STRENGTHENING THE FRAMEWORK OF FINANCIAL STABILITY IN ALGERIA AND NEW PRUDENTIAL MECHANISM

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1. Macro-economic stability and recent strengthening of the framework of financial stability

The return to macro-economic stability in the year 2000 and the financial performances achieved from the year 2001 to 2008 characterized by an excess of savings to investments, enabled the national economy to cope with the global economic and financial crisis. In particular, the sustained accumulation of official foreign exchange reserves from the year 2000 to 2008 and the early repayment of external debt in the mid 2000's have set Algeria in a position of net creditor to the rest of the world. The net external position of Algeria reached nearly 91% of GDP in 2013, in situation of continued prudent management by Bank of Algeria of official foreign exchange reserves.

Such level of external financial stability, driven by the prudent management of official foreign exchange reserves, is backed by the active management of the exchange rate through the interventions of the Bank of Algeria on the interbank foreign exchange market aiming to maintain the real effective exchange rate of the dinar close to the level of medium term fundamental equilibrium. Thus, in the first semester of 2014, the real effective exchange rate of the dinar remained slightly appreciated in context of disinflation. The performance in terms of inflation over the past twelve years, with the exception of the year 2012, is an achievement for monetary stability in Algeria, despite the structural excess of liquidity on the monetary market. The disinflation trend that initiated in February 2013 has continued since and the inflation rate standing at 1.44% on yearly average in August 2014.The contribution of monetary policy to financial stability remaining crucial.

Over the same period, the financing capacity of the Treasury constituted from the year 2000 to 2008 allowed to cope, as from year 2009, with the impact of the external shock on public finances, due to a lack of financial eviction. This financing capacity remaining high and represented 34% of GDP at the end of 2013, in a situation characterized by very low domestic public debt (8% of GDP at the end of 2013).

Unlike the situation in several emerging and developing countries, credit growth continued at the same pace than before the global financial crisis and even at a more sustained pace since the year 2010, particularly as regards loans to the private sector. The high growth rate of credit to the economy (20.3% in 2013 versus 15.1% in 2012 and 14% in 2011) is driven by the dynamism of medium and long term credits (27.6%) and emerges as the main determinant of monetary expansion in 2013. As regards the private sector and for the past thirteen years or from the year 2001 to 2013, the average growth rate of loans stood at 19.4%.

Before the expansion of the credit cycle, as from the year 2013, the Banking Law of 2003 was amended and completed by the Order of August 2010 relating to Money and Credit that expands the tasks of the Central Bank by assigning the explicit objective of financial stability in addition to the mandate of price stability. The contribution of monetary policy to the financial and monetary stability is of particular importance in Algeria in view of the persistence, for over twelve years, of the excess of liquidity in the monetary market.

The banking law of 2010 put forward the role of Bank of Algeria in the area of stability of the banking sector, as it must ensure of its soundness and safety. For this purpose, Bank of Algeria is provided since the year 2010 with wider prerogatives to conduct any investigation in banks and financial institutions, allowing a greater capacity for early detection of vulnerabilities. This led Bank of Algeria to strengthen micro-prudential controls at the level of local banks, of which the component relating to the control of the mechanisms to fight money laundering and the financing of terrorism. Improvement in the efficiency of these controls contributes to the orderly development of the banking sector. For overall management of the stability of the banking sector, Bank of Algeria periodically assesses the strength of the sector through stress tests developed as from the year 2007 and reinforced in years 2013 and 2014. Results of these stress tests enable to anticipate any possible risks that could weaken the sector.

As for instruments that fall within macro-prudential approach in context of excess of liquidity, the existing instruments forming part of the micro-prudential regulations such as the level of mortgage loans relative to the value of property given as collateral by individuals, mandatory reserves which are also an instrument of monetary policy, and the ratio of debt service relative to income of borrowers of mortgages, were all reviewed and could be modulated according to potential systemic risk. In addition, an enhancement of macro-prudential tools was initiated at the beginning of 2013 through the introduction of new tools that would allow for horizontal risk analysis and stress tests.

