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TUNISIA

Financial System Stability Assessment Update

Prepared by the Monetary and Financial Systems and Middle East and Central Asia Departments

Approved by Charles Enoch and Amor Tahari

May 10, 2006

This report is based on the work of joint IMF/World Bank FSAP Update missions to Tunisia during January 15–31 and March 26–April 1, 2006. The mission comprised Emilio Sacerdoti (IMF/MFD, mission co-leader), Luigi Passamonti (World Bank, mission co-leader), Rodolfo Maino, Marie-Therese Camilleri, Marianne El-Khoury (all IMF); Didier Debals, Eric Haythorne, Michael Pomerleano, Pauline Aranda, Jean Pesme, Cedric Mousset, Isabelle Schoonwater, Emile Van der Does (all World Bank), Oscar Madeddu, David Welch (IFC), Guillaume Almeras (SME expert), and Jean-Luc Couëtoux (banking supervision expert, French Banking Commission). The mission met with the Minister of Finance, Mr. Kechiche, the Minister of Economic Development and International Cooperation, Mr. Jouini, the Governor of the Central Bank of Tunisia, Mr. Baccar, and other senior officials and private sector representatives. Mr. Sadok Rouai, Senior Advisor to the IMF Executive Director for Tunisia, attended some of the meetings.

The main conclusions are :

- Overall, despite recent improvements, the banking system needs to make further progress in strengthening its soundness, which will require additional supportive measures in the regulatory, judicial, and fiscal areas.

- Recent measures to strengthen bank governance and credit-risk management, improve the judicial environment, increase transparency in financial statements, and establish a 70 percent NPL provisioning target are steps in the right direction**.** However, a more focused strategy is needed to reduce the high-level of NPLs. This would include improved procedures for loan work-outs and partial write-offs, while limiting moral hazard, a more effective judicial system, extra-judicial debt settlement procedures, and improved management of the three public commercial banks.

- For public commercial banks, management contracts should be established with quantitative operational targets; if operating income is not adequate to attain the medium-term NPL provisioning target set by the authorities, they should stand ready to recapitalize these banks as needed.

- The Central Bank has achieved significant progress in terms of liquidity management, although to further deepen money markets it would be important to allow more fluctuations of money market rates. The foreign exchange market has gained depth, but restrictions on forward cover for commercial operators should be relaxed.

The authors of this report are Emilio Sacerdoti and Rodolfo Maino.

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Contents

MAIN ABBREVIATIONS AND ACRONYMS

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BCP	Basel Core Principles
BCT	Central Bank of Tunisia (*Banque Centrale de Tunisie*)
CAR	Capital Adequacy Ratio
CMF	Financial Market Board (*Conseil du Marché Financier*)
DNFBPs	Designated Non-Financial Businesses and Professions
FDI	Fund Direct Investment
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicator
IAS	International Accounting Standards
NPLs	Non Performing Loans
ROA	Return on Assets
ROE	Return on Equity
ROSCs	Report on Standards and Codes
SICAF	Investment Companies (*Société d'Investissement à Capital Fixe*)
SICAR	Venture Capital Funds (*Société d'Investissement à Capital Risque*)
SICAV	Open–end Mutual Funds (*Société d'Investissement à Capital Variable*)
SME	Small and Medium Enterprises
STR	Suspicious Transaction Report
TMM	Money Market Rate (*Taux Marché Monétaire*)

I. Summary and Overall Stability Assessment

1. **Since the 2002 FSAP a number of structural reforms have been carried out in the financial system, to increase transparency and accountability, modernize the banking system, strengthen the regulatory framework, and promote nonbank financial intermediation**.

2. **These reforms are especially important because, despite the generally good performance of the Tunisian economy in recent years, the growth slowdown in 2002, with a marked recession in the tourism sector, adversely affected the asset quality of the banking system, which plays the predominant role in the financial system.** NPLs increased from 19 percent of total loans at end-2001 to 24 percent at end-2003, and declined only modestly in 2004 to 23.7 percent, and more rapidly in 2005, reaching 20.9 percent by year-end. In 2005, operating results of all banks also improved markedly, and the banks strengthened provisions. The government majority-owned commercial banks did not distribute dividends, so as to boost loan-loss reserves.

3. **Following the 2002 FSAP, the authorities have taken a number of measures in the regulatory, fiscal, and legal areas to improve credit quality and financial transparency (Table 1).** The tax deductibility of provisions for NPLs was increased, legal reforms were introduced to accelerate the sale of collateral, two government-controlled banks were privatized, and a number of private banks were recapitalized by owners. This contributed to improved financial soundness of a number of banks, including a significant decline of the NPL ratio in 2005, in particular among the private banks and for the public mortgage bank, but weaknesses remain in some other banks. Nevertheless, there remains a need to strengthen provisioning and accelerate the reduction of the NPLs that continue to be high for the system as a whole.

4. **The authorities' strategy to improve credit quality is to require stricter governance in banks and higher provisioning.** All banks have been required to reach a provisioning ratio of 70 percent by 2009, up from 46.4 percent at end-2005. This increase will be monitored on a semiannual basis, and banks will be prohibited from distributing dividends until they meet the provisioning target. The mission emphasized that banks that will not be able to attain this target will have to undergo recapitalization and that the authorities should set a more ambitious target of NPL reduction, to no more than 10 percent of total loans by 2009, to speed up the strengthening of the banking system.

5. **The authorities noted that banks governance is improving.** New regulations requiring banks to strengthen credit evaluation and credit approval procedures and establishing stronger credit committees accountable to the bank board will be issued shortly, following the promulgation in early May 2006 of the revised banking law, which calls for the establishment of such committees. To enhance the quality of companies' financial statements and improve transparency, a new law adopted in 2005 imposes additional requirements on external auditors, reinforces the obligations for publication of financial information, and requires companies above a given size to establish audit committees. The FSAP mission

concurs that the provisions of the law are broadly appropriate to enhance transparency and accountability.

6. **The mission underscored that NPL reduction requires improved procedures for loan workouts and partial write-offs, which must be accompanied by measures to limit moral hazard.** Previous restructuring efforts paid insufficient attention to the situation of debtors, so that loan servicing continued to be incomplete, and loans remained in the NPLs category. This may reflect inadequate incentives for banks to undertake deeper restructuring, as they are allowed to rely on real estate collateral as coverage for the NPLs, without being forced to put up cash. With relatively favorable prospects of recovery in the hotel sector, and real estate values rising, banks have shown forbearance with their clients, as evidenced by the very low share of NPLs subject to judicial recovery procedures.

7. **Loan restructuring also needs a more effective judicial system, the recourse to extra-judicial procedures, and more favorable tax treatment of partial write-offs, presently not eligible for tax deduction.** There is also the need for recourse to more expert advice in debt and corporate restructuring. Collateral registration and realization needs to become more effective, and in particular delays in registration of real estate titles and mortgages, and in real estate transfers, need to be corrected.

8. **The mission recommends that the management of the three remaining government-controlled commercial banks be strengthened,** and made accountable for the achievement of precise targets, in particular regarding the decline in NPLs.

9. **The stress tests confirm the system's vulnerabilities to a sharp fall in real estate collateral value on which the banks rely heavily for covering NPL risks.** Credit risk is identified as the most important vulnerability in the Tunisian banking system. Several shocks applied to the loan portfolio of banks could reduce the capital adequacy ratio of the banking system below the minimum required level of 8 percent, although this would not generate a systemic threat. The system is not exposed to direct interest rate risk, but could eventually suffer from the adverse effect of real interest rate fluctuations on the quality of banks' credit portfolios. Foreign exchange and liquidity risks are negligible.

10. **The authorities are promoting equity financing of small- and medium-sized enterprises to decrease reliance on bank financing.** To that end, fiscal incentives have been provided to private venture and equity capital funds, which rely in part on capital from institutional investors, banks, and foreign investors. In the view of the mission these incentives appear broadly appropriate to stimulate equity financing. While the number of these funds has risen fast and their capital has expanded rapidly, their assets remain modest in comparison to the resources provided by the banking system. The capitalization of the stock market is also relatively small, and no new issues have occurred in recent years. An area of rapid development has been leasing activity, with assets rising by one half in 2000–04. However, the relative modest size of alternative sources of finance highlights the importance of a robust banking system for enterprise financing.

11. **Concerning liquidity management, the mission highlighted the importance of adopting further steps to deepen the money market, *inter alia* by allowing somewhat wider fluctuations of money market rates, presently maintained in a very narrow band by central bank interventions.** Further development of the foreign exchange market, in particular eliminating restrictions on forward operations and permitting foreign exchange options, would also help to deepen money and foreign exchange markets in the transition to a regime with wider fluctuations of the exchange rate and further opening of the capital account. The mission emphasized the importance of implementing rapidly the decision, already adopted in principle, to put an end to the requirement for banks to transfer end-of-day foreign exchange balances to the central bank.

