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# Algeria

## FSA | Financial Sector Assessment

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## I. INTRODUCTION

1. **As part of the joint IMF-World Bank Financial Sector Assessment Program (FSAP), two missions visited Algeria in March and June 2003.**<sup>1</sup> The main objectives of the missions were to assist the Algerian authorities in identifying strengths and potential vulnerabilities in the financial system that could have macroeconomic consequences, as well as problems likely to delay the development of the financial system, and its role in economic growth. The missions also provided an assessment of the observance of international standards and codes in banking regulation and supervision and financial policy transparency.<sup>2</sup> The missions identified measures to improve the functioning and supervision of the financial system, and reduce its risks. This report and the assessment of standards were presented and discussed with the authorities.

## II. OVERALL ASSESSMENT

2. **Over the past decade Algeria has courageously attempted to modernize its financial system despite social strife and unique challenges posed by the large hydrocarbon sector. However, lending by state-owned banks, mostly to public entities, still dominates financial intermediation, financial markets remain in their infancy, and implementation of otherwise laudable regulatory reforms is lagging.** Because of hydrocarbon-funded state support to borrowers and lenders alike, the financial system appears stable although this “stability” carries high costs and distorts risk pricing and governance.

3. **To alter these patterns, the authorities should push on several mutually reinforcing policy fronts:** privatize all public banks over the medium term; ameliorate the bank operating environment to cut intermediation costs; modulate the hydrocarbon-induced liquidity and credit cycles that curtail banks’ risk-taking; and undertake longer-term reforms to stimulate the non-bank financial sector.

## III. MARKET ENVIRONMENT

4. **Algeria has not yet completed its transition to a market economy initiated in the late 1980s.** Growth and internal and external balances are highly dependent on the hydrocarbon sector. Although positive over the last 10 years, growth remains below potential suggested by Algeria’s high investment rate. The second half of the 1990s saw the achievement of macroeconomic stabilization and the launch of supply-side reforms.

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<sup>1</sup> The missions comprised Messrs. Christian Durand (Mission Chief, IMF) and Dimitri Vittas (Deputy Mission Chief, World Bank), Gabriel Sensenbrenner and Laurent Bouscharain, and Ms. Hannah Faux (Assistant) (all IMF/MFD); Messrs. Philippe Callier (MED), Mazen Soueid (ICM), Michel Svetchine (French Banking Commission), Leon Chaize (Bank of France, retired), Najy Benhassine, Charlie Garrigues, Olivier Hassler, Aristomene Varoudakis (all World Bank) and James Bonnardeaux (Consultant, World Bank).

<sup>2</sup> These included: the Basel Core Principles for Effective Banking Supervision and the IMF Code of Good Practices on Transparency in Monetary and Financial Policies.

5. **The large public enterprise sector has struggled to limit losses.** Many state-owned enterprises (SOEs), mainly in intermediate sectors, have ceased to be viable as a result of more open competition and realistic treatment of costs mandated by the reforms, and the non-oil public sector has shrunk somewhat. However, SOEs remain the dominant users of bank loans (mostly floating rate overdraft facilities). State guarantees remove incentives for screening and monitoring borrowers. High leverage makes SOEs vulnerable to cash flow swings, including from increases in interest rates: debts are below 50 percent of assets in only 8 out of the largest 38 SOEs according to official figures.

6. **The 97 percent of private businesses that employ fewer than 100 persons are typically opaque family-owned enterprises in the construction, trade and service sectors.** More than half were created under the command economy. Three percent are incorporated, the rest are limited liability firms, partnerships, or sole proprietors. Algeria's business density is one for 50 inhabitants (one for 20 in Europe). Bankers complain that borrowers' credit worthiness is exceedingly costly to analyze and monitor because firms run several books. By default, true credit is based on relationship banking—the costliest kind for borrowers, with stringent non-price terms. A friendlier tax regime would improve the quality of financial information, but progress would also come from faster growth that would force constrained net worth owners to seek outside finance. Robust valuation practices and collateral systems, starting with land and real estate, and valuation practices are also needed.

