businesses struggle to gain access to finance, however, cronies have had easy access. As a result, the performance of the loan portfolio is very weak and increasingly poses a risk to the stability of the financial system. Also, progress in product innovation and quality service has generally been low. The distorted operation of the financial sector has contributed to undermine competition across the economy (by favoring crony firms) and has resulted in the accumulation of large liabilities that will have to be repaid by taxing economic performance in Tunisia.

The disappointing performance of the financial sector is the result of a severe lack of competition, despite a large number of banks, in part due to poor regulation and corporate governance failures. Using a measure of the elasticity of bank revenue to changes in costs (Panzar-Ross approach), we show that the degree of competition in the Tunisian banking sector is lower than the regional average. Several other indicators also point to lack of competition in the sector—and reflect the fact that the performance of the sector has been stagnating. The low level of competition appears due to the existence of an environment characterized by weak regulatory practices and substantial failures in the corporate governance in particular of state-owned banks. Improving the performance of the sector therefore requires reforms to address these shortcomings.

In order to have banks increasingly finance the best projects, a series of profound reforms are needed in the financial sector. To improve the efficiency of the banking system, priority should be given to reexamining the role of the state in the banking sector, engaging the restructuring of state-owned banks, and strictly enforcing bank regulation with a view to level the playing field and increase competitive pressures in the banking sector. As part of this process it will be important to improve the corporate governance of state-owned banks, which is at the root of the problem. In addition to these measures, competition in the financial sector can also be enhanced by promoting the development of capital markets as alternative sources of finance to bank loans. Building a reliable yield curve is the first step to take, which will have a catalytic impact on all the other debt markets. The modernization of Tunisia's bankruptcy regime is needed to improve debt recovery and thereby strengthen the credit environment and improve confidence between debtors and creditors. There is also a need to take expeditious action to resolve the accumulated problem loans in the tourism sector, which impair both the stability of the financial sector and growth and jobs creation in the tourism sector.

Improving the performance of the financial sector can have significant implications for growth and jobs creation across the economy. By itself the reform of bankruptcy procedures could achieve additional investments of US\$2.1 billion, corresponding to approximately 80,000 new jobs. Further, deeper reforms of the sector that result in an increase in the share of credit to GDP from the current 70 percent to its potential level of 80-90 percent could generate in excess of US\$10 billion in additional credits that could be injected in the economy, over say the next 10 years, to finance private investment. Such an increase in investment corresponds roughly to an additional 380,000 jobs.

The next chapters will discuss a proactive agenda for economic growth by exploring what policies the government can put in place to support industry, services, and the agricultural sector. Our discussion so far has highlighted the need to improve the operation of markets in Tunisia, by increasing contestability and reducing distortive government interventions, and also to improve the investment policies, labor market policies, and the operation of the financial sector. In addition, there is a need to define a proactive strategic policy to enhance and guide the development of the economy to realize its full potential, and this is the focus of the next few chapters. Chapter Seven will focus on industrial policy and barriers to growth in specific high-potential export sectors. Chapter Eight will focus on fulfilling the potential of the services sectors. Chapter Nine will discuss the challenges of the agricultural sector. Finally, Chapter Ten will discuss what policies can help integrate lagging regions.

Notes

1 In addition the financial sector also enables firms and households to cope with economic uncertainties by hedging, pooling, sharing, and pricing risks. An efficient financial sector therefore reduces the cost and risk of producing and trading goods and services and thus makes an important contribution to raising the standard of living, which goes beyond the investment and efficient allocation of resources across the economy.

2 In this report we focus only on access to credit for firms; however, access to finance for the population is also very constrained. Only thirty-five percent of Tunisians have a bank or postal current account and 10 percent a bank loan. These are relatively good figures by regional standards but not by international standards.

3 Profitability has deteriorated since the revolution, weakening the banking sector as a whole.

4 Credit to GDP increased significantly in 2010 and 2011 largely as a result of the expansionary monetary policy of the Central Bank.

5 A recent IMF study examines the evolution of credit to the private sector versus the potential amount of credit provision in Morocco, Tunisia, and a sample of Central and Eastern Europe and the European Union and arrives at similar conclusions (Veyrunes 2011).

6 Tunisia's results are similar to Lebanon's, where 53 percent of the firms have a loan and 35 percent of firms perceive that access to finance is a major constraint.