12. **The assessment of observance of the Basel Core Principle (BCP) for Effective Banking Supervision shows a marked improvement in compliance with a number of principles, in comparison with the 2002 assessment (Annex).** This reflects improved regulation on licensing, tighter investment criteria, better information sharing, improved accounting standards, and the introduction of consolidated supervision. With regard to the AML/CFT framework, it is encouraging that important directives detailing the implementation of suspicious transaction reports have been issued in April 2006; however, a number of additional steps are needed in order to implement an effective AML/CFT system (Section IV, E).[1]

13. **The main recommendations of the FSAP Update (Table 2) require different implementation time frames.** Most recommendations can be implemented within a one-year time horizon. They include measures aimed at strengthening bank credit risk management, promoting NPL restructuring, establishing operational targets for public banks, enhancing the supervisory framework, deepening the money and exchange markets, and accelerating corporate debt restructuring. A few measures need a medium-term horizon, including achieving higher provisioning targets and strengthening banks' internal audit functions.

Key recommendations

Banking sector

- Strengthen the capital base of banks, by rigorous implementation of the authorities' target to reach 70 percent provisioning for all NPLs, without consideration of existing collateral.

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[1] A ROSC on the AML/CFT is under preparation and will be issued as a Supplement before Board consideration of the FSSA.

- Reduce by 2009 the ratio of NPLs to total loans to no more than 10 percent of loans through a proactive policy of loan restructuring, including partial write-offs, with safeguards to avoid moral hazard.

- Accelerate restructuring of bank loans to the tourism sector, on the basis of a realistic assessment of the debt repayment capacity of borrowers.

- Strengthen management of public commercial banks, ensuring full independence of management, tighter risk management procedures, and improved estimates of NPLs recovery prospects.

- Establish program contracts with management of public commercial banks including quantitative operational targets.

- Stand ready to recapitalize public commercial banks if operating income is not sufficient to reach the 70 percent provisioning target for NPLs.

- Improve the information system for lending to SMEs and households by promoting the establishment of private credit bureaus.

Prudential supervision and regulation

- Ensure rapid implementation of new rules on credit risk management, envisaged by a draft new central bank circular on internal controls.

- Establish prudential ratios on a consolidated basis.

Central bank policy, and systemic liquidity management

- Deepen interbank markets by widening the central bank narrow interest rate corridor.

- Relax restrictions on forward foreign exchange cover for commercial operators.

Corporate debt restructuring

- Promote extra-judicial procedures for debt workouts, with preset rules for creditors and debtors to speed up agreements.

- Review the preferred creditor status of tax authorities and social security agency claims.

II. Macroeconomic Context

14. **During the last decade Tunisia recorded a sustained period of economic growth, which has been among the strongest in the region, and has led to a significant reduction in poverty.** Real GDP grew on average by 5 percent per year in 2000–05, while inflation

declined and the overall balance of payments strengthened (Table 3). The external debt-to-GDP ratio has been broadly stable in recent years, while external reserves have risen gradually to the equivalent of four months of imports, and the overall fiscal deficit has remained stable at about 3 percent of GDP. Inflation declined to 2 percent in 2005, and the real effective exchange rate stabilized, following a steady decline in recent years which boosted competitiveness. The government is committed to prudent macroeconomic polices, with a view to gradually reducing the public and external debt. A key challenge is to accelerate further the growth rate, to absorb the rapidly growing labor force and increase per capita income, in the context of further trade liberalization.

15. **While the overall GDP real growth trend has been positive over the last five years, a sharp growth slowdown to 1.7 percent occurred in 2002, reflecting the downturn in tourism after the September 11, 2001 events and the 2002 bombing in Djerba.** This led to a decline of 22 percent in tourist hotel occupancy in 2002, and a further 2 percent fall in 2003, affecting the hotel industry's ability to service its bank debt at a time when significant new investment capacity was coming on stream. This contributed to a spike of NPLs, which had been on a declining trend in the late 1990s, from 19.2 percent of total loans at end-2001 to 24 percent at end-2003. NPLs declined modestly in 2004, to 23.7 percent, and more rapidly in 2005, reaching 20.9 percent by year-end.

16. **After a rapid growth in the 1990s in excess of nominal GDP, bank credit to the nongovernment sector decelerated since end-2000 because of banks' concerns about credit quality and expanded broadly in line with nominal GDP.** The ratio of bank credit to the nongovernment sector was 67 percent at end-2005, which compares favorably with other countries in the region and other emerging countries.

17. **In recent years the central bank has reduced its intervention in the foreign exchange market and has allowed more flexibility in the exchange rate, leading to a trend real depreciation.** The managed floating and the remaining capital restrictions give scope to autonomous monetary management.

18. **The authorities have also taken steps to liberalize gradually the capital account.** Priority has been given to promoting foreign direct investment, and relaxing restrictions on foreign borrowing and on outward direct investment by Tunisian companies.[2] Restrictions on inward portfolio investments have also been relaxed. Since July 2004 purchases by nonresidents of treasury bills are permitted within a limit of 5 percent of each issue; the purchase by foreign nationals of shares in Tunisian companies was fully liberalized in March 2005, but portfolio inflows have been very small. Outbound portfolio investment

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[2] Inward nonfinancial sector FDI is free. Companies can acquire equity participations abroad subject to limits (higher limits for exporters). Since January 2005 banks have been free to borrow abroad at maturities longer than 12 months. Companies with ratings are also allowed to borrow abroad.

remains subject to restrictions.[3] Further capital account liberalization is predicated on strengthening the banking and financial system, and moving to a floating exchange rate system.

19. **The authorities are aware that a sound financial system is essential in order to sustain growth and employment creation, and to strengthen the ability of the economy to resist external and domestic shocks.** While significant reforms in recent years have enhanced the transparency of financial transactions and strengthened the financial system, the high level of NPLs of the banking system represents a main weakness, which hampers the system's ability to support investment and growth.

20. **The banking sector plays a predominant role in financing the economy (Table 4).** Indeed, stock market capitalization is still limited (approximately 9 percent of GDP in 2004), new issues remain modest (TD 204 million in 2004, equivalent to 0.8 percent of GDP and 3.7 percent of private investment), and most of the growth in assets of the collective securities investment schemes is in government instruments. The venture capital investment companies (SICARs) are an appropriate instrument for financing new enterprises and have developed rapidly between 2000 and 2004 (with their assets almost tripling to TD 550 million or 1.5 percent of GDP), although in 2004 asset growth was moderate (approximately TD 40 million). The largest share of nonbank financing comes from leasing, with new operations worth TD 500 million in 2004, equivalent to 11 percent of total private investment.

III. Banking Sector Risks, Vulnerabilities, and Challenges

A. Update of Banking Sector Developments and Policy Measures

Key developments

21. **After significant improvements in the second half of the 1990s, some key FSIs of the banking system deteriorated in 2001-03, including higher NPLs.** The NPL ratio had declined to 19.2 percent at end-2001, from 25 percent in the mid-1990s, with the fall reflecting improved loan quality after an extended period of public influence on lending decisions. However, they rose again to 24 percent at end-2003 (Table 5). Loans to the tourism sector accounted for one quarter of the total NPL increase in the two years, but there were also marked increases in NPLs to industry (35 percent of the total, reflecting the restructuring under way) and the service sector. The risk weighted regulatory capital adequacy ratio (CAR) for the banking system also deteriorated between 2001 and 2003, with a decline from 11.1 percent to 9.9 percent.

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[3] Accumulation of assets abroad by residents is subject to authorization. Commercial banks still have to transfer to the BCT their foreign exchange balances at end-of-day.

22. **Financial soundness indicators started improving in the second half of 2004, and more substantially in 2005,** with the aggregate CAR rising to 10.7 percent, and the NPL ratio declining by 2.8 percentage points to 20.9 percent at end-2005, as previously indicated.

23. **There are significant differences in financial soundness indicators between banks, with private banks performing better as a group than the three government majority-owned banks (public banks).** Out of 13 commercial banks, excluding development banks that have received universal banking licenses in 2005 (see below), 10 were under private ownership, and 3 under government majority ownership, following the privatization of two banks in 2002–05.[4] At end-2005, the public banks' assets account for 44.5 percent of total commercial bank assets. The NPL ratio is higher for the three public banks as a group than for the ten private banks (at end-2005 the ratio was 22.1 percent for the former and 20 percent for the latter, Tables 6 and 7). However, even within these groups there are significant differences, with NPL ratios at end-2005 ranging from 7 percent to 24 percent for private banks, and between 10 and 32 percent for public banks. The CAR ratios and the rates of return on equity and on assets are not very different among the two groups of banks, again masking significant intragroup variations, the aggregate data for the private banks being lowered by two banks in the process of recapitalization.