#### IV. FINANCIAL SYSTEM STRUCTURE AND SOUNDNESS

7. **The Algerian financial system is dominated by the banking sector which accounts for 93 percent of total financial system assets.** Public banks continue to overwhelm the system, representing 90 percent of total banking assets, although their share in the extension of credit to the private sector is much lower at 74 percent. Insurance companies account for less than 3 percent of total financial system assets.

8. **The performance and soundness of Algeria's banks are distorted by pervasive state support and forbearance.** Bank credit is 34 percent of GDP (60 percent of non-oil GDP), of which 80 percent by public banks. Private banks accounted for 26 percent of credit to the private sector before the failure of the largest private bank in 2003. Following its failure (it offered attractive deposit rates to fund related parties), retail depositors have become aware of risk and shifted deposits to public and foreign banks. A second small bank was also closed in 2003.

9. **Public banks' losses have on average represented over 4 percent of GDP each year from 1991 to 2002.** The reported budget was almost balanced, on average, over the same period. Financial restructuring of banks and SOEs has occurred in three off-budget rounds in 1991–94, 1995–98, and 2001 (which was to be the final round and which brought the average reported capital ratio to 14 percent). However, a Bank of Algeria (BA) audit of large exposures at end-2002 revealed that public banks require additional injections to maintain their capital ratios.

10. **Fixed-income and money markets are in their infancy.** Bonds swapped for SOE loans represent 90 percent of Treasury domestic debt, but these bonds were not designed for trading. Treasury also issues a few tradable series (2.5 percent of GDP) of short duration; yields beyond two years have little meaning because primary amounts remain symbolic. Securities are held to maturity. BA uses refinancing ceilings for each bank when injecting liquidity and deposit auctions when absorbing. The reference rate is currently BA's deposit rate. As concerns offshore yields, Algeria represented 0.24 percent of the emerging market bond index and whatever debt is "tradable" has virtually no liquidity.

11. **The insurance sector is insignificant; life insurance is not yet regulated** Insurance, liberalized in 1995, comprises six state-owned, two mutual, and six small private insurers, and one state-owned reinsurer. External reinsurance is with reputable firms. Premiums are 0.5 percent of GDP. Non-life insurance accounts for 99 percent of total premiums. With the exception of the automobile branch that suffers from high expense ratios, lines are profitable and the sector meets local prudential requirements.

12. **Institutional and informational (accounting) underpinnings for bringing companies to the equity market are absent.** Trading is almost nonexistent on the three listed stocks. The Surveillance Commission (COSOB), an independent authority, has expended major efforts since 1993 to develop the market. Brokers have been licensed and a central depository created, but highly opaque financial information, banks' inability to provide investors with information, and small institutional investors prevent issuance.

13. **The value of Algeria's housing deficit is estimated at 25 percent of GDP, yet housing loans to households represent barely 1.5 percent of GDP.** Private houses are built on family funds, implying slow uneven completion. Multi-family units, generally developed by municipalities, are financed by the state-owned thrift, CNEP. Starting in 1996, tenants have been allowed to purchase apartments, including through financing from commercial banks. However, CNEP's 2002 portfolio still accounted for 97 percent of housing finance.

14. **Microfinance is undeveloped**, with only a few programs based on government-run social services. The design of existing instruments is inconsistent with international best practices. Rates of return have been disappointing, loan authorization takes 3–12 months, and the rejection rate is 96 percent.

## V. OVERARCHING ISSUES AND POLICY ADVICE

15. **Financial intermediation in Algeria will rest on banks for the foreseeable future.** To build strong institutions, the authorities should push on several mutually reinforcing policy fronts: privatize all public banks over the medium term; ameliorate the bank operating environment to cut intermediation costs; modulate the hydrocarbon-induced liquidity and credit cycles that curtail banks' risk-taking; and undertake longer-term reforms to stimulate the non-bank financial sector.

## **Privatize All Public Banks Over the Medium Term**

16. **Only politically difficult decisions to privatize public banks can eliminate the drag that current banking practices place on resource allocation in Algeria.** There is ample cross-country evidence that public banks are: (i) a constant drain on budgets because their incentive structures cannot be set right; (ii) rarely returned to profitability by a state shareholder; (iii) considerably undermine supervisory credibility; and (iv) associated with low growth of GDP/capita and productivity. International experience suggests that well-supervised private banks—especially foreign—boost competition and innovation.