7 Bank lending is also constrained by the low quality of credit applications. According to the 2012 Enterprise Survey, only 32 percent of firms had financial statements certified by an external auditor.

8 In fact the number of NPLs would be even higher if it were not for the Circular issued by the Central Bank in April 2011 that allowed banks not to classify and provision as NPLs loans restructured in 2011 and 2012 as a result of the economic difficulties. It is likely that NPLs may have deteriorated by approximately five percent since the revolution.

9 Source: Press statement by the Governor of the Central Bank of Tunisia in February 2011.

10 The baseline scenario included a moderate pick-up in growth in 2012, followed by strong medium-term performance. The adverse scenario simulated a further negative growth shock in 2012, followed by a gradual but lower medium-term recovery to a moderate growth level.

11 Further, as detailed in the FSAP report, banking sector vulnerabilities are likely to be higher than implied by officially reported balance sheet data (IMF and World Bank 2012).

12 The financial situation of the three public banks has prompted the Minister of Finance to launch full audits of the three largest state-owned banks and to decide to recapitalize the banks. Following an initial recapitalization of 0.3 percent of GDP in 2012, an additional amount is planned for 2014 (to be defined based on the results of the audits).

13 In fact these problems have been ongoing for a long time. Banking reforms undertaken since the early 2000s did not lead to the anticipated financial deepening. The reforms consisted of making all banks universal (including former

development banks in 2005), injecting significant resources to recapitalize the three large state-owned commercial banks, selling the small and poorly performing state-owned banks to foreign banks, and creating two new specialized state-owned institutions to support microcredit and small and medium enterprises (SMEs). Efforts made to restructure state-owned commercial banks produced disappointing outcomes. Notably, the situation of the STB bank (*Société Tunisienne de Banque*) sharply deteriorated after it absorbed two distressed former development banks in the early 2000s.

14 In fact, in most MENA countries the high level of concentration has led to poor outcomes in terms of access to credit for households and for SMEs, as poor performing large banks never exit the market.

15 The Ross-Panzar index measures the pricing power of firms in a market. This methodology computes an H-statistic that measures how much an increase in input prices is translated into output revenues. If H is equal to 1, it means that there is a perfect competition such that an increase in input prices is fully included into output prices. If H is lower than 0, it means that increase in input price is not translated into higher revenues but into lower output and we are in a situation of a monopoly. When H is comprised between 0 and 1, we are in a monopolistic competition. (Ross-Panzar 1987).

16 The Lerner index is a standard measure of market power used in the literature and is derived from the first order equilibrium condition of a profit-maximizing firm that chooses prices. It follows that $L_i = \alpha_i \cdot \epsilon = ((P-MC))/P$, where L_i is the Lerner index expressed as the equivalence of inverse demand elasticity ϵ weighted by α_i , the market share of firm i , and the Price Cost Margin (PCM), indicating the difference between price and marginal cost (MC) as proportion of the price. In the case of a monopolist, α is equal to 1 and the Lerner index can be derived from the monopoly equilibrium condition $MR = P(1+1/\epsilon) = MC$. Note that the Lerner index varies between 0 and 1, where 0 reflects $P=MC$ and hence perfect competition. Thus, the higher the PCM measure the higher is the average market power in the sector.

17 The lack of competition can explain both the limited improvements in bank efficiency and the lack of industry consolidation. In fact market competition is the usual key driver of industry consolidation across jurisdictions but has been unable to play this role in Tunisia.

18 The FSAP identified a number of breaches of solvency regulations (insufficient equity in most banks because of unrecognized risk); liquidity (average ratio for the whole less than 100 percent sector 2011); or high risk, which did not give rise to any sanction from the Central Bank of Tunisia.

19 While in line with international norms, provisions are calculated on a net-of-collateral basis; valuation rules for mortgage collateral can be considered lax by international comparison, which translates into lower provisioning efforts. This observation explains why provisioning ratios are lower in Tunisia than in many other countries (the international average is around 70 percent) and also why banks rarely accept other forms of collateral.