24. **Prudential regulations allow real estate and financial collateral to be taken into account in determining the amount of provisions required against NPLs, in conformity with international standards.** For the whole system, the provisioning ratio was 46 percent at end-2005, up from 43 percent at end-2003. As the value of real estate collateral is subject to unavoidable uncertainty, the relatively low provisioning ratio increases the vulnerability of the system to external shocks. To increase the resilience of the system, the authorities have set a target of 70 percent provisioning by 2009; supporting measures include raising the tax deductibility of provisions to 85 percent in 2004 and to 100 percent in 2005. To boost provisioning in banks, they prohibited dividend distributions in 2005 and in 2006.

25. **While private banks as a group have a provisioning ratio similar to public banks (about 46 percent at end-2005), this result is influenced by the private banks under recapitalization.** A number of private banks, accounting for 17 percent of total assets of the system, have already reached the 70 percent provisioning target, in part through recent capital injections. Others aim to reach it over the next two years to boost their international rating. In contrast, with the government not planning additional capital injections in the

[4] The banking system also comprises eight off-shore banks, one public micro-finance institution, and one bank specialized in cofinancing with other banks loans to small- and medium-scale enterprises.

public banks, their ability to attain the 70 percent provisioning target by 2009 remains in doubt.[5]

26. **Net income before provisions has eroded in public banks since 2000.** This reflects in part higher NPLs, which reduced interest earnings, while non interest income has remained flat. With provisions increasing by about half, the rate of ROA and on ROE dropped sharply since 2000. In private banks, net income before provisions more than doubled between 2000 and 2005, due to a rise in both interest- and non-interest income. This has allowed private banks to more than double provisions.

Policy measures

27. **Since 2001, the authorities have taken a number of measures to strengthen the credit culture, and enhance financial transparency.** These measures, detailed below, include actions to strengthen the reliability of financial statements, enhance bank credit risk management, and improve creditor rights, along the lines recommended by the 2002 FSAP. While concurring that these steps go in the right direction, the mission underscored that further measures are needed in the regulatory, tax, and judicial areas to promote NPL restructuring and enhance credit quality.

28. **In 2001 the revision of the banking law tightened the rules on investments and bank licensing, and increased the minimum capital requirement.** It required banks to obtain external auditor reports and certified financial statements on each borrower above a certain loan threshold, and to tighten banks' exposure limits. The newly revised banking law, promulgated in early May 2006, requires banks to establish an executive credit committee reporting to the board of directors, and to put in place a compliance control system also under the supervision of the board.

29. **New transparency requirements on companies have been introduced by the 2005 law on financial transparency**. In particular: (i) all stock corporations and all commercial companies with balance sheet exceeding a given threshold must appoint external auditors with a term limit of three years; (ii) all companies raising funds from the public are subject to tighter information obligations; (iii) external auditors must transmit their reports to the central bank when companies raise funds from the public and when their bank borrowing exceeds a certain limit; (iv) companies with consolidated accounts and with total balance sheet exceeding a threshold must have two external auditors; and (v) permanent internal audit committees must be instituted in all stock-market listed companies and in those unlisted with a balance sheet exceeding a given threshold.

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[5] To assess the banks' ability to constitute adequate provisions, the staff carried out simulations of the banks' income generating prospects to 2009.

30. **Creditor rights have been strengthened** through the revision in 2003 of the 1995 law on companies restructuring, and the revision in the civil procedure code to facilitate the auctioning of real estate collateral.[6]

31. **The banking system restructuring process was accelerated** with the full privatization in 2002 and 2005 of two banks and the transformation of all the five development banks (jointly held with foreign governments) into universal banks, one of which is also under privatization.

32. **While acknowledging the breadth of the measures taken so far, the mission recommended that the target of increased provisioning be complemented by a more aggressive policy on reducing NPLs, to no more than 10 percent of loans by 2009, including through partial write-offs and well-designed loan restructuring.** The mission underscored that in the absence of a rapid decline in NPLs the provisioning target may prove very costly, and indeed unattainable by public banks without additional capital infusions. The mission noted that a policy of NPL restructuring can be more easily implemented in the tourism sector, where the number of companies is relatively small, and the cash flow forecasts and sustainable debt service profiles are easier to evaluate.

33. **The mission also recommended that the reinforced strategy on NPLs be accompanied by close central bank monitoring of loan recovery and restructuring, and be backed by improvements in the judicial, legal, and tax environment.** More recourse should be made to extrajudicial procedures with a voluntary workout process, accompanied by rules to facilitate agreements between creditors and debtors.[7] To avoid moral hazard, any debt restructuring or write-off should be accompanied by dilution of debtors' control over assets. Existing judicial procedures for companies restructuring under the 1995 enterprise restructuring law should be improved, to allow prompter initiation of procedures before enterprises enter into serious difficulties. The judicial procedures should also be tightened, with less possibility of delaying tactics by debtors. Commercial courts could also play a more active role in settling commercial disputes.

34. **Regarding the regulatory and tax area**, **the present preferred creditor position of the tax and social securities authorities should be reexamined.** If these agencies would forego part of their claims in conjunction with the write-offs by other creditors, banks would have more incentive to push for debt restructuring. Partial write-offs should be tax

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[6] Sale of collateral by auction has been speeded up, with the norm that after an initial deserted auction the base price of the asset for the successive auction can be reduced by 40 percent.

[7] These rules could provide for standstill periods, qualified majority agreements binding all creditors, and provisions for creditors and debtors to absorb losses through haircuts and equity dilution, respectively.

deductible. Also, the write-off process for fully provisioned loans should be speeded up, by eliminating existing barriers to the tax neutrality of these operations.[8]

35. **Bank lending to the household sector has increased rapidly since 2002, but remains still at a low level (17 percent of total loans).** As loans to households are likely to increase in the future at a faster pace than total loans, it is necessary for banks to improve their credit risk management systems. It would also be important to establish a credit bureau specialized in assessing the creditworthiness of households and small-and medium- scale enterprises.

B. Stress Tests

36. **The mission conducted stress tests of the banking system, which are designed to examine the impact of large shocks which inherently have low probability of occurrence**.[9] The results (Table 8) show that the system is fairly resilient; the shocks would result in the need of recapitalization for some banks, but would not generate systemic threats.

Foreign exchange, liquidity, and interest rate risk

37. **Commercial banks have very limited exposure to foreign currency and liquidity risk**. Banks hold a very small net open position in foreign currency (below 1 percent of capital), and foreign exchange lending is below 3 percent of the total. Banks have limited exposure to contagion risk due to a small interbank market.

38. **Banks also show very limited sensitivity to interest rate fluctuations because most credits and interest-bearing deposits are indexed to the money market rate.** An interest rate increase would affect their portfolio of fixed rate government bonds, which has been increasing in recent years. The calculations assume that securities are "marked-to-market," i.e., changes in their market value have a direct impact on the capitalization of the banks.[10] Increasing rates by about 200 basis points would cause a fall in the CAR by less than

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[8] At present, certain requirements have to be met for the write-offs to be non taxable. These include no recovery on the overdue loans for at least two years, and the existence of a final judicial ruling on the non recoverability of the credit.

[9] Stress tests have been carried out on the largest 10 commercial banks in Tunisia, both private and state-owned, excluding former development banks, that account for more than 90 percent of the total assets of the entire banking system**.** They were based on end-2005 balance sheet data.

[10] In the absence of more accurate duration data, a weighted average residual maturity for the government bonds portfolio of each Tunisian bank is used to measure the impact of a shock of the TMM of 200 basis points. This, in turn, leads to increases in the yields of the government bonds portfolio at each maturity bucket. It is assumed that an increase in TMM leads to a parallel movement in the whole yield curve.

one percentage point from the end-2005 level of 10.5 percent for the sample of banks tested. However, for two banks, for which the government bond portfolios represent a significant portion of their total assets, the loss is relevant, with one bank suffering a fall in its CAR of 3.8 percentage points. Interest rate increases could also affect the solvency of some creditors, and the value of real estate collateral, and thus adversely affect the health of the banking system.

Real estate collateral and credit risk

39. **The substantial reliance of banks on real estate collateral to cover NPL risk exposes them to considerable vulnerabilities, should the value of collateral decline.** To estimate the extent of this vulnerability it was assumed that real estate collateral declines by 50 percent, because of a generalized shock on real estate values. This resulted in a reduction of the CAR to 7.3 percent, with the ratio for some banks falling as low as 4.6 percent.

40. **Credit risk represents the key risk to which commercial banks are exposed.** The magnitude of the credit risk stress tests have been calibrated so as to replicate the major distress episodes that occurred during 2001–03. The most severe credit shock assumes a migration of 8 percent of the stock of performing loans to the NPL loss category (past due over 360 days); this would decrease the CAR of the system to 5.5 percent. Applying a simultaneous real estate collateral haircut of 50 percent would curtail the CAR to 1.9 percent. Other credit risk stress tests performed assumed the migration of current loans to tourism, industry, and the real estate sector to the loss category reflecting the 2001–04 experience.[11] Without a simultaneous 50 percent cut in real estate collateral, these shocks would result in a fall in the CAR to a range of 9.3 to 10 percent. With a simultaneous cut in real estate collateral of 50 percent, the CAR would decline to a range between 6 and 6.8 percent.