To further develop the operational framework for financial stability, after the implementation as from the year 2010 of new accounting rules consistent with international standards and rules relating to risk assessment of new financial instruments; a regulation concerning the identification, measurement, management and control of liquidity risk was enacted by the Council of Money and Credit in May 2011. This regulation establishes a threshold for short term minimum liquidity that banks and financial institutions must comply with at all time. In this same goal to establish a best practice of liquidity management, to monitor interbank transactions and to improve the quality of prudential reporting, the Council of Money and Credit also enacted in May 2011 a second regulation establishing a system of internal monitoring and limitation by counterparty of outstanding loans and interbank borrowings, including those transacted on the monetary market. The assessment made by Bank of Algeria in respect of year 2013 indicates that local banks fulfill the requirement regarding liquidity ratio (169.87% at end of 2013), although bank liquidity recorded a relative stabilization during the past year and continuing in the first half of 2014.

In terms of depth of the banking sector, it is useful to mention that the ratio of collected resources (sight and term deposits excluding deposits of the hydrocarbon sector) relative to GDP (excluding hydrocarbons) increased in 2012 and 2013 (62.73%) after a stabilization at 61.44% in 2011. The upward trend of the ratio bank loan to the private sector relative to deposits in dinars of the private sector from the year 2008 to 2013 is another relevant indicator of depth of the banking system, in the context of enhanced financial transformation.

The high growth rate of credit to the economy recorded in 2013 or 20.26%, confirmed for the first half of 2014 at 11.72%, with a much higher rate in the second quarter 2014. Indeed, bank credit to the economy reached 5,760.61 billion dinars at the end of June 2014 versus 5,156.20 billion dinars at the end of December 2013. This upward trend confirms the dynamism of credit to the economy and in particular the access facilitation of private enterprises to bank credit. Analysis of the structure of credits by legal sectors indicates that 51.44% of credits were granted to the private sector at the end of June 2014 (2,591.06 billion dinars versus 2,373.92 billion dinars at end of 2013. These credits improved 19.33% relative to the level at end of June 2013 (2,171.41 billion dinars).

Medium and long term credits represented 73.77% of total credits at the end of June 2014, of which 22.68% are medium term credits and 51% long term credits, versus 23.82% for medium term credits and 48.58% for long term credits at the end of 2013. Thus, the dynamic of medium and long term credits to private enterprises can be explained by the progression in the access to bank credits and reflects the effect of the improvement of the structure and terms of financing (extension of maturities and decrease in costs). Facilitation measures taken early 2013 made more effective the apparatus of support implemented by the government, in the framework of development of healthy credits to SME's, in order to stimulate economic growth outside of the hydrocarbon sector. The dynamic of bank credits to the economy is supported by these facilitation measures and is even more significant in real terms in the first half of 2014 compared to the year 2013 and with respect to year 2012 that was marked by a surge in inflation.

Banks have consolidated their indicators of financial soundness during the year 2013, while continuing their efforts on provisioning. Indeed, the solvency ratio remained significant, well above the regulatory levels required and in line with the recommended standards under Basle III. The soundness of the banking sector is thus anchored on high solvency ratios (15.5% relative to core capital and 21.5% relative to regulatory capital at end of 2013), and on high profitability and significant liquidity. In fact, the indicators of financial soundness are in line with those of similar emerging countries.

An assessment of the banking and financial sector conducted in 2013 by the IMF and the World Bank helped identify areas for further reform of the banking sector and additional consolidation of the financial stability in Algeria, with effective implementation as from the first quarter of 2014. In this context, the framework of prudential regulation is being refined for compliance of prudential regulation with new standards and regulations of the Basle Committee.

2-The new prudential framework

The new prudential regulations applicable to banks and financial institutions as from October 2014 constitute a structuring reform for the Algerian banking sector which is now robust, judging by the assessment made by multilateral financial institutions.