17. **Performance contracts for public bank managers, introduced in 2001 in conjunction with the last bailout, have not stopped new losses or solved governance problems public.** Public banks' net income before provisions is barely positive. The performance contracts are not published, so criteria for evaluation are unknown. With Treasury eventually assuming losses on SOE loans, bank managers lack incentives to assess risk, condemning large parts of the economy to operate outside any credit culture.

18. **The healthiest public bank should be privatized rapidly, followed by a second one soon thereafter.** Two small public banks seem in better financial shape: provisioning of remaining impaired assets would push both into loss in 2002 but still leave them with acceptable solvency ratios. Selling them quickly will show a break with the past and the demonstration effect will help boost foreign interest.

19. **All the other public banks should be given a timetable to prepare for privatization.** If managers cannot make their banks attractive to reputable bidders, a substantial curtailment of operations should occur to remove the Damocles' sword of further bail-outs. This approach, buttressed by concomitant "demonstration" privatizations, can help show public bank managers that they either face dismissal or convince new owners to retain them by showing quality profits.

20. **Although bank privatization in Eastern Europe showed that initial ownership structures were less important than relinquishing management control, the de facto ceiling of 49 percent on private ownership of Algerian public banks should be lifted.** Most reputable buyers are willing to incur the cost of due diligence under three conditions: full management control; guarantees that the state assumes hidden liabilities that materialize within an agreed timeframe; and a contract that obligates the state to sell its remaining shares within an agreed timeframe. On the strength of such contracts, some investors might purchase less than 51 percent initially. However, in the case of Algeria, the government did invite foreign banks to bid for majority ownership of the cleanest public bank in 2002. It then imposed a 49 percent ceiling and the foreign bank withdrew. New tenders would be more attractive to a broader range of reputable investors if the ceiling were lifted.

21. **Privatization should not attempt to recoup past budgetary outlays, but prevent future ones and let new owners decide on investments and cut costs.** Private

investors will focus on the level and volatility of a bank's profits, not on budgetary outlays sunk into restructuring it. The Algerian government has no comparative advantage in running banks, including investing in systems and skills and rationalizing branches and staff. Such outlays, while possibly making a bank more attractive, will be heavily discounted by bidders; new owners will introduce their own systems and practices. These uncertainties may be bypassed and time gained by selling the banks "as is."

22. **Privatizing two small banks still leaves the government with the task of running two large generalist banks and three specialized institutions (in housing and agriculture/food processing).** Some of them might yet become attractive to bidders if the government focused on becoming a pro-active shareholder; seeking bank ratings from reputable agencies; and putting on-budget all financing of public entities. In the meantime, the government must be prepared to provide yet more capital.

23. **The state shareholder must become proactive; it does not yet enforce performance contracts on public bank managers.** The supervisor has been criticized for informing the state shareholder too late of new losses in public banks. That the state shareholder relies on the supervisor rather than on its representatives on banks' boards for such information exposes distortions in control. Boards, not supervisors, must ensure profitability and financial strength. Managers that fail to keep their boards apprised of material developments affecting profits should be dismissed. Especially for impaired public banks, the shareholder must demand of managers to provide frequent, timely and accurate reports of compliance with restructuring plans. Slippages must be disclosed immediately because of their budgetary implications. The state shareholder will know that its system of information and control works if it knows of losses much earlier and in more detail than the supervisor.

24. **Direct budgetary support should replace lending to non-viable SOEs and financial support to public programs, such as housing or agriculture.** After the last bailout, the government has assumed credit risk of public banks more directly via guarantees and/or interest rate subsidies. For this to work in Algeria, public banks need pricing data and underwriting procedures to decompose interest rates charged a given entity into cost of funds, operating expenses, compensation for default risk, value of guarantees if applicable, and profit margin. The record suggests that Algerian public banks lack this capability. They charge a single rate of interest for each type of loan to avoid discriminating among borrowers; at current margins, they would show losses even for minimal loan loss charges. The government should therefore consider replacing the current guarantees/subsidies with direct budgetary financing of public entities.