41. **Stress tests show a highly differential impact across individual banks and moderate differences on average between the private and the state-owned banks.** As observed in the stress tests conducted in the 2002 FSAP, some banks are able to withstand even the most severe of shocks and retain a solvency ratio of 8 percent or higher, while others slip below the 8 percent minimum capital requirement. Some even become insolvent, reaching a negative ratio. On average, state-owned banks fare worse than private banks, though by a limited margin. It is worth noting that two private banks, which are in the process of being recapitalized, start out with relatively low levels of capital, thus driving down the results for private banks on average.

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[11] The stress tests are based on the experience of increase in NPLs for loans to different sectors in 2001–03. They involve a migration of either 16 percent of performing loans to tourism, or 6 percent of performing loans to industry, or 4 percent of performing loans to real estate, to the NPL loss category (past due over 360 days).

Scenario analysis

42. **A scenario analysis, which assesses the impact of combined shocks on the capital adequacy ratio, was also carried out.** An increase in interest rates could affect the ability of borrowers to repay loans, thus affecting the credit quality of the bank portfolio. It could also reduce the value of real estate collateral. This scenario was tested by combining a 200 basis shock on the money market rate, a 4 percent migration of performing loans to the loss category, and a 50 percent decline in the value of collateral. Under this scenario, the CAR drops to 3.9 percent. To bring the capital ratio to its minimum requirement of 8 percent, the system would require a recapitalization equivalent to 2.2 percent of GDP, corresponding to one third of its current capital base.

C. Bank Regulation and Supervision Update

43. **The quality of bank supervision and regulation has improved since the 2002 FSAP, as indicated by progress in BCP implementation.** A summary of the assessment is presented in the Annex. Some important improvements include the requirement for commercial borrowers to submit audited financial statements when their bank indebtedness exceeds a given threshold, and the introduction of new rules on banks' equity participation. Central bank monitoring of credit risk has been enhanced, and inspectors' training improved. The role of banks' external auditors in the supervisory system has become significant, as they have to submit a number of reports to the central bank, and attend the periodic meetings of the central bank with the supervised institutions.

44. **In the area of credit policy and provisioning, further progress needs to be made in strengthening banks' credit policy, close monitoring of doubtful credits, and loan recovery.** Provisioning should take into account the actual prospects of doubtful loan recovery, and their related time dimension, in line with international accounting standards.

45. **Tighter internal control mechanisms will be required by a draft new central bank circular, which is expected to be issued shortly.** This will require banks to strengthen their risk assessment methods, apply a rating to each borrower, monitor their exposure on a quarterly basis, and carry out stress tests to assess the adequacy of their equity position. In compliance with the 2006 revised banking law, each bank will also have to establish an executive credit committee that will be in charge of credit policy and will respond to the board of directors or the supervisory board. The FSAP mission recommends that these new management systems be implemented without delays.

46. **While stricter rules have been introduced in connected lending and investment, there is a need to further improve regulations in these areas.** Equity participations taken in the process of loan restructuring should be subject to central bank authorization, when they exceed the regulatory threshold of 30 percent of capital of the beneficiary company.

47. **The progress in consolidated supervision has been modest, despite the reforms in the accounting law in 2003 mandating consolidated accounts.** There is a need to monitor prudential ratios on a consolidated basis, and to strengthen relations with the other financial

sector supervisors; also, NPLs transferred to fully-owned asset management companies should be monitored more closely.

D. Public Banks

48. **The authorities are of the view that following the privatization of two majority government–owned banks in 2002–05, the structure of the banking system is broadly appropriate, and privatization of the remaining three commercial banks under government majority control is not envisaged.** Out of the three, one is specialized in mortgage lending (Banque de l'Habitat), one is the key lender to the agricultural sector (Banque de l'Agriculture), and the third has a diversified portfolio, with large exposure to the tourism sector (Société Tunisienne des Banques, the largest bank in the country).

49. **The recent trends of gross income and income before provisioning of public banks is less favorable than for private banks.** Their cost-income ratio is also higher. This points to the need to strengthen the management of the three banks. This should be achieved by ensuring that the board of directors is completely independent from external influences, and by making management accountable for the attainment of precise operational targets, in particular regarding loan recovery and NPL reduction. Provided adequate progress is achieved over the next 24 months on the basis of a number of indicators, the government should stand ready to recapitalize these banks, if operating income is not sufficient to strengthen the provisioning of NPLs.

E. Former Development Banks

50. **The five existing development banks received in 2004–05 universal banking licenses.** Each of these institutions is jointly owned by the Tunisian government and the governments of four Gulf States and Libya. They carry a very high capital-asset ratio, with their equity base being the main source of funding. In the past, they have specialized in medium- and long-term financing, and their equity investment represents a larger share of assets than for commercial banks. The government's strategy is to promote their privatization, which could be followed by mergers with commercial banks. The mission encourages the authorities to speed up this process, in order to establish stronger institutions.

IV. Other Financial Sector Issues

A. Capital Markets

51. **The development of the capital markets over the last few years has presented mixed results.** New issues on the stock exchange have been modest, and the capitalization of the stock exchange has not increased in recent years, remaining at 9 percent of GDP. Some family-owned enterprises are still reluctant to be listed on the stock exchange, although the 2005 law on financial transparency has reduced the difference in information and certification requirements between listed and unlisted companies.

52. **More positively, mutual fund resources have expanded at an average annual rate of 9 percent in 2000–04.** At end-2004, 40 percent of their assets were invested in government bonds and 24 percent in bonds and shares of private companies, with the remainder placed in liquid assets. The expansion of venture capital funds (SICARs) has been very rapid, both in terms of new entities established (an increase of 50 percent from 2000 to 2004), and in terms of assets (threefold increase in 2000–04 up to the equivalent of 1.6 percent of GDP); they are specialized in channeling resources both to new projects and companies, and to restructuring initiatives.

53. **The bond market is modernizing and gaining depth.** Secondary market transactions have increased, although they remain modest, and a yield curve has been recently established for government paper by the financial market supervisory authority (CMF). It would be beneficial to disclose this yield curve more widely to financial market participants. Efforts are being made to establish a similar curve for private bonds. This should facilitate the issuance of private debt paper, indexed to benchmarks, and widen the range of financial instruments. The public debt directorate has made progress in creating benchmark issues, by reopening existing bond issues, and by increasing the size of issues.

54. **Leasing has developed in a successful manner, with a 50 percent increase in assets between 2000 and 2004, and leasing companies are among the main private bond issuers.** This is an effective channel for meeting the financing needs of small- and medium-scale enterprises.

55. **Inflows of foreign capital for purchases of Tunisian shares were liberalized in early 2005, but purchases of nonresidents have been limited so far.** However, this liberalization is likely to deepen over time the Tunisian capital market.

B. Regulation and Supervision of Insurance Companies

56. **The 2002 FSAP found that supervision of insurance companies was inadequate.** State-owned and mutual companies were under-capitalized and under-reserved, in contrast with the large private companies, which maintained adequate capital and reserves. The insurance regulatory statute also exhibited significant weaknesses, and supervisory resources were insufficient.

57. **Against this background, the authorities implemented a number of significant reforms.** The insurance regulatory statute was overhauled by law in 2002 with the adoption of prudential norms in line with international practices, specifically concerning solvency requirements and minimum capital. The supervisory agency was completely reorganized, with a significant strengthening of resources dedicated to off-site and on-site inspections. To promote life insurance contracts, tax deductibility of premia paid by employees and employers was introduced in 2002, and annuity income became tax exempt from 2004.

58. **Further revisions to the insurance regulatory statute, involving tighter companies' governance rules, have been submitted to parliament in early 2006.** Areas in which the regulatory and supervisory framework are being enhanced include: (i) the

supervision of life insurance contracts with guaranteed minimum returns, which are creating risks for companies given the interest rates decline; and (ii) the review of life insurance premia, which have to be updated on the basis of new mortality tables under preparation.

59. **The opening of the capital of the largest state-owned company to a strategic investor is under way.** A number of private companies are also strengthening their capital, through new strategic partners. Given the importance of placing all operating companies on a sound financial basis, the process of boosting capital with outside injections should be accelerated.

C. Payments System

60. **A new real time gross settlement system, which was under consideration at the time of the 2002 FSAP, is now in the last phase of testing**. The system will become operational in a few months. It meets best practice requirements, including settlement finality, fully collateralized intraday central bank advances, and optimization procedures for queues.

