Tunisian Banking System Vulnerabilities beyond the Global Financial Crisis and Recent Political Instability

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Abstract
The Tunisian banking sector has weathered the global financial crisis and the revolution's immediate impacts. Political uncertainty and prevailing social tensions have considerably impacted the activities of certain sectors.
The paper aims at examining the implications of the macroeconomic environment on the soundness and performance of Tunisian banks. In other words, the paper purports to identify whether the Tunisian banks' profitability, liquidity and leverage indicators have been impacted by the world financial crisis and the recent political instability by use of financial soundness indicators during the period 2002-2012.
We propose first to analyse the evolution of the economic performance during this period. Second, we attempt to study the repercussions of the economic downturn on the Tunisian banks' overall soundness and profitability.
The results suggest that Tunisian banks remain resilient from the affects of the global financial crisis. Nevertheless, they have been impacted by the revolution's turmoil. It will be argued that the difficult economic situation resulting from the political changes has enhanced the Tunisian banks' vulnerability.
Key Words: *Tunisian Banking System, Global Financial Crisis, Political Instability, Financial Ratios*

JEL Codes: G01, G20, G21 and G32

1. Introduction

Since the deregulation and liberalization processes which were conducted in the mid 1980s, the Tunisian financial sector which is heavily dominated by banks has become more market oriented and has become of paramount importance for economy.
Financial sector reform was an integral part of Tunisia's structural reform effort of the late 80s and early 90s. It involved a move towards the implementation of monetary policy through indirect instruments of monetary control, the modernization of the legal and institutional structure of the financial system and the adoption of internationally accepted methods of supervision and prudential regulation. This "ambitious" reform program has lead to the reinforcement of the financial sector as well as its regulatory and supervisory framework, by improving the institutional framework, which enabled it to be more resilient to shocks.
The stability and performance of the banking system depends upon the macroeconomic environment within which it operates. This requires an appropriate infrastructure and a stable macroeconomic environment. Sound macroeconomic policies that encourage sustainable economic growth with low inflation have a strong and positive influence on the soundness of the banking system. By contrast, policies that result in significant macroeconomic imbalances frequently have serious adverse implications for banks. Even sound banks can be pushed into crises with a sufficiently large macroeconomic shock. These macroeconomic shocks often lead to systemic unsoundness since all banks will be exposed to the same conditions.
Macroeconomic shocks such as a sudden decline in growth often contribute to bank unsoundness. Several cases of banking distress have been preceded by recessions and a decline in economic activity. The sharp contraction in economic activity has been identified in the empirical literature as one of the main early-warning signals of banking crises. Low and declining growth rates can adversely affect the borrowers' capacity to payback the loans and hence increase credit risk.
This study investigates the impacts of crises on the performance of Tunisian commercial banks over the period between 2002 and 2012. The rationale behind this selection is that the Tunisian banking system within this period has witnessed two major crises: the financial crisis (current global crisis) and the political crisis (political instability generated by the revolution).
The paper is structured as follows. The next section surveys a selection of significant studies. Section three analyses the Tunisian economic performance during the financial crisis and after the Tunisian revolution. Section four presents the structure of the Tunisian banking system. Section five assesses the impact of the recent financial crisis and the political instability on banking system's performance by analysing the evolution of a number of indicators concerning capital adequacy, asset quality, liquidity and profitability.
Finally, the conclusion is provided in section six.

2. Literature Review

The impact of the recent financial crisis on overall banking performance has drawn the interest of several economists. Many cross-country empirical studies have been conducted to measure the performance of commercial banks especially before, during, and after financial or political crises.
Dietrich and Wanzenried (2011) examined factors that affect the profitability of Swiss commercial banks over the period from 1999 to 2009 by using the pre-crisis period of 1999–2006 and the crisis years of 2007–2009. Their results provide evidence that the financial crisis did have a significant impact on banks profitability. Cornett, McNutt, Strahan and Tehranian (2011) concluded that during the financial crisis of 2007-2009 the banks with more illiquid asset portfolios, increased their holdings of liquid assets and decreased lending.