25. **In managing their housing and agriculture finance programs, the authorities should consider other methods than encumbering public banks with difficult-to-monitor risks.** Weak management and underwriting expose banks to unacceptable risks in running such programs. The concentration of housing finance in one housing institution is also fraught with risk. Better collateral systems and valuation practices would encourage well-run banks to diversify toward viable housing and agriculture borrowers.

26. **If, nevertheless, public banks were asked to administer such activities, the government should pay management fees.** The government may wish to use its banks as disbursement agents, or even monitoring or collection agents. However, the government should compensate banks for the provision of such services. Fees should be open to bidding, which public banks can win if they are competitive.

27. **BA as supervisor can play a useful role in the operational restructuring of public banks by enforcing provisioning rules to gain a firm handle on bank profitability.** All banks, and especially public banks, must strive to fully price their risks. Boards and managers must ensure, and the supervisor must insist, that interest rates charged borrowers reflect not only funding and operating costs, but also provisions and charge-offs. Only full pricing can reveal the underlying profitability that measures bank performance.

### **Ameliorate the Bank Operating Environment to Cut Intermediation Costs**

28. **Although most laws and regulations governing financial intermediation have been modernized, poor implementation and opaque financial information inflate intermediation costs.** Sub-par auditing and accounting compromises standard bank tasks of screening and monitoring borrowers; true financial information often is concealed outright for tax reasons. Local accounting norms and regulations, some of which date back to the command economy, are too open to interpretation and financials fail to give a true and fair view of company performance. Payment system inefficiencies also impose costs on financial intermediation in Algeria.

29. **Licensing, now tightened, should be kept under close watch.** Licenses had been given to individuals lacking experience, owners' net worth could not be reliably established, and the law did not require that capital be fully paid-in. This culminated in the failure of the largest private bank in 2002 that will cost taxpayers three percent of GDP assuming 30 percent liquidation value.

30. **Supervision needs strengthening in many core areas.** BA still does not have a permanent system to detect difficulties in individual institutions and scrutinize prudential returns in a formalized way. Inspections—although they now exist and are better focused on material risks—systematically fail to assess asset quality, guarantees, provisions, or related-party activities. Generally speaking, resources and budgets allocated for the various aspects of supervision are insufficient. Within BA, supervisors should have exclusive responsibility for assessing compliance with norms and their job content and career prospects should be enhanced. Assuming lending to non-viable SOEs is terminated, BA supervisors can become tougher, more responsive to warning signs, and more effective in making use of prescribed remedies.

31. **The ordinance on Money and Credit of October 2003 contains some improvements, but other provisions could undermine BA's financial and**

**operational autonomy.** While it aims at better coordination between the MoF and BA, it could give rise to widespread interference by the MoF in BA's day-to-day management. It will reinforce the MoF's influence on the Council on Money and Credit, on foreign exchange reserve management, and on banking supervision. It could also undermine BA's financial autonomy, by providing that the Treasury may obtain an "exceptional" advance from BA for external debt management operations. While such financing of the government may have a limited impact on monetary aggregates, the current large excess liquidity suggests that domestic debt issuance is preferable.

32. **Although the authorities have a range of law and regulations to address solvency concerns at individual institutions, they have hesitated to apply them.** This was particularly evident when dealing with the deteriorating financial situation of certain private banks. The recently incorporated Deposit Insurance Corporation has neither functional nor budgetary independence.

33. **The market in its current form may not fund private banks experiencing liquidity pressures and BA lending facilities are formally constrained by the availability of eligible paper.** Although there is excess systemic liquidity, it is concentrated in the public bank that holds the account of the state oil and gas company. Public banks mistrust locally-held private banks, making them vulnerable to sudden withdrawal of retail deposits. BA has provided liquidity to public banks on demand in the past.