D. Liquidity Management

61. **The BCT has achieved significant progress in terms of liquidity management.** In particular, the BCT improved its forecasts of autonomous liquidity factors and increased its recourse to open market operations. In line with the recommendations of the 2002 FSAP and Article IV consultation reports, significant efforts were directed toward strengthening the interbank market. Thus, on several occasions in 2005, the BCT refrained from providing liquidity through its weekly credit auctions (*appel d'offres*) to allow the banks to turn to the interbank market instead. The monthly average volume of transactions on the interbank market tripled between 2002 and 2005, although it remains modest when scaled against monetary aggregates.

62. **To strengthen the interbank market, it is necessary to widen the very narrow money market interest rate band currently maintained by central bank interventions.** This would increase the incentives for the commercial banks to manage their liquidity needs more effectively. It would also prepare the banks for the prospect of potentially larger exchange rate fluctuations, in the context of further exchange and capital account liberalization, which would lead to closer links between money and exchange markets. Wider money market interest rate fluctuations would imply a smaller presence of the BCT in the markets; this should be limited to weekly credit auctions and open market operations, with much less recourse to fine-tuning operations.

63. **The foreign exchange interbank market has deepened considerably in recent years, as the transactions' volume increased by 46 percent between 2002 and 2005.** Transactions on the forward market also increased, enabling hedging of exchange rate risk. However, it would be beneficial to relax some restrictions which currently limit how

companies can obtain forward cover.[12] It is also recommended that banks be allowed to sell foreign exchange options to their customers, in order to widen the range of available hedging instruments.

64. **The decision to proceed to a full repeal of the current requirement that banks transfer end-of-day foreign exchange balances to the BCT should be rapidly implemented.** It should be accompanied by close monitoring of banks' external positions to ensure that any exposure thereby incurred falls within prudential norms.

E. AML/CFT

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

66. **Overall, the implementation of the AML/CFT Law is still at an initial phase.** The prosecutorial authorities have begun using the CFT component of the law, but on a limited basis. Beyond this, the Tunisian authorities should lay out a criminal policy on their fight against money-laundering, based on a more comprehensive risk-assessment and analysis of criminal patterns in the country. A Financial Intelligence Unit (FIU) has been formally set up within the BCT. Only a handful of STRs have been filed with the FIU in more than two years. The key challenge going forward lies therefore in implementation and enforcement, in particular through a more active supervision of compliance of the financial sector with their AML-CFT requirements. The adoption of two directives in April 2006 by the FIU is in that regard a welcome step forward. While the first directive deals with the STR template, the second one details requirements on due diligence, internal controls, and suspicious transactions reporting obligations for credit institutions, off-shore banks and the Postal Office. However, it needs to be complemented in the short term by circulars to be issued by the central bank.

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[12] At present forward cover can be bought by commercial operators only on maturities that are closely aligned with the timing of the underlying commercial operations.

Table 1. Implementation of Tunisia 2002 FSAP Recommendations

Principal Recommendations (By Area)	Status 1/
A. Transparency	
Revise Central Banking Law to indicate that the priority objective of the BCT is monetary stability. Clarify criteria for appointing and removing Board members.	PL
Present more systematic assessment of results of monetary policy compared with objectives.	PI
BCT should produce a periodic report on banking supervision.	NI
BCT's accounts should be systematically audited by independent authority.	PL
B. Bank regulation and supervision	
Strengthen loan evaluation and loan loss provisioning.	PI
BCT should ensure that appraisal of collateral is based on net realizable value	PI
BCT should introduce time limits on deducting real estate collateral values from provisioning requirements.	NI
BCT should analyze financial information on both individual and consolidated basis.	PI
BCT should use in a systematic manner its powers to bring about corrective actions in banks.	PI
BCT should establish formal agreements on information sharing with foreign supervisory authorities.	PL
C. Credit policy and enterprise finance	
Banks should refuse to finance excessively leveraged tourist projects.	PI
NPLs should be transferred to asset management companies (AMC) with adequate expertise in loan recovery, collateral realization, and enterprise restructuring.	PI
AMCs should seek local and foreign partners.	PI
Financial structure of enterprises must be strengthened, and leverage reduced.	PI
D. Securities regulation and supervision	
Security regulations should be enforced more strictly, and severity of sanctions increased.	PI
Consolidated accounts for industrial, commercial and financial groups need to be established.	FI
In collective investment schemes Chinese walls between various activities of managers need to be established.	PI
E. Insurance regulation and supervision	
DGA (the insurance regulator) must have full authority to reject license applications and change in control.	FI
DGA must be able to evaluate and challenge valuations assumptions for technical reserves.	FI
DGA must establish rules and regulations on code of conduct and conflict of interest.	PL
Restructure and strengthen under-capitalized companies.	FI
F. Payments Systems	
For the check clearing system, BCT should ensure that clearing and settlement is done the same day.	NI
BCT should implement measures to reduce the long delay for beneficiaries to receive credit for deposited checks.	PI
The establishment of a real time large value transfer system (RTGS) should be accelerated.	FI
G. Liquidity management	
Role of government securities in BCT's monetary operations should be expanded.	PI
BCT should discontinue use of claims on strategic sectors in refinance operations.	FI
H. Financial sector strategy and crisis management	
Authorities need to reconsider extent of state-ownership of banks and open markets to greater foreign competition.	PI
BCT should be ready to cope with specific banking crisis.	PI
BCT should undertake detailed study of modalities of a new deposit insurance scheme.	NI

1/ FI=fully implemented; NI= not implemented; PI=partially implemented; PL=pending legislation

Table 2. Main FSAP Update Recommendations

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

ST= Short Term; MT=Medium Term

Table 3. Tunisia: Selected Economic and Financial Indicators, 2000–2005

	2000	2001	2002	2003	2004	Est. 2005
Production and income (percent change)						
Nominal GDP	8.2	7.8	4.1	7.6	8.8	6.2
Real GDP	4.7	4.9	1.7	5.6	6.0	4.2
GDP deflator	3.3	2.7	2.4	2.0	2.6	1.9
Consumer price index (CPI), average	3.0	1.9	2.8	2.8	3.6	2.0
Gross national savings (in percent of GDP)	22.8	23.2	21.8	22.0	21.9	22.7
Gross investment (in percent of GDP)	27.3	27.9	25.7	25.1	24.2	23.9
External sector (percent change)						
Exports of goods, f.o.b. (in $)	-0.4	13.6	3.4	17.1	20.6	8.4
Imports of goods, f.o.b. (in $)	1.0	11.2	-0.2	14.7	17.6	2.8
Exports of goods, f.o.b. (volume)	7.3	15.7	1.9	7.2	10.6	1.2
Import of goods, f.o.b. (volume)	6.5	13.6	-2.4	3.4	7.3	-5.7
Trade balance (in percent of GDP)	-11.6	-11.8	-10.1	-9.1	-8.7	-6.8
Current account, excl. grants (in percent of GDP)	-4.2	-4.2	-3.5	-2.9	-2.0	-1.3
Foreign direct investment (percent of GDP)		2.2	3.6	2.1	2.1	2.5
Terms of trade (deterioration -)	-2.1	0.1	-0.7	-1.5	-0.5	-1.8
Real effective exchange rate (depreciation -) 1/	2.3	-2.4	-0.2	-5.0	-3.4	-4.5
Central government (percent of GDP, unless otherwise indicated) 2/						
Total revenue, excluding grants and privatization	24.0	24.0	24.4	23.6	23.9	24.0
Total expenditure and net lending	27.9	27.8	27.8	27.0	26.8	27.2
Central government balance, excl. grants and privatization	-3.9	-3.8	-3.5	-3.4	-2.9	-3.2
Central government balance, incl. grants, excl. privatization	-3.7	-3.5	-3.1	-3.2	-2.6	-3.0
Total government debt (foreign and domestic)	60.8	62.7	61.5	60.4	59.7	59.0
Foreign currency public debt (percent of total debt)		62.4	63.5	64.4	63.2	63.9
Money and credit (percent change)						
Credit to the economy	8.0	10.3	6.7	4.6	5.3	7.5
Broad money (M3) 3/	13.2	11.3	5.2	6.3	10.3	10.8
Velocity of circulation (GDP/M3, deposit money banks)	1.88	1.84	1.83	1.85	1.81	1.81
Liquidity aggregate (M4)	4.47	6.41	3.92	5.64	9.5	10.9
Velocity of circulation (GDP/M3)	1.71	1.65	1.64	1.66	1.63	1.56
Interest rate (money market rate, in percent, e.o.p)	5.88	5.94	5.91	5.00	5.00	5.00
Official reserves						
Gross official reserves (US$ billions, e.o.p)	1.8	2.0	2.3	3.0	4.0	4.4
In months of imports of goods & services, c.i.f.	2.4	2.3	2.7	3.0	3.5	3.7
Total external debt						
External debt (US$ billions)	11.4	12.9	15.2	17.9	19.8	18.5
External debt (in percent of GDP)	59.0	65.8	67.6	67.2	67.8	67.9
Debt service ratio (percent of exports of GNFS)	22.6	15.6	17.2	15.1	16.2	14.5
Financial market indicators						
Stock market index 4/	1443	1,267	1,119	1,250	1,332	1,615
Memorandum items:						
GDP at current prices (TD millions)	26685	28,757	29,933	32,212	35,035	37,202
GDP at current prices (US$ billions)	19.5	20.0	22.4	26.7	29.2	27.3
GDP per capita (US$)	2036	2,068	2,294	2,699	2,942	2,713
Unemployment rate (in percent)	15.7	15.1	15.3	14.5	14.2	14.3
Population (millions)	9.6	9.7	9.8	9.9	9.9	10.1
Poverty rate (World Bank, "core poverty", 2000)	4.1	...	...	...	...	...
Exchange rate: dinar/US$ (average)	1.37	1.44	1.42	1.29	1.25	1.30

Sources: Tunisian authorities and staff estimates and projections
1/ Information Notice System.
2/ Excludes the social security accounts.
3/ Financial system (Deposit money banks and Development banks)
4/ TUNINDEX. (1000 = 4/1/1998).