Xiao (2009) used qualitative and quantitative tools to examine the performance of French banks during 2006 and 2008. Finding shows that French banks were not immune but proved relatively elastic to the global financial crisis. Cornett, McNutt and Tehranian (2010) analyzed the internal corporate governance mechanisms and the performance of US banks before and during the financial crisis. They find that largest banks had the most important losses during the crisis.
Others studied the real effects of deterioration in bank health or competition during the financial crisis on bank performance. Almeida, Campello, Laranjeira, and Weisbenner (2009) and Duchin, Ozbas and Sensoy (2010) studied the effect of the recent financial crisis on corporate investment. Results show that the corporate investment declines significantly following the onset of the crisis. Berger and Bouwman (2010) examined the effect of pre-crisis bank capital ratios on banks' ability to survive financial crises, market shares, and profitability during the crises. Their finding shows that capital helps banks of all sizes during banking crises; higher capital helped banks to increase their probability of survival, market shares, and profitability.
On the other hand, the correlation between political instability and economic growth has been a controversial topic among economists, political scientists and politicians. The findings of previous studies suggest that economic growth and political instability are profoundly interrelated. The uncertainty associated with an unstable political environment may reduce investment (Schneider and Frey (1985), Rodrik (1989), Barro (1991)) or cause high levels of inflation (Cukierman, Edwards and Tabellini (1992)) and as a result lower national growth rate. Both Alesina, et al (1996) and de Haan and Siermann (1996), state that political instability causes slower economic development. In a more recent paper, Jong-a-Pin (2009) also finds that higher degrees of political instability lead to lower economic growth.
Despite the continuous interest in this area as reflected by the huge number of published research on banking efficiency, little has been conducted to explore the combined effect of financial and political crises on banking performance.
The goal of this paper is to fill up this gap, at least partially by unfolding the impact of recent political turmoil and its economic repercussions on leverage, liquidity and the profitability areas of Tunisian banks.

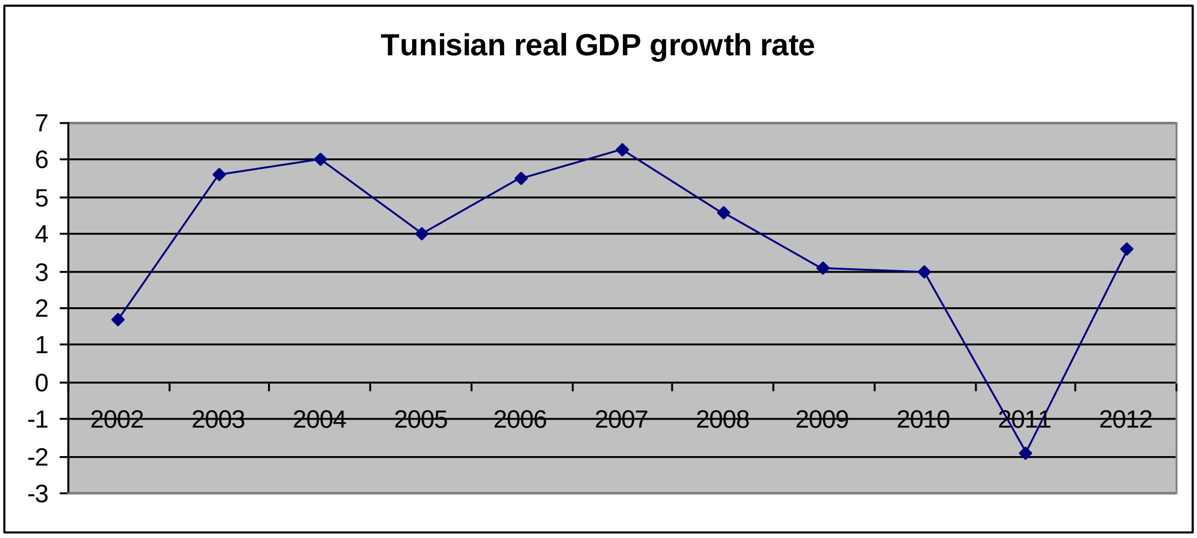
3. The Tunisian economic performance during the financial and the political crises