#### **Modulate the Liquidity and Credit Cycles that Curtail Bank Risk-Taking**

34. **Measures that modulate the hydrocarbon-induced liquidity and credit cycles would foster sound and sustainable macroeconomic policies, which are among the preconditions for effective banking supervision.** Even assuming supportive accounting, supervisory and judicial environments, well-run banks operating in Algeria would be justifiably cautious in extending credit to the poorly diversified and highly volatile economy.

35. **Financial system stability and development in Algeria have strong overtones of public debt and expenditure management, because of the importance of such policies in modulating the effects of the oil cycle on bank liquidity and credit risks.** Although an oil stabilization fund was created in 2000, hydrocarbon revenues have continued to cause procyclical fluctuations in public spending and system liquidity, which amplify bank liquidity and credit risks. Modulating liquidity and credit cycles in Algeria rests partly on immunizing public expenditure from swings in hydrocarbon revenues and improving the transparency of quasi-fiscal operations and contingent liabilities.

36. **Increasing domestic debt issuance during the present good times would help expenditure immunization, thereby containing bank liquidity and credit risks.** Self-

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<sup>4</sup> For example, prudential regulation on leasing is the same as for bank credit, progressive amortization is not allowed, there is double-taxation in lease-back transactions.

insurance in the form of higher primary issuance likely will not increase debt service if the 20-year amortizable bank restructuring bonds are replaced with bullet securities staggered between one and ten years. Treasury could further increase dinar issuance by substituting domestic for relatively costly foreign debt. The resulting lower external debt ratios of the sovereign might well be sufficient for an investment grade rating, with tangible benefits for domestic banks and borrowers.

37. **Assuming the Treasury coordinates public debt and spending management with the BA, modulating the liquidity and credit cycles will also require strengthening the BA's monetary management.** Although issuance of central bank bills is conceivable, Treasury paper is preferable by far for the development of local debt markets. A combination of the two operations described above seems sufficient to absorb the current excess bank reserves. Conditions would then fall in place for competitive setting of interest rates along the yield curve, a building block of modern financial intermediation. However, competitive markets are unlikely to emerge as long as state banks dominate the financial system.

### **Stimulate the Development of the Non-Bank Financial Sector**

38. **Although the banking system is likely to continue to play a leading part in Algeria's financial system, only the development of non-bank financial institutions and markets will help generate long-term financial savings. Contractual savings institutions, i.e. life insurance companies and pension funds, can play an important part in generating long-term resources.** When these reach critical mass, they can act as a countervailing force to the dominant position of commercial banks. International evidence shows that, if they are well organized and privately managed, contractual savings institutions can contribute to the development of securities markets, facilitate the long-term financing of both the enterprise and household sectors, and even strengthen banking sector stability.

39. ***Contractual Savings.* In order to stimulate the development of the insurance sector, it will be necessary to overcome the severe constraints in the motor and life insurance branches, as well as to bolster the professional capacity of the supervisory authority.** With respect to motor insurance, it is necessary to adopt local market agreements so as to expedite settlements and to raise rates and scales in order to ensure that motor insurance is in technical equilibrium. The life insurance market is hamstrung by the virtually complete absence of regulation. The authorities should introduce fiscal incentives and implement prudential regulations as well as take steps to facilitate marketing. If it is to discharge its various responsibilities in a comprehensive and satisfactory fashion, the Insurance Commission (Direction des Assurances) must have functional and budgetary independence, a staff recruitment and training program, as well as an action plan to address the numerous deficiencies in the regulatory framework.

40. **The national pension funds lack financial reserves and are frequently faced with liquidity problems.** In recent years, the national funds placed a sizable portion of their available funds in time deposits with a private bank, which was offering interest at

considerably higher rates than the public banks but is now undergoing liquidation. The pension funds have been able to recover part of these funds but they will experience substantial losses once the private bank is liquidated.

41. **To ensure the financial equilibrium of the system and to prevent a rapid deterioration in its operations, two reform components should be considered.** One component involves the immediate abolition of the proportional pension and the pension entailing no age limit. The other component has to do with reducing the annual accrual benefit rate which would allow for a reduction in the contribution rate and an increase in effective participation in the system. The reduction of benefits and contributions within the pay-as-you-go framework will thus allow for the introduction of a supplementary fully-funded system, whether mandatory or optional. The latter system will facilitate efforts to generate longer-term resources that should in turn be instrumental in invigorating the financial markets.