Table 4. Tunisia Financial System Structure, 2000 and 2004

Type of Institution	2000 Institutions	2000 Assets (MD)	2000 % in Total Assets	2000 % of GDP	2004 Institutions	2004 Assets (MD)	2004 % in Total Assets	2004 % of GDP
Commercial banks	13	19,613	62.5	73.5	16	31,138	69.7	88.7
State-controlled	5	11,676	37.2	43.8	3	13,677	30.6	39.0
Private	8	7,936	25.3	29.7	13	17,461	39.1	49.7
Development Banks	6	1,119	3.6	4.2	2	407	0.9	1.2
Off-shore Banks	8	1,961	6.2	7.3	8	2,080	4.7	5.9
Postal checking system (CCP) 1/	1	1,000	3.2	3.7	1	1,150	2.6	3.3
Postal saving bank (CENT) 1/	1	800	2.5	3.0	1	920	2.1	2.6
Leasing companies	9	861	2.7	3.2	11	1,275	2.9	3.6
Factoring companies	2	30	0.1	0.1	3	72	0.2	0.2
Open-end mutual funds (SICAV)	28	1,398	4.5	5.2	34	1,998	4.5	5.7
Investment companies (SICAF)	85	469	1.5	1.8	92	490	1.1	1.4
Venture capital funds (SICAR)	26	207	0.7	0.8	38	547	1.2	1.6
Insurance companies 1/	16	1,300	4.1	4.9	16	1,508	3.4	4.3
Pension funds 1/	2	2,500	8.0	9.4	2	2,900	6.5	8.3
Microfinance institution (Banque Tunisienne de Solidarité, BTS) 1/	1	143	0.5	0.5	1	180	0.4	0.5
Total	198	31,399	100.0	117.7	225	44,665	100.0	127.2

Source: BCT
1/ Estimates for 2004

Table 5. Tunisia: Commercial Banks- Financial Soundness Indicators, 2000-05
(In percent, unless otherwise indicated)

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

Source: Banque Centrale de Tunisie
1/ Total disbursed loans(excluding off- balance sheet commitments).
2/ Defined as total exposures greater than 25% of bank capital.
3/ Data on household loans are not available for 2000 and 2001. They are included in loans to enterprises.
4/ Excluding credit for social housing in 2000 and 2001.
5/ After tax
6/ Quarterly averages; average assets net of provisioning and interest in suspense.
7/ Gross income is defined as interest income minus interest expenses plus net commissions ad fees plus net gains on bond portfolio.
8/ Liquid assets and short term liabilities as defined in the BCT liquidity ratio regulation.

Table 6. Tunisia: State-Owned Commercial Banks- Financial Soundness Indicators, 2000-05
(In percent, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
Capital adequacy						
Regulatory capital to risk-weighted assets	11.8	11.8	10.1	11.5	10.8	10.7
Regulatory tier I capital to risk-weighted assets	11.3	11.3	9.6	11.0	10.4	10.3
Capital to assets	8.1	7.7	7.8	7.6	7.2	7.2
Asset quality						
Nonperforming loans to total gross loans	26.8	22.8	24.3	26.7	27.4	22.1
Nonperforming loans net of provisions to capital	146.4	123.5	163.2	152.5	165.3	134.6
Provisioning ratio	46.6	47.1	42.9	46.2	47.6	46.3
Provisioning ratio (net of interest in suspense)	30.1	31.2	26.0	33.0	35.1	33.3
Foreign currency loans to total loans 1/	1.6	1.4	1.2	1.8	1.1	1.3
Large exposures to capital 2/	85.4	61.9	86.0	79.8	74.9	…
Sectorial distribution of total loans						
Total loans to residents	99.4	99.7	99.7	99.7	99.8	99.7
Loans to private sector	87.4	91.7	92.7	90.8	91.4	91.3
Households 3/	…	…	19.9	19.7	20.4	22.4
of which: housing loans	…	…	15.2	15.4	15.3	15.3
Enterprises	85.8	89.6	70.7	69.1	68.4	66.2
Financial institutions	1.6	2.1	2.1	2.1	2.6	2.7
Loans to public sector	12.0	8.0	7.0	8.9	8.4	8.5
Government	0.0	0.0	0.0	0.0	0.0	0.0
Public enterprises	12.0	8.0	7.0	8.9	8.4	8.5
Total loans to non-residents	0.6	0.3	0.3	0.3	0.2	0.3
Distribution of private sector loans by sector of economic activity						
Agriculture	11.9	11.9	11.4	11.9	10.5	10.1
Industry	36.2	28.4	26.6	26.7	27.4	27.2
Real estate 4/	18.9	21.3	23.0	23.5	22.8	23.1
Services	32.9	38.4	39.0	37.9	39.3	39.6
Tourism	17.6	17.9	18.1	17.9	17.1	14.9
Commerce	10.2	8.6	9.1	9.4	9.8	10.0
Other	5.1	11.8	11.7	10.5	12.5	14.7
Distribution of Nonperforming loans by sector of economic activity						
Agriculture	8.8	10.8	10.9	8.3	9.1	8.9
Industry	37.8	33.9	33.1	32.6	30.2	30.4
Real estate	3.9	6.6	7.8	8.7	7.9	7.8
Services	49.5	48.7	48.3	50.5	52.9	52.9
Tourism	37.3	35.8	35.9	38.1	39.4	35.9
Commerce	3.7	3.8	4.7	4.5	6.9	7.5
Other	8.5	9.1	7.7	7.9	6.6	9.5
Earnings and Profitability						
Return on Average Assets (ROAA) 5/ 6/	1.1	0.9	0.5	0.5	0.2	0.5
Return on Average Equity (ROAE)5/ 6/	12.7	9.5	5.4	5.2	2.8	6.7
Interest margin to gross income 7/	61.0	59.4	58.5	58.7	59.5	61.5
Noninterest expenses to gross income 7/	59.0	64.5	69.2	73.1	73.5	64.2
Personnel expenses to noninterest expenses	68.2	67.9	67.0	69.3	70.7	71.0
Net gains on bond portfolio and other financial instruments to gross income 7/	15.4	15.4	13.7	12.1	13.8	12.5
Average lending-deposit spreads	…	…	…	…	…	…
Liquidity						
Liquid assets to total assets 8/	…	23.5	19.6	19.1	20.0	20.7
Liquid assets to short-term liabilities	…	100.3	99.0	105.6	118.9	120.6
Customer deposits to total (noninterbank) loans	46.3	45.9	46.6	46.2	46.9	46.8
Foreign currency liabilities to total liabilities	4.4	3.9	5.3	4.6	5.3	5.0
Sensitivity to market risk						
Net open position in foreign exchange to capital	…	0.2	0.2	0.2	0.2	0.2

Source: Banque Centrale de Tunisie
1/ Total disbursed loans(excluding off- balance sheet commitments).
2/ Defined as total exposures greater than 25 percent of bank capital.
3/ Data on household loans are not available for 2000 and 2001. They are included in loans to enterprises.
4/ Excluding credit for social housing in 2000 and 2001.
5/ After tax
6/ Quarterly averages; average assets net of provisioning and interest in suspense.
7/ Gross income is defined as interest income minus interest expenses plus net commissions ad fees plus net gains on bond portfolio.
8/ Liquid assets and short term liabilities as defined in the BCT liquidity ratio regulation.