With respect to regulations enacted in 1994-1995 and in 2007, the new prudential regulations cover not only credit risk but also operational and market risks. These are regulation 14-01 relating to solvency ratios applicable to banks and financial institution, regulation 14-02 relating to large exposures and shareholding and regulation 14-03 relating to the ranking and provisioning of claims and commitments by signature. The economics of this new prudential framework shall be explained through a succinct presentation of these three regulations.

2.1 Regulation 14-01 relating to solvency ratios defines core capital and additional equity capital by including the overall recommendations in this area under the so-called Basel II standards.

In terms of core capital relative to the definition contained in the regulations issued in 1994, two deductions are required: the deduction for exceeding limits of shareholding set in regulation 14-02 is to be done on core capital, while total shareholding in banks and financial institutions (for which there is no standard levels) is to be deducted as follows: 50% from core capital and the remaining 50% is to be deducted from the additional equity capital. The previous regulations did not provided for the first deduction, while the second deduction applied to 100% of the shareholding in banks and financial institutions.

The new definition of core capital incorporates elements that may be included at intermediate periods. These elements are the same as the ones included in the previous regulation, namely: statement of income approved by auditors and validated by the Banking Commission calculated after deduction of all expenses incurred in the period and depreciation and amortization expenses and provisions, calculated net of corporate income tax and advance payments on dividends.

As to additional equity capital, they include only 50% of revaluation differentials and unrealized gains arising from the fair value valuation of assets available for sale and only 1.25% of total risks in respect of provisions constituted to cover general banking risks (excluding regulated provisions of 5% on medium and long term credits as part of core capital). Furthermore, as in the previous regulation, additional equity capital may be taken into consideration only within the limit of core capital and subordinated loans may be included in additional equity capital only within the limit of 50% of core capital.

The solvency ratio (regulatory equity capital over risks incurred on credit risks, operational risks and market risks) is raised to 9.5% versus 8% earlier. Unlike the previous regulation, a solvency ratio for core capital is introduced and fixed at the level of 7% of total risks. In addition, a safety cushion in core capital is implemented and covers 2.5% of weighted risks.

The new regulations provide the possibility for the Banking Commission to require banks and financial institutions of systemic importance higher standards of solvency ratios to those imposed. Moreover, in case of non-compliance with solvency ratios, the Banking Commission may impose deadlines on banks and financial institutions concerned for compliance with the requirements in this area, as well as restrictions on the distribution of dividends in the case of non-constitution or insufficient constitution of core capital with regard to safety cushion.

Credit risks incurred are redesigned by using, depending on the nature and quality of the counterparty, ratings assigned by external credit assessment institutions whose list shall be decided upon by the

Banking Commission or in the absence of rating, the standard weights provided for.

The new regulations provide weighting benefits for credits to small enterprises (weighting of 75% under certain conditions), for residential mortgage loans (weighting of 35% under certain conditions), and mortgage loans for commercial use (weighting of 75% under certain conditions), whereas the previous regulations provided the possibility of a weighting of 50% of mortgage loans only. In addition, particular larger weightings are provided for non-performing loans, that is to say with regard on the level of provisioning constituted, contrary to the previous regulations.

Securities loaned or sold under repurchase agreements are weighted according to the quality of the issuer, while the previous regulations did not specify this component.

Quantum conversion of credit risk for commitments by signature have not been altered in the new regulations due to the fact that local banks do not make conditional and / or derivatives operations that have entries in the off balance sheet statement. Financial guarantees as a factor of risk reduction have been specified, namely the conditions of their admission and their weighting has been further refined. This was not explained in detail in the previous regulations.

The definition of operational risks measurements (15% of net banking income over the average of the last three fiscal balance sheets) and market risks (position risk on the trading book minus general and specific risks and minus exchange risk) is that of the basic method of Basle II with quantum evaluation of regulatory equity capital and integration of this quantum in the overall formula for calculating the solvency ratio of regulatory equity capital. Those risks were not regulated.