42. **Other non-bank financial intermediaries. Factoring and leasing companies, can play an important part in financing small and medium-sized enterprises (SMEs).** Their successful operation will require substantial improvements in the collection and sharing of credit information and in the overall reliability of financial data as well as improvements in the creation, registration and liquidation of collateral security. Moreover, weaknesses in the leasing regulation<sup>4</sup> is still constraining its development, despite new entrants in this area over the past years.

43. **Securities Markets. Active and well-regulated securities markets for government bonds, corporate securities, both bonds and equities, and mortgage securities can play a big part in financing the government, enterprise and household sectors and facilitating the growth of nonbank financial intermediaries.** The growth of securities markets will require major improvements in regulation, financial information, and settlement systems. Some progress has been made in the area of securities markets, through the establishment of an autonomous regulatory authority and the creation of central depository facility but, as in the area of contractual savings, considerable further improvement is needed.

44. **Currently, the securities markets—public or private—are virtually nonexistent.** A major effort has been made to create a regulatory framework for the licensing and supervision of market participants and for the creation of an efficient technical infrastructure, but trading volumes on primary and secondary markets remain negligible.

45. **The institutional and technical infrastructure has developed through the licensing of a number of specialized intermediaries and the creation of Algérie Clearing as the central depository.** There are 5 intermediaries engaging in stock market operations [*intermédiaires en opérations de bourse (IOB)*] and 13 primary dealers specializing in treasury instruments [*spécialistes en valeurs de trésor (SVT)*]. However, the role of the IOBs and SVTs remains very limited. At the technical level, Algérie Clearing complies with international standards and has adopted a system similar to that of

other regional depositaries, such as STICODEVAM (Inter-Professional Tunisian Company for Securities Clearing Deposits). The small size of institutional investors deprives markets of effective demand for innovation and reform. An open-ended mutual fund (SICAV) has been created but has not yet commenced operations.

46. **The creation of specialists in treasury instruments (SVT) and the establishment of a technical infrastructure are not sufficient in and of themselves to galvanize the securities markets.** It is also essential to establish an active and effective money market and to adopt professional management for the public debt. To develop the money market, it is necessary to reduce commercial banks' access to the Bank of Algeria's refinancing facilities, to ensure the more widespread use of a Reuters-type system in order to facilitate bilateral transactions, to adopt a legal framework governing repurchase operations (repos), and to encourage participation by those banks for whom optimizing liquidity management is an important goal. An active money market would boost competition among banks inasmuch as those banks whose branch network is limited could borrow on the market in order to finance credit operations. The money market would support the development of the bond market.

47. **The management of public debt lacks transparency and a professional focus.** Debt managers seek to finance their budgetary requirements at the least cost while avoiding exposure to excessive risks. To invigorate this market, it would be necessary to articulate and disseminate the public debt management strategy, create an appropriate institutional structure, make greater use of benchmark issues characterized by greater liquidity, abide by the issue timetable, and encourage transparency between professionals and the public.

48. **The narrowness of the securities markets and the lack of liquidity discourage participation by investors.** The transaction costs highlight the inefficiency of the market: sometimes it takes up to a month for an investor to recover his investment after having sold securities. The regulations are obscure and the rights of minority shareholders are not clearly defined. Bankruptcy procedures and the enforcement of judicial decisions leave much to be desired, and the same goes for the compliance with financial accounting standards. Businesses should be required to report reliable data to holders of securities frequently.

49. **Nonetheless, the main problem of the Algerian stock market is that it was created before the necessary institutions were put in place and before the diffusion of a "financial culture."** Although capital gains as interest and dividend income are tax-exempt, investors show scant interest in the stock market, reflecting their lack of confidence. Public enterprises have no desire to issue stock for fear of seeing the stock prices fall, whereas private firms refrain from issuing stock in order to avoid diluting their share capital. The dearth of stock issues hinders the emergence of financial analysis services and hampers efforts to instill a sense of the importance of finance, which in turn exacerbates investor mistrust.