Table 1: Evolution of Real GDP Growth Rate

GDP growth	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Developed countries	1.7	2.0	3.3	2.6	3.0	2.7	0.2	-3.4	3.0	1.6	1.2
European union	1.1	1.3	2.4	2.1	3.3	3.1	0.7	-4.1	1.8	1.4	-0.6
Emerging countries	4.6	6.7	7.7	7.1	7.8	8.3	6.1	2.8	7.4	6.4	5.1
Tunisia	**1.7**	**5.6**	**6.0**	**4.0**	**5.5**	**6.3**	**4.6**	**3.1**	**3**	**-1.9**	**3.6**
Morocco	3.2	5.5	4.2	2.4	8.0	2.2	5.6	4.9	3.2	5.0	3.0

Source: Central Bank of Tunisia Annual Reports: 2002- 2012

Figure 1: Real GDP Growth



Economic growth in real terms was of 1.7 % in 2002. Along with the difficult international context marked by ongoing negative impacts from September 11th attacks and growing geopolitical problems, causing a drop in exports, Tunisia has had to meet the challenge of difficult national conditions marked by ongoing drought, slowing investment and lower growth in tourism. Economic activity remained sustained during the period 2003-2004 but it slowed down considerably in 2005 due notably to the combined effect of weak demand in Europe, greater world competition in the wake of dismantling of the multifibre agreements and soaring oil prices.
Despite difficult international conditions due to subprime crisis and financial markets fall, Tunisian economic growth improved in 2007 with real GDP growth of 6,3% versus 5,5% in 2006. Also, in 2008, despite the adverse effects of the international financial crisis, Tunisia has generally realised good performance thanks to the vigilance and measures taken by the authorities to limit the impact of the crisis on national economy.
Since the increase of the global crisis in September 2008, the Tunisian state has been very vigilant to deal with the consequences

of the crisis. In fact, a set of measures were taken by the authorities such as the promulgation of Law N° 2008-79 on cyclical support for economic enterprises to continue their activities. Furthermore, resistance to external shocks has been made possible thanks to the diversification of the country's economy and its high degree of integration.

Economic activity in Tunisia was, however, severely affected in 2011 by domestic events as well as the conflict in neighbouring Libya. Although Tunisia figured well in international rankings on the private sector, it has become less attractive to investors since the revolution. Tourism receipts dropped by 30 percent and FDI fell also by about 25 percent. The economic downturn and the return of Tunisian workers from Libya helped push the unemployment rate to 19 percent. Real GDP reached -1,9 % in 2011.

Tunisia has stabilized following a major political transformation, but uncertainties remain. Following successful democratic elections for a Constituent Assembly in October, a new interim-government was confirmed by the assembly in December 2011. The new government's priorities include establishing transparent and participatory governance, tackling high unemployment, supporting private investment, and developing the disadvantaged regions of the interior.

The Tunisian economy is expected to recover gradually. In 2012, real growth was of 3,6 % and is projected to reach 4,1% in 2014, supported by a gradual rebound in tourism and FDI as well as a sizable fiscal stimulus.

Nevertheless, significant downside risks remain that may impact the financial sector.

The economic impacts of the revolution will further deteriorate the banking sector's performance.

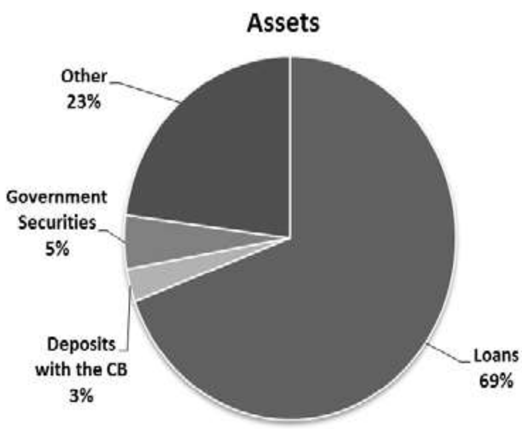
4. Structure of Tunisia's banking system