20 Law 99-64 (see <http://www.jurisitetunisie.com/tunisie/codes/teg/tie1000.htm>)

21 In addition, as banks started competing more aggressively on deposit interest rates in the aftermath of the revolution,

the Central Bank of Tunisia (CBT) cut this competition short by capping the maximum deposit rate. This measure enabled banks to preserve their margin, but it also triggered adverse effects: it increased banks' dependency on CBT funding, and it discouraged savings (as the difference between the inflation rate and deposit rates grew), thus maintaining liquidity pressure on banks. Deposit rates lower than inflation could also channel the savings toward real estate (the sector is booming) and foreign currency (putting more pressure on the CBT foreign currency reserves level). The CBT has recently removed the cap on deposit rates but not the cap on loans.

22 Tunisia currently has two laws dealing with restructuring and bankruptcy in Tunisia: Book IV of the *Code de Commerce* setting out the 1959 bankruptcy law, *Du concordat préventif et de la faillite*, and Law no. 95-34, (modified in 2003), setting out the provisions on business rescue, *Redressement des Entreprises en Difficultés Economiques*. Although these laws have helped strengthen Tunisia's bankruptcy regime to a certain extent, they have resulted in a fragmented bankruptcy regime with duplicate processes and overly lengthy processes for business rescue and business exit. Some of the primary problems include: obliging all businesses to go through *règlement judiciaire* proceedings, even if they are insolvent and the additional time will only drain money from the estate; providing that the *Commission de Suivi des Entreprises* (CSEE) play a role that includes a quasi-judicial role, which might not be suitable for such an entity; not providing for confidential *règlement amiable* proceedings, which makes debtor businesses reluctant to file for amicable settlement; including duplicate procedures in the two laws thereby extending delays; minimizing creditor's rights in the business rescue responding; and including heavy sanctions, even for non-criminal activities, increasing the stigma associated with bankruptcy.

23 In Tunisia, lenders use a very narrow range of security, limited to mortgage and personal guarantees.

24 The establishment eight years ago of the SOTUGAR (a partial credit guarantee scheme), and the BFPME (a public credit institution focused on start-ups), has offset this problem only to a very limited extent (see discussion below).

25 Since the revolution the Tunis Stock Exchange has been much more active and a number of new companies have been floated since 2012.

26 Investment in foreign countries financed by FCPRs could open new opportunities for Tunisia. As a first, immediate step, the government could authorize FCPRs to benefit from the common regime enabling Tunisian firms, under certain conditions, to invest abroad (FCPRs would be subject to the same rules, in particular the ceilings in terms of capital outflows) and, in some cases, to overcome this ceiling up to the total amount of their foreign liabilities (for the funds that collect foreign funds). These investments would primarily aim to support Tunisian firms in their effort to conquer markets overseas. Another useful measure would consist of giving FCPRs' managers the possibility to tap into technical assistance funds (TAF) to assist firms in their effort to grow their business. For instance, the TAF could finance the hiring of an expert in charge of assisting a firm in its efforts to register a trademark or to protect an innovation. It would be also very interesting to expand current experiment aiming at establishing public funds managed by private sector managers (such as SAGES Capital) selected through international procurement (the international

dimension of this selection process is critical to bring new skills).

27 The three large commercial banks (STB, BNA, and BH) have different business models that call for different restructuring approaches. However, a commonality is that there is great uncertainty about their financial strength due to major weaknesses in accounting, risk management, internal audit, external auditing, and supervision. Different evolutions can be contemplated to restructure and modernize these banks.

28 Specific laws applicable to public entities (on public markets and staff remuneration, for example) have made it more difficult for state-owned commercial banks to build up an effective governance structure and oversight mechanisms (that is, risk management, IT systems, and external auditors), resulting in less efficient operations and higher risks.

29 The government also considered establishing a sovereign investment fund (Inter-Generational Fund) managed as a private fund to leverage private resources to support equity finance in Tunisia (for details see IMF and World Bank 2012).

30 Development banks may be publicly or privately owned and operated, although governments frequently make substantial contributions to the capital of private banks. The form (share equity or loans) and cost of financing offered by development banks depend on their cost of obtaining capital and their need to show a profit and pay dividends. Development practices have provoked some controversy. Because development banks tend to be government run and are not accountable to the taxpayers who fund them, there are few checks and balances preventing the banks from making bad investments. Nevertheless, there are some examples of well-performing development banks, notably in Brazil and the Republic of Korea.

31 In June 2012, the Circular (91-24) of the Central Bank of Tunisia strengthened some aspects of its supervision over the banking sector.

32 The rules must be clearly defined in the case of mergers, antitrust, and state aid in the financial sector and also to clarify the responsibilities of the Competition Council in this area.

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