50. **The stock market could play an important role in two ways: by serving as a catalyst for the privatization process and by helping businesses to ease their reliance on bank financing.** In addition, the stock market could promote the emergence of modern corporate governance and instill a sense of the importance of finance. As is often the case in Algeria, it is regrettably difficult to set the process in motion as the existing system is self-reinforcing. That is why it is essential for the authorities to get actively involved. They could begin by encouraging public enterprises to issue bonds, which would enhance liquidity and offer a broader range of options for investors, businesses, and banks. Businesses should be required to ensure frequent reporting of reliable information to bondholders in order to facilitate the emergence of a finance-oriented environment.

51. ***SME Finance.* Most SMEs are excluded from the credit market and have difficulty gaining access to bank credit. Collateral requirements are high, and there are long delays in credit processing.** The owners of SMEs complain that the cost of bank credit is too high. However, it should be noted that access to finance is far more important for SMEs than its cost. Moreover, financing costs represent a small part of total operating costs of SMEs, which by their nature do not use capital-intensive methods of production. The interest rate on SME lending should reflect the higher risk of losses in such lending.

52. **Developing SME finance calls for better information systems on the solvency of businesses, promoting new forms of credit, such as leasing and factoring, expediting reform of the judiciary, and undertaking reforms of the real estate market.** Reliable databases on company accounts, bank lending, nonperforming loans, dishonored checks, and other information—incorporating both positive and negative data—would facilitate efforts to develop lending to SMEs and would encourage the participation of leasing and factoring companies. Expedited judicial reform, entailing efforts to train judges in financial issues, reductions in the time required to realize collateral, and removal of the risk of penalties associated with acts of management would have a very significant impact. Finally, reform of the real estate market (urban and industrial) would reduce the access and titling problems that prevent a good number of businesses from using their real estate assets as bank collateral.

53. ***Housing Finance.* CNEP remains the dominant lending institution in housing finance. Despite the high profitability of this type of lending, other banks have been slow in developing their operations in housing finance.** The specialized institutions created since 1997 to promote housing finance—such as the SRH for funding with long-term resources and the SGCI for mortgage insurance—have thus far had only limited impact.

54. **Providing financing for housing and overcoming the sizable housing deficit, estimated at one million units, represent a major challenge for the financial system.** Mindful of the fact that it lacks the resources to eliminate the housing deficit, the government has adopted a series of measures to mobilize collective saving: modernizing the various forms of assistance designed to enable households to achieve solvency, partial replacement of the direct assumption of the cost of low-cost housing by a system of hire

purchase [*location-vente*] entailing the use of bank resources, as well as significant improvements in the legal and tax-related environment associated with lenders' activities.

55. **Important steps still need to be taken in order to bolster the volume of resources allocated for the financing of housing through the banking system.** For one thing, credit risk control instruments need to be appreciably strengthened: collateral is not always enforced, in spite of the recent reforms in mortgage law, and precise procedures need to be specified in order to make them operational; efforts to regularize property rights in urban areas must be expedited; a network for the systematic gathering of information (both good and bad) on the status of borrowers should be developed; and finally, credit insurance products ought to be reviewed in order to align them more closely with market needs. Furthermore, as the current system is funded almost exclusively by very short-term savings deposits, lenders take on a liquidity risk, while rate-related risks are also comparatively substantial albeit mainly supported by borrowers. It is necessary to promote long-term financing through fixed-rate loan formulas. For this to occur, it will be necessary to redress the balance in the yield structure for saving between bank placements (liquid and entailing no market risk) and less liquid investments, and it will be important to encourage the provision of mortgage-backed securities to institutional investors.