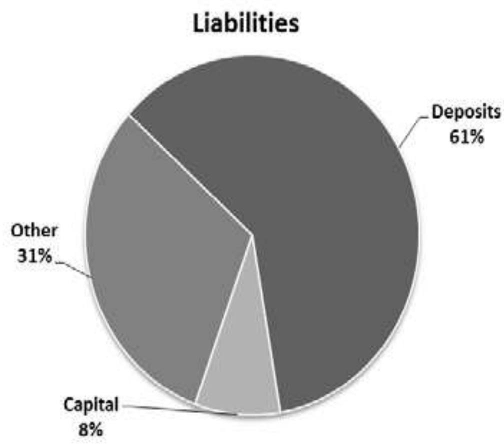
At the beginning of 2001, Tunisia banking system consisted of 4 categories of banks: 14 commercial banks, 5 development banks, 8 offshore banks and 2 merchant banks. A new law amending 1967 banking law, was introduced in 2001. This law blurred the distinction between development and commercial banks and introduced a new category of banks: the universal bank.

Merchant banks, has lost their status of bank and are considered as non-bank financial institutions. Concerning development banks which are joint venture between the Tunisian government and governments of other Arab States and whose initial mission was to support the development of specific sectors such as housing, agriculture, tourism and industry, they have been transformed into universal banks through mergers, in order to enhance their competitiveness. Nevertheless, they inherited both the policy of providing funds to specific sectors and the high level of NPLs.

Three state-owned banks control about one third of the Tunisian banking system (38.7% of total assets, 43.5% of loans and 36.5% of total deposits at the end of 2009). The significant share and roles played by the state-owned banks in the current economy shows that the Tunisian banking system is still subject to the government's interference, which weighs heavily on their performance.

Figure 2: Assets and Liabilities (end 2011)





Source: Central Bank of Tunisia

The banking system played a key role in supporting government policy through government backed loans to state-owned enterprises, but was progressively affected by the asset predation of the former president's entourage. A number of Tunisian banks have suffered from weak corporate governance. Under the previous regime, their lending decisions and ownership structures were often subject to political interference. Moreover, board members often lacked independence and their appointment was in many cases influenced more by their political position than by their skills. Some banks belonged directly or indirectly to the former president's entourage. It is estimated that about 7% of banking loans were granted to the companies controlled by the former president's extended family and entourage. Many of these loans might not be recovered until the assets are legally settled.

5. Financial soundness indicators and risk exposure

The reported data suggests that the banks' financial positions have not deteriorated during the recent financial crisis. The Tunisian banking sector has demonstrated a significant resilience to the financial crisis thanks to its rigorous policy of investment**.** By the end of 2009, the official level of NPLs was 13.2 percent, down from over 19 percent in 2006. Regulatory capital remained almost

unchanged at 11.6 percent of risk-weighted assets during the period 2007-2010, and bank profitability remained relatively unchanged during this period (the return on equity (ROE) was 10.2 percent).
However, the soundness of the sector has been deteriorating since the revolution. Tunisian banks have not been spared by the political crisis and its economic consequences.
The Tunisian banking system was already plagued with a structural vulnerability before the revolution. These weaknesses include under-capitalisation, weak reporting practices, deficiencies in the supervisory framework and inadequate management of risk. Loans to Small and Medium Enterprises (SMEs) are often granted against collateral, without evaluation of business potentials.
The difficult economic situation resulting from the political changes has stressed those vulnerabilities. Tunisian banks have been exposed to risks related to vulnerable sectors like tourism and agriculture and to companies belonging to the former president's family.
The tourism sector presents a particularly serious risk for banks in Tunisia. Over the last 15 years, multiple structural issues have undermined the financial soundness of the tourism sector, and, more recently, political instability and security concerns have pushed the sector in a severe recession. Out of the 850 hotels, it is reported that one-third is likely to be in severe financial distress during 2011.

Table 2: Capital Adequacy

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Capital adequacy ratio	**9.3**	**11.6**	**12.4**	**11.8**	**11.6**	**11.7**	**12.2**	**11.6**	**11.9**	**12.3**

Source: National authorities and IMF staff estimates
As shown in Table 2 , the ratio of bank regulatory capital to risk weighted assets ranged between Banks appear undercapitalised even though almost all banks comply with the regulatory minimum capital adequacy ratio of 8%.