Finally, the new regulations regarding solvency ratios introduce for the benefit of banks and financial institutions, some elements of prudential supervision relating to the adequacy of equity capital to risks and some elements of financial communication. The monitoring system must be documented and reviewed regularly, allowing periodic reporting to the legislative body and the executive body. Prudential supervision is also requested through the conduct of stress tests to assess the vulnerability of loans portfolio in case of an economic downturn or deterioration in the quality of counterparties. As regards financial communication, the establishment of a formalized procedure for financial communication is also requested and shall be approved by the governing body, in compliance with legal and regulatory provisions in force.

2.2- Regulation14-02 relating to major risks and shareholdings defines "major risk" as total risk incurred on same beneficiary as a result of these operations whose amount exceeds 10% of the regulatory equity capital of the bank or the financial institution concerned. It defines “related persons” as natural persons or legal entities that have ties of such nature that it is likely that the difficulties of funding or repaying of loans experienced by one person affect the other persons. As to “shareholdings", these are securities whose term ownership enables to exert an influence or control over the issuing company, which is deemed to exist only if the shareholding is of at least 10% of the capital or the voting rights of the company concerned. A "same beneficiary" is a natural person, a legal entity or related persons upon which the bank or the financial institution incurs a risk.

Standard risk division is the same as in the previous regulations, namely a maximum ratio of 25% between the net weighted overall credit risks that a bank or a financial institution incurs on a same beneficiary and the amount of regulatory equity capital. In the new regulations the concept of beneficiary or group is better defined. However, the Banking Commission may require for some beneficiaries or for all beneficiaries of a bank or financial institution a maximum ratio lower than this threshold.

The total major risks is limited to eight (8) times the amount of regulatory equity capital of the bank or financial institution concerned, corresponding to a tightening of the standard risk as compared to the previous regulations.

Exceeding the standards set for large personal risk at 25% of total equity capital and for total major risks at 60% of regulatory equity capital shall, unlike the previous regulations, be subject to sanctions by the Banking Commission. As regards total credit risks on a beneficiary, it is defined as in the previous regulations, as balance sheet and off-balance sheet credit exposures.

Financial guarantees admitted to be deducted from major risks are the financial guarantees accepted in respect of credit risk as defined in Regulation 14-01, but possibility is given to deduct from residential real estate loans 50% of the asset concerned pledged under certain conditions. Weighting ratios of credit risks for the purpose of assessing large risks are identified depending on the nature of the debts and do not take into account external ratings of credits on residents; off-balance sheet risks being assessed in equivalent credit risks by applying conversion factors. Banks and financial institutions are compelled to have an external audit report on beneficiaries falling into the category of "major risk".

Standard shareholdings of banks and financial institutions are individually set at 15% of regulatory equity capital and at 60% for all of shareholdings. Shareholdings in banks and financial institution based in Algeria shall not be subject to standard levels due to the fact that these shareholdings are deducted from equity (50% from core capital and 50% from additional equity capital). The same applies for shareholdings in companies under Algerian Law that constitute a division or continuation of banking activity, including real estate development companies set up by banks and financial institutions and companies that manage local interbank services.

2.3- Finally, regulation 14-03 relating to classification and provisioning of claims and commitments by signature of banks and financial institutions redefines all of the components of classification and provisioning of claims and commitments by signature and their methods of accounting as compared to the regulations of 1994.

Claims are represented by credits granted to natural persons or legal entities and recorded in the balance sheet of banks and financial institutions. These claims are either ongoing or classified as uncollectible. Ongoing claims are those for which full collection within the contractual deadline seems assured. Shall be included among ongoing claims, those that do not meet the definition of ongoing claims above but which are coupled with the guarantee of the State; with guarantees in the form of deposits lodged with the lending bank or financial institution; or with secured pledged securities that can be settled without their value being affected. Indeed, these are claims that are not subject to the provisioning provided for claims classified as uncollectible.

Claims classified as uncollectible fall into three categories. With respect to the previous regulations, the elements of assessment and ranking are more detailed in this new regulation. The elements of assessment include information relating to the deteriorating financial position of the counterparty, namely the significant decrease in turnover, the excessive indebtedness and internal difficulties such as shareholder disputes. The new regulation supports the requirements for the classification of leases and secured personal mortgage loans, which were not expressly provided for in the previous regulations.