Table 7. Tunisia: Private Commercial Banks- Financial Soundness Indicators, 2000-05
(In percent, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
Capital adequacy						
Regulatory capital to risk-weighted assets	10.6	10.5	10.3	8.6	10.2	10.6
Regulatory tier I capital to risk-weighted assets	10.3	10.2	10.0	8.3	9.3	9.8
Capital to assets	8.0	7.5	7.7	7.6	7.7	8.0
Asset quality						
Nonperforming loans to total gross loans	15.4	16.1	18.1	21.6	20.4	20.0
Nonperforming loans net of provisions to capital	73.8	89.2	109.1	171.2	125.4	115.7
Provisioning ratio	54.7	47.7	44.9	39.9	43.5	46.4
Provisioning ratio (net of interest in suspense)	47.6	40.2	37.4	32.3	35.8	38.8
Foreign currency loans to total loans 1/	4.9	4.3	4.0	4.3	3.6	4.1
Large exposures to capital 2/	71.3	45.1	58.8	171.9	92.9	…
Sectorial distribution of total loans						
Total loans to residents	97.7	98.1	98.3	98.2	98.6	98.4
Loans to private sector	91.8	93.0	93.8	94.6	94.5	93.9
Households 3/	…	…	7.1	7.8	9.8	13.0
of which: housing loans	…	…	2.6	3.6	3.9	5.3
Enterprises	85.2	86.9	80.4	81.7	81.4	79.3
Financial institutions	6.6	6.1	6.3	5.0	3.3	1.7
Loans to public sector	5.9	5.1	4.6	3.6	4.1	4.4
Government	0.0	0.0	0.0	0.0	0.0	0.0
Public enterprises	5.9	5.1	4.6	3.6	4.1	4.4
Total loans to non-residents	2.3	1.9	1.7	1.8	1.4	1.6
Distribution of private sector loans by sector of economic activity						
Agriculture	3.2	3.0	2.6	2.7	2.7	2.7
Industry	45.6	46.9	45.5	44.9	44.6	42.5
Real estate 4/	2.7	3.8	6.6	7.9	7.9	9.4
Services	48.5	46.3	45.2	44.5	44.7	45.4
Tourism	9.4	9.4	9.8	10.2	9.9	9.5
Commerce	22.1	22.0	20.6	21.1	21.1	20.5
Other	16.9	14.9	14.8	13.2	13.8	15.4
Distribution of Nonperforming loans by sector of economic activity						
Agriculture	3.2	3.4	3.3	3.9	3.3	2.9
Industry	54.6	51.8	51.0	49.7	48.4	48.9
Real estate	1.1	1.2	1.8	2.8	4.0	4.0
Services	41.1	43.7	44.0	43.6	44.3	44.3
Tourism	9.6	9.8	9.1	9.3	10.1	9.0
Commerce	11.5	13.2	15.8	17.6	18.8	19.3
Other	20.0	20.7	19.1	16.7	15.3	16.0
Earnings and Profitability						
Return on Average Assets (ROAA) 5/ 6/	1.4	1.3	0.8	0.8	0.6	0.6
Return on Average Equity (ROAE)5/ 6/	16.5	16.8	9.5	9.1	7.1	7.0
Interest margin to gross income 7/	64.6	63.3	61.7	59.6	54.3	53.7
Noninterest expenses to gross income 7/	50.3	50.9	55.6	58.9	59.5	59.6
Personnel expenses to noninterest expenses	58.6	60.4	59.7	61.1	61.4	59.7
Net gains on bond portfolio and other financial instruments to gross income 7/	14.1	12.8	12.8	14.3	16.9	18.5
Average lending-deposit spreads	…	…	…	…	…	…
Liquidity						
Liquid assets to total assets 8/	…	37.3	34.6	34.6	35.4	36.3
Liquid assets to short-term liabilities	…	95.6	105.1	104.6	110.6	116.6
Customer deposits to total (noninterbank) loans	46.4	46.8	46.5	47.8	48.1	46.1
Foreign currency liabilities to total liabilities	12.7	10.1	9.5	8.6	9.1	11.3
Sensitivity to market risk						
Net open position in foreign exchange to capital	…	0.6	0.6	1.2	1.5	1.5

Source: Banque Centrale de Tunisie
1/ Total disbursed loans(excluding off- balance sheet commitments).
2/ Defined as total exposures greater than 25 percent of bank capital.
3/ Data on household loans are not available for 2000 and 2001. They are included in loans to enterprises.
4/ Excluding credit for social housing in 2000 and 2001.
5/ After tax
6/ Quarterly averages; average assets net of provisioning and interest in suspense.
7/ Gross income is defined as interest income minus interest expenses plus net commissions ad fees plus net gains on bond portfolio.
8/ Liquid assets and short term liabilities as defined in the BCT liquidity ratio regulation.

Table 8. Tunisia: Stress Tests Results for Commercial Banks, Dec. 2005
(In percent, unless otherwise indicated)

	Banking System		Private Banks		State-Owned Banks	
	Shocks A	Shocks B 9/	Shocks A	Shocks B 9/	Shocks A	Shocks B 9/
Initial capital adequacy ratio (CAR)	10.5		10.7		10.1	
Initial regulatory capital (in MDT)	2268		1286		982	
Bank assets in percent of total	100.0		54.5		45.5	
CAR after shocks:						
Credit risk 1 1/	7.3*		7.8		6.5*	
Credit risk 2 2/	5.5*	1.9*	5.9*	2.7*	5.0*	1.0*
Credit risk 3 3/	8.0	4.7*	8.4	5.3*	7.6*	3.9*
Credit risk 4 4/	9.7	6.4*	9.9	6.9*	9.4	5.8*
Credit risk 5 5/	9.3	6.0*	9.4	6.3*	9.2	5.5*
Credit risk 6 6/	10.0	6.8*	10.5	7.6*	9.5	5.9*
Interest rate risk 7/	9.7		9.8		9.6	
Scenario 8/	3.9*		4.3*		3.4*	
Recapitalization needs (in percent of capital)	36.7		32.1		42.8	

Sources: Banque Centrale de Tunisie and Fund staff estimates. Stress tests were carried out on the 10 largest commercial banks, excluding former development banks, on end-2005 data.

Note: (*) indicates that the capital adequacy ratio after shock is below minimum required (8 percent)

1/ Haircut of 50 percent of real estate collateral on NPLs (loss category, class 4, past due over 360 days)
2/ Migration of 8 percent of performing loans to the loss category (NPL class 4), provisioned at 70 percent
3/ Migration of 4 percent of performing loans to the loss category (NPL class 4), provisioned at 70 percent
4/ Migration of 16 percent of performing loans in the tourism sector to the loss category (NPL class 4), provisioned at 70 percent.
5/ Migration of 6 percent of performing loans in the industry sector to the loss category (NPL class 4), provisioned at 70 percent.
6/ Migration of 4 percent of performing loans in real estate to the loss category (NPL class 4), provisioned at 70 percent
7/ Increase of the money market rate (TMM) by 200 basis points.
8/ Scenario: Migration of 4 percent of performing loans to the loss category (NPL class 4), combined with a collateral haircut and an increase in the money market rate (TMM) by 200 basis points.
9/ Shocks B assume a supplementary shock of 50 percent real estate collateral haircut in addition to Shocks A.

Observance of Financial Sector Standards and Codes—Summary Assessment

Basel Core Principles for Effective Banking Supervision

General

67. This assessment of the BCT's compliance with the Basel Committee's Core Principles for Effective Banking Supervision (BCP) was carried out on January 16-31 and March 27-31, 2006 as part of the joint IMF/World Bank FSAP Update. It was conducted by Jean-Luc Couetoux (external consultant, French Banking Commission) and Didier Debals (World Bank, formerly with the French Banking Commission). The assessment was based on a review of relevant laws, regulations, standards of best practices and other guidelines related to the financial sector. It also included discussions with BCT, and other relevant authorities and stakeholders including commercial banks, the bankers association, and the accounting and auditing profession.

68. The BCP team received full cooperation from the Tunisian authorities and the private sector. This included receiving relevant information necessary for the assessment. The BCP team would like to express its gratitude to the BCT, as well as the private sector institutions for their assistance. In preparing this report, the assessors used the assessment methodology prescribed in the Core Principles Methodology published by the Basel Committee on Banking Supervision.

Institutional and macroprudential setting, market structure—overview

69. The BCT has legal responsibility for bank supervision in Tunisia. The BCT parameters for operations, mandate, objectives and responsibilities for bank supervision are specified in the Law 58-90 creating and organizing the BCT and the Law 2001-65 on credit institutions which has been further modified in 2006. This set of laws empowers the BCT to supervise all credit institutions, comprising commercial banks, development banks, merchant banks, off-shore banks, leasing and factoring companies. In 2004-05 all former development banks have received universal banking licenses. Within the BCT, the Directorate General for Banking Supervision (DGSB) is the unit responsible for the supervision of all the above-mentioned institutions. The BCT is an autonomous agency and has a high degree of financial independence, and its governor reports to the president of the Republic. The Ministry of Finance (MoF) issues banking licenses on the basis of a report prepared by the BCT. The Banking Commission is a disciplinary authority that imposes the most severe penalties, while lower penalties are within the power of the BCT governor.

