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Mthuli Ncube
Chief Economist and Vice President
(ECON)
m.ncube@afdb.org
+216 7110 2062

Gilbert Mbesherubusa
Ag. Vice President
Operations III
(OIVP)
g.mbesherubusa@afdb.org
+216 7110 2034

Timothy Turner
Director
Private Sector Department
(OPSM)
t.turner@afdb.org
+216 7110 2051

Resolving Nonperforming Loans in Tunisia: a Coordinated Private Sector Approach

Pietro Calice[1]

1 Introduction

This brief reviews the current and prospective balance sheet vulnerabilities of the Tunisian banking system and, based on historical experience in dealing with bank restructuring, derives some policy recommendations on a nonperforming loan (NPL) resolution strategy for the country. In particular, this brief discusses the role of asset management companies (AMCs) in easing the disposal of impaired assets thus strengthening banks' capital position and reinvigorating credit growth.

The brief argues that given the extent and the nature of the NPL problem in Tunisia, a coordinated private sector approach is the most effective and efficient resolution strategy. Coordination among all the stakeholders involved is of the essence in a market-based asset management strategy. For one thing, the private sector is not likely to jump-start a NPL market. More importantly, a private AMC requires a conducive legal and regulatory framework, which in turn might require some reforms. In this context, international financial institutions (IFIs) can play a facilitating role, serving as honest brokers and providing advisory, technical assistance and financing.

2 Balance sheet vulnerabilities

The civil unrest and subsequent regime change in Tunisia are having substantial economic costs for the country. Growth is likely to have stagnated in 2011 compared to 3 percent in 2010, due to temporary disruptions to economic activity as well as significantly lower tourism receipts and foreign direct investment. GDP is expected to rebound in 2012 though downside risks associated with political uncertainty both in the country and the region as well as with growth variation and volatility in Europe.[2]

In this context, Tunisian banks are likely to suffer from a significant increase in NPLs, which will compound the already relatively weak asset quality of the banking sector. NPLs have long been a source of vulnerability for Tunisia. In the mid-1990s, NPLs accounted for 25 percent of total loans. While loan quality improved in the following years, with the NPL ratio reaching 21 percent in 2001, it peaked in 2003 at 24.2 percent, reflecting problems in the service sector, particularly tourism and trade. Since then, loan quality has improved consistently, with NPLs accounting for 13 percent of total loans at end-2010 or TND 6.3 billion (see

[1] Pietro Calice is Principal Investment Officer at the African Development Bank. Comments should be addressed to: p.calice@afdb.org.
[2] IMF (2011).

Chart 1). Despite this remarkable progress, however, NPLs still remain relatively high by international standards and are expected to increase significantly. Growth opportunities for the banking system have been limited in 2011 in the face of the poor prospects for the economy. Asset quality is also expected to deteriorate as a result of direct provisioning against troubled exposures related to the former ruling family.[3]

The Tunisian authorities have implemented a number of measures in recent years to deal with the NPL problem. The legal framework for corporate restructuring has been reinforced; creditor rights have been strengthened through a simplification of the procedures for realizing real estate collateral; a more favorable tax treatment of provisions and write-off has been introduced; asset recovery companies have been established within banking groups.[4] More recently, in an effort to mitigate the impact of the current turmoil on the banking sector, Tunisian authorities have relaxed loan classification rules.

These measures however have, proven insufficient in reducing NPLs in the system. Moreover, with an aggregate 12.6 percent capital adequacy ratio at end-2010, the banking system has a relatively thin capital buffer to absorb any substantial additional increase in provisions. This can limit the credit intermediation capacity of the banking sector and act as a drag on economic growth. A comprehensive and transparent resolution strategy is therefore needed to sustain credit growth and mitigate contingent fiscal risk for the government.

3 Options for NPL resolution

A possible approach to NPL resolution is through an effective asset management strategy, where NPLs are identified, organized and then resolved. This usually involves the establishment of an asset management company (AMC). Historically, many countries have turned to AMCs as a central strategy for solving the problem of bank bad loans.

Country experiences point to various institutional arrangements for NPL resolution through asset management companies.[5] AMCs can be either publicly- or privately-owned, with a number of intermediate solutions. Each model has its own advantages and disadvantages, and there is no “one-size-fits-all” approach (see Table 1). For example, a centralized AMC is usually effective when the extent of the NPL problem is systemic and the legal infrastructure for debt resolution is relatively weak.[6] Private AMCs possess greater managerial flexibility than public AMCs, and for this reason they may be more effective when the extent of industry problems is limited or concentrated and the legal and regulatory framework is relatively developed.[7]

A review of AMCs around the world reveals a mixed record of AMC performance. Centralized, government-owned AMCs prove more successful when established as rapid disposition vehicles to coincide with a systemic crisis rather than as a set up to assist in corporate restructuring. Success factors include the possibility to liquidate the purchased assets, professional management, political independence, skilled staff and sufficient funding.[8]

Private AMCs were found to report good performance when banks had high loss absorbing capacity to face the write-offs associated with transferred bad loans without endangering their financial viability. Other factors of success include the right set of regulatory incentives to facilitate bank restructuring such as loss carry-over or tax reductions for NPL transfers; and, severance of banks and corporation cross-ownership to avoid that banks preserve the corporation as a going concern when this is no longer the case.[9]

4 Policy considerations for Tunisia

A private sector approach might be the most suitable option for NPL resolution in Tunisia. While a comprehensive due diligence is necessary to assess the true extent and nature of the problem as well as the ability of banks to manage bad loans, NPLs in Tunisia are already high and likely to increase. However, bad loans are typically but not exclusively concentrated in public banks, and are mostly found in manufacturing, tourism and trade. They are

[3] Some private sector analysts estimate that the level of NPLs may reach 20 percent of total loans in 2011. See, for example, Abed et al (2011).
[4] See IMF and World Bank, 2007.
[5] See, for example, Klingebiel (2000).
[6] Ingves et al (2004).
[7] Ibidem.
[8] Klingebiel (2000).
[9] Klingebiel and Dado (2002).

collateralized by real estate. Moreover, the legal and regulatory framework is relatively developed. All this suggests that the government can afford to take a gradual approach and opt for a private sector route.

A number of issues need to be weighed carefully to ensure that a private AMC can operate successfully within the Tunisian environment. A private sector NPL resolution mechanism requires a proper regulatory framework and incentive structure to ensure that its objectives are met. A first area where there might be a need for reform or special treatment is the regime for foreign investment, which is currently heavily regulated.[10] Given the size of the NPLs and the resulting investment requirements, it is likely that the required amounts cannot be raised domestically and involvement of private international investors would be needed.

Regulatory action might also be needed to create incentives for banks to sell their NPLs to an AMC, and to encourage investor participation in the NPL market. Cross country experience shows that the development of an effective market for NPLs can be incentivized by correcting deficiencies in the tax and accounting framework.[11]

On the other hand, an AMC is attractive to potential investors if the powers exercisable by such company in debt and corporate restructuring are wider than those available to the original lender. From this perspective, the bankruptcy process in Tunisia is deficient. Creditors and other stakeholders are not involved in the insolvency process. Access to bankruptcy documents is restricted to the court and there is no meaningful creditor participation in decision-making as only the court can initiate a rehabilitation plan. Moreover, secured creditors do not have absolute priority over the propriety of a bankrupt firm.[12]

Finally, the success of a private sector approach requires the ability of banks to maintain depositor and investor confidence. In particular, to engage in meaningful, restructuring banks need to be adequately capitalized to withstand loan write-downs. Recapitalization can be very effective if accompanied by improvements in corporate governance, risk management systems