Downgrading of a claim entails, via contagion effect, the downgrading of all other claims on same counterparty, toward the same category of classified claims, as well as the downgrading of commitments by signature. If the counterparty belongs to a group, the assessment is made of the impact of the failure of this counterparty on the situation of the group, and if necessary, the downgrading of all claims on group entities is made.

In case of restructuring classified claims, these are to be maintained in the category of classified claims for a period of at least twelve (12) months. After this period, reclassification into ongoing claims may be considered, provided that the new repayment schedule is respected and the interests thereon are effectively received. The list of classified claims that have been subject to at least a restructuring and whose amount is over 50 million dinars must be notified quarterly to the Banking Commission and to Bank of Algeria.

Claims classified as uncollectible, that is to say those for which there is no prospect of collection, should be written off only after exhausting all amicable or judicial means, except for small claims that may be directly written off, considering the amount of litigation costs.

With regard to provisioning, the resulting percentages in the new regulation of 20%, 50% and 100% respectively for the three categories of classified claims, are revised compared to those in the previous regulation. Provisioning is performed on gross amount (excluding uncollected interests) net of collateral accepted. The latter and the threshold of deductions are however more clearly specified in this regulation than in the previous.

In case of failure to implement real guarantees within a five (5) years period as from the first downgrading of the claim concerned, the latter must be funded in full without deduction of such guarantees. Banks and financial institutions must have internal procedures such as to enable them to ensure the legal validity of the collateral received, verify casualty insurance underwritten and assess the amount of coverage actually offered and the ability of effective and prompt implementation of the collateral.

Examination of the ranking of claims must be made at least quarterly. The quality of collateral received, in particular with respect to market value and the ability to implement them needs to be reviewed at least annually.

The method of accounting for non-performing loans is specified in light of new accounting standards implemented for banks and financial institutions as of January 2010.

Interests due on outstanding non-performing loans are not to be charged to the profit and loss account as in the previous regulation. Accrued interests but not yet due resulting are thus respectively charged to the debit of the appropriate account of related receivables and to the credit of appropriate accounts of related debts.

Conclusion

Within the framework of strengthening financial stability, Bank of Algeria completes in 2014 the updating of the infrastructure of payment systems implemented in 2006 and consistent with international standards (Real-Time Gross Settlement system, urgent payments and clearing system).

At the same time, the completion in 2014 of the operation of modernization of the existing credit registry and the recent launch of the setting up of a new infrastructure for a more comprehensive credit risk registry shall provide as from the second half of 2015, an important tool for the monitoring of credit risks.

The new, more forward looking approach of supervision and based on risks, shall put more emphasis on the process of credit allocation by banks, in order to stem the resurgence of concentration of credit risks.

Anchored on a strengthened financial stability framework and high financial soundness indicators for banks and financial institutions, deepening of the reform of the banking sector as from 2014 shall allow the implementation of more efficient allocation of national saving resources toward productive investment and financing of growth outside of the hydrocarbon sector, namely job creating inclusive growth, less dependent on budgetary sphere and driven by the development of SMEs. The continued improvement of the financing for the development of SME must be further supported, especially through better access to credit and banking services. It is also expected that banks diversify their financing instruments for SMEs, while continuing the effective improvement of assessment, analysis and management of credit risks.

Given the dominance of banks in the financial system in Algeria and their potentially important part in the development of financial intermediation, banks are thus expected to play a critical role in the financing scheme of the economy. A more efficient allocation of financial savings resources towards productive investment, anchored on opportunity cost of resources shall contribute to preserve the benefits of financial stability over the medium term.

For this purpose, and in order to strengthen its ability to assess the risk situation of the banking sector, Bank of Algeria shall rely, as from the beginning of 2015, on the effective use of the new model of stress testing as well as on the generalization of the rating system of local banks.