70. Tunisia's financial system assets are equivalent to 125 percent of GDP. The banking system dominates the financial system, accounting for 70 percent if its assets. It consists of 13 commercial banks, of which three are majority government-owned, 5 former development banks, which are joint ventures between the government and several Gulf states and Libya, 8 off-shore banks, one public micro-finance institution, one public bank specialized in lending to small- and medium-scale enterprises, 11 leasing companies, and 3 factoring

companies. Nonbank financial institutions consist of the postal saving and checking agency, insurance companies, collective investment companies, and investment companies.

General preconditions for effective banking supervision

71. Most pre-conditions for effective banking supervision exist in Tunisia, including a stable macroeconomic environment, a generally well-developed public infrastructure, market discipline, and procedures for the resolution of insolvent banks. However, weaknesses are constituted by delays in judicial procedures and lack of effective out-of-court settlement mechanisms. There are also delays in the registration of real estate and mortgages. The role of external auditors has been strengthened in recent years, and they are now required to submit several reports to the BCT, including on adjustments to financial statements, internal controls and management, and the loan portfolio. On the basis of the 2005 law on financial security all banks are required to have two auditors. To improve the information available to credit institutions for credit risk analysis, the BCT over recent years established a number of information bureaus, including on companies financial statements, on payment incidents, and on companies indebtedness; on the other hand no credit bureau specialized in assigning ratings to single counterparties has yet been established. Despite these improvements, there is still a need to address specific areas that may affect the quality of banking supervision.

Main findings

72. During the past four years, Tunisia has made important progress in updating its regulatory and supervisory framework to bring it further into line with best practices. Thus, there has been an upgrading of the rating on CP1.4 (enforcement powers), CP1.6 (information sharing), CP3 (licensing criteria), CP5 (investment criteria), CP20 (consolidated supervision), and CP 21 (accounting standards). As regards CP7 and CP8, the legal and regulatory requirements will be observed once the provisions of the BCT draft circular on internal controls are implemented; this circular is to be issued shortly, following the promulgation in early May 2006 of the revised banking law. However, there are still some obstacles to fully effective supervision that need to be addressed, in particular in the area of consolidated supervision.

- **Objectives, Autonomy, Powers, and Resources (CP 1).** The objectives of the BCT in relation to bank supervision are clearly defined in relevant laws. BCT management and staff have good qualifications, are knowledgeable, and receive training on a regular basis. They are protected from liability when performing their supervisory responsibilities in good faith, by a central bank regulation, but it would be advisable that this be included in the law. The BCT has sufficient resources to carry out its mission, but its independence could be enhanced by specifying grounds for removal from office of its governing body. The BCT participates in the work of other agencies involved in supervising the financial system, but formal information sharing agreements will be authorized only by the revision of the central bank law now in parliament.

- **Licensing and Structure (CPs 2–5)**. Financial institutions licensed for banking activities and subject to banking supervision are clearly defined. Licensing criteria are described in the banking law and are adequate. The BCT has the authority to review and reject transfers of significant ownership or controlling interest in banks, and the 2001 modification of the banking law has defined thresholds beyond which the BCT has to be informed. The BCT has established criteria for review of major acquisitions of banks, and the banking law defines clear assessment criteria for authorization and waivers. It would be advisable to establish a cumulative ceiling for investments by credit institutions, in addition to individual ceilings.

- **Prudential Regulations and Requirements (CPs 6–15)**. The banking law and prudential regulations establish the minimum capital requirement and a capital adequacy ratio, and actions or sanctions that may be taken based on the levels of capital shortfall. However, the capital adequacy ratio should be calculated on a consolidated basis. There is still no regulatory provision specifically addressing credit risk management by credit institutions. This gap will be addressed by the draft circular on internal controls to be issued shortly, following the recent promulgation of the 2006 banking law. While loan classification rules are in line with best practices (CP8), loan loss provisioning remains weak, but the authorities have recently communicated to banks targets to raise provisioning to 70 percent of NPLs by 2009. Banks with weak provisioning have been prohibited from paying dividends in 2005 and 2006. Banks should strengthen the surveillance of doubtful loans and the recovery of overdue loans.

  The definition of large exposure (CP 9) should be set on the basis of consolidated exposure; this will be implemented with the issuance of the draft circular on internal control. The same circular will also contain guidelines on market risks (CP 12). To monitor other banking risks (CP 13), there is the need to increase the frequency of information technology audits during on-site inspections. The guidelines on internal control systems (CP 14) will be strengthened with the issuance of the circular on internal controls. The 2006 version of the banking law introduces the requirement for banks to establish an executive loan committee responsible to the board of directors, and to introduce compliance control systems. Legal provisions to prevent money laundering and the financing of terrorism are contained in the 2003-75 law on AML/CFT, and the related directives 2006-01 and 2006-02.

- **Methods of Ongoing Supervision (CPs16–20)**. The framework for on-site and off-site supervision is adequate. It would be important that the procedures for on-site examinations be laid down in a manual. It would also be advisable that the president of the supervised institution receive the full inspection report, and not only a summary of the key results. There are still weaknesses in the consolidated supervision regime. Although, starting with the 2004 accounts, banking groups have been required to compile consolidated account, the BCT does not yet possess all the resources for surveillance on a consolidated basis, including basic prudential norms, such as consolidated capital and overall exposure limits, and formalized information sharing agreements with other supervisors. These will be permitted by the revision in the central bank law now in parliament.

- **Information Requirement (CP 21)**. Tunisia largely complies with this Principle. Reporting generally complies with IAS although in case of NPLs the Tunisian standard does not take into account an estimate of the time needed for loan recovery. External audits have to be conducted according to International Auditing Practices. The audits cover a broad range of issues, including loan quality, loan loss identification and provisioning, asset valuation, trading activities and internal controls. Also, external auditors have a statutory duty to inform the supervisory agency within a stated timeframe if they detect any matters of significant importance to the bank concerned.

- **Formal Powers of Supervisors (CP 22)**.While the banking law provides for sanctions, penalties have never been applied in a formal manner. The Banking Commission, which has the power to impose the more severe sanctions, including revocation of the license, others being in the remit of the governor, has never been convened. It would be advisable to confer all sanctioning powers to the Banking Commission, so as to have a separation between supervisory and sanctioning powers. The governor of the BCT should have the power to issue injunctions. A system of waivers for modest violations of regulatory limits should be established. The sanctions imposed should be publicized.

- **Cross-Border Banking (CPs 23–25)**. Tunisian banks have limited activity in foreign territories. Foreign banks in Tunisia are subject to local prudential regulations. The relations maintained by the supervisory authorities with their counterparts abroad are informal, because the current central bank law does not allow information sharing agreements. This will be corrected with the approval of the revised central banking law, now in parliament.

Table 9. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
CP 5	Establish a cumulative ceiling for investments by credit institutions, in addition to individual ceilings.
CP6	Introduce consolidated prudential solvency ratios
CP 7	Address existing gaps in the credit risk management guidelines by issuing the draft circular on internal controls, following the promulgation of the revised banking law.
CP8	Banks should strengthen the surveillance of doubtful loans and the recovery of overdue loans. The BCT should make sure that institutions are compliant with off-balance sheet exposure provisioning. The provisioning system should take into account actual recovery prospects and the time factor in estimating future recovery flows.
CP 13	Increase frequency of inspections of information systems, and highlight areas in which improvements are needed.
CP 14	Following issuance of new circular on internal controls, ensure that all institutions apply the new rules.
CP 16	After each examination, the president of the institution should receive the full inspection report, and not only a summary of key results
CP 20	While the BCT closely scrutinizes the consolidated accounts that institutions are required to submit since 2004, it must establish consolidated ratios and conclude information sharing agreements with other financial sector supervisors.
CP 21	The time needed for loan recovery should be explicitly taken into account in the valuation of NPLs.
CP 22	Strengthen the sanctioning system by applying formal sanctions when needed; establishing a system of waivers for exceeding a regulatory limit; installing the Banking Commission on a permanent basis; publicizing the sanctions imposed each year.

Authorities' response

73. The BCT broadly agreed with the assessments and recommendations, and expressed their appreciation for the work carried out by the assessment team.

74. The BCT noted that on Credit Policy (CP 7) the implementation of the circular on internal control to be issued shortly will cover current regulatory gaps in credit decisions and monitoring procedures. They also noted that they are taking measures to strengthen consolidated supervision (CP20), and that the draft revised central bank law, now in parliament, will authorize the central bank to enter into information sharing agreements with other domestic and foreign financial supervisors, which is needed for effective consolidated supervision. This will also allow compliance with CP 25 (supervision of foreign banks establishments). The BCT did not agree with the recommendations regarding (i) the transformation of the Banking Commission into a permanent body, noting that it can be convened rapidly when needed, and (ii) the devolution to this commission of all sanctioning powers, currently split under the banking law between the Governor and the Commission, which they consider appropriate.