56. ***Micro Finance.* Micro finance and micro credit are not well developed. The only existing programs, designed by the government in connection with social public service programs, seem unlikely to be able to serve as a sustainable source of resources.** The Social Development Agency (Agence de Développement Social (ADS)), as well as other public institutions (ANSEJ, FNRDA), were set up in response to the effects of the structural reforms implemented during the 1990s. The design of the existing instruments is inconsistent with the successful standards of micro credit encountered at the international level: (i) interest rates are subsidized; (ii) the portfolios are not managed by dedicated institutions but rather by general public banks; (iii) they are not handled by dedicated staff with appropriate training and incentives based on portfolio growth and repayment rates; (iv) they are not supported by information and monitoring systems that are key in microfinance; (v) they do not follow the management standards that are specific to this type of lending activity; and, finally, (vi) they are focused on new ventures and investment loans as opposed to working capital financing. In consequence, repayment rates are low by international standards; the rates of return have been disappointing (according to the BNA, the rate of arrears is 56 percent), and loan authorization times are long (3-12 months), while the rejection rates for loan applications exceed 96 percent.

57. **Recent experience at the international level underscores the fundamental principles of optimal management of micro finance operations.** This experience shows that access to financial services for low-income groups is more important than cost considerations. Microfinance services are more efficient when they are not heavily subsidized. It is important to apply commercial rates that take account of the fact that micro-transactions entail significantly larger operating and monitoring costs; it is necessary to rely on collective contracts and peer pressure; and it is important to use gradual access to credits (the amounts of credit increase steadily as repayments are made

in a timely fashion). A three-pronged structure (local, regional, and national) for specialized institutions can ensure a profitable and sustainable supply.

58. **Legal and Judicial Framework.** Since the end-1980s, the Algerian authorities have embarked upon a wide-ranging program for modernizing the legal framework governing the financial system. This program has addressed commercial banks as well as other sectors such as insurance, the securities market, and financial market participants. The program has also led to substantial changes to the Commerce Code, and in particular, it has significantly reformed the safeguards for the rights of shareholders and creditors.

59. **However, the texts of laws and regulations display significant deficiencies, while a number of provisions are not compatible with international standards.** The banking law is generally satisfactory. However, the abolition of the article specifying the length of the governor's term of office and the fact that the Governor can be removed from office without cause is not in line with international standards. The fact that the minimum capital of banks is paid up on a deferred basis—which is not prescribed by banking law, but which has been allowed pursuant to a CMC decision—is a further deficiency. The most significant gaps are the failure to modernize the legal framework surrounding corporate governance, bankruptcy, mergers and acquisitions, and life insurance.

60. **The debate surrounding corporate governance and safeguarding shareholders' rights has not yet taken place in Algeria.** This may be partly accounted for by the fact that in most firms under Algerian law, the equity holders directly manage their businesses. Furthermore, most private-capital firms adopt the SARL [*sociétés à responsabilité limitée*] structure. That said, the commercial code makes provision for a single board of directors or the combination of a board and a supervisory council.

61. **The conventional rights of shareholders and creditors seem to be well-protected but the absence of detailed rules on corporate governance and mergers and acquisitions weaken the protection of minority shareholders.** Banks and financial institutions have legal privileges to recover their claims. This privilege takes rank immediately after the rank of employees, the Public Treasury, and social insurance funds and it dispenses with the slow pace of civil proceedings.

62. **The legal framework has been generally reformed, but the enforcement of the new laws remains very unsatisfactory.** The judicial system is a bone of contention for the business community, not only foreign but also (and in particular) local entrepreneurs. The main criticisms leveled at the judiciary have to do with the slow pace of judicial proceedings, the fact that judges lack technical expertise in business cases and the difficulty involved in enforcing decisions, the insufficient use of alternative dispute resolution (i.e., extrajudicial proceedings such as arbitration, mediation, and conciliation), and the lack of efficiency and impartiality.

63. **The efforts to adapt the legal and judicial framework to reflect international standards need to be especially wide-ranging.** The regulations on corporate

governance, mergers and acquisitions, bankruptcy, and life insurance need to be modernized. The establishment of a centralized and computerized register for collateral security is one possible option for enhancing the security of credit transactions and encouraging the extension of both bank and trade credit. The exact procedures remain to be determined in order to ensure the operational implementation of the recent reforms of mortgage law. The use of extrajudicial procedures should be encouraged as an alternative to bankruptcy proceedings. A program of training and education for the judiciary would appear to be necessary; the legislative drafting for the major laws and regulations needs to be based on a consultation mechanism involving the business community and other agents.