Table 3: Asset Quality

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
NPLs to total loans	**24.2**	**23.6**	**20.9**	**19.3**	**17.6**	**15.5**	**13.2**	**13**	**13.3**	**13.5**
Bank provisions to NPLs	**44.1**	**45.1**	**46.8**	**49.0**	**53.2**	**56.8**	**58.3**	**58.5**	**57.3**	**57.3**

Source: National authorities and IMF staff estimates

The rate of non performing loans remained artificially stable between 2010 and 2012 thanks to exceptional measures concerning the classification of doubtful loans. In fact, in mid-2011, the CBT issued a circular allowing banks to reschedule loans due from companies hurt by the political turmoil of 2011. This circular prevented banks from placing loans into non performing loan category even if repayments fell behind by more than three months. The effects of this measure were the sector artificially low NPL ratio and the ensuing lower provisioning. Reclassifying these rescheduled loans as nonperforming would add about 5 percent to the overall NPL ratio.
State owned banks are the most vulnerable; they are affected by the increase in bad loans especially those with large exposure to the tourism sector.
Inflated collateral valuation means that provisioning for bad loans is likely inadequate, since provisions are calculated on a net-of-collateral basis. The team stressed the importance of applying international standards to loan classification, provisioning, and valuation of collateral, and cautioned that weaknesses in these areas seriously compromise the ability of the CBT to estimate and address the vulnerability of the banking sector.
In May 2011, the Central Bank issued a circular for good governance practices in banks, as a first step to improve the banking sector's governance.
A transparent and accountable management system in the banking system will help build better governance in the banking sector, and contribute to cleaning up the bank's portfolio by classifying bad loans without political considerations.

Table 4: Profitability

Source: National authorities and IMF staff estimates

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Return on assets	**0.6**	**0.4**	**0.5**	**0.7**	**0.9**	**1.0**	**1.0**	**0.9**	**0.6**	**0.8**
Return on equity	**7.5**	**5.0**	**6.1**	**7.0**	**10.1**	**11.2**	**11.7**	**10.2**	**6.6**	**9.9**

The economic downturn has had consequences for the profitability of the sector. Bank profitability reached 6.6% in 2011

Table 5: Liquidity

	2006	2007	2008	2009	2010	2011
Liquid assets to total assets	34.2	37.5	37.1	37.2	34.7	30.5
Liquid assets to liquid liabilities	**120.8**	**121.9**	**124.0**	**119.1**	**104.1**	**89.4**
Deposits to loans	**99.1**	**104.8**	**104.5**	**106.9**	**100.7**	**92.9**

Source: National authorities and IMF staff estimates

The liquidity situation worsened in 2011.
Banks' shortage of liquidity has been mitigated by central bank liquidity support. In response to the difficult operating conditions of banks since the revolution, the Tunisian Central Bank has implemented several measures such as a sharp increase in liquidity support through direct injections and the decrease of reserve requirements from 5% to 2%.
In addition, the Central Bank decided the reduction of the policy interest rate and the introduction of a maximum deposit rate to prevent banks from aggressively competing for deposits in the low liquidity environment.
Banks are not reliant on external funding, and capital controls limit possibilities for deposit flight. However, depositors can shift their deposits into cash relatively easily. Recently, deposit growth slowed while currency in circulation increased. Nonetheless, credit growth remained strong, since banks have been provided ample liquidity by the CBT at interest rates that are negative in real terms.

6. Conclusion

The results have shown that the Tunisian banks have been shielded from the impact of subprime crisis. Nevertheless, the macroeconomic environment has been deteriorating since January 2011. The uncertainty surrounding policies of the new administration have had a major effect on the financial sector development. Widespread strikes and sit-ins have continued to hamper investment an industrial activity thus weakening economic growth which resulted in increased NPLs. As a consequence, the banking sector faces significant challenges. The performance of the banking sector is affected by the macroeconomic environment in which is operates.
Loan quality, solvency, and profitability have deteriorated, and weaknesses in underwriting had led to inappropriate lending to well-connected borrowers. Moreover, weakness in supervisory reporting and data provision mean that vulnerabilities could be much higher than reported. The CBT's data on financial soundness indicators suggest continued strength in the banking sector.
The restoration of political stability and effective reforms are essential if the Tunisian economy is to return to solid growth that benefits the population as a whole. Stability would help promote investments, job creation and sustainable economic growth. The banking sector in turn, can play an essential role in financing these investments and be a motor for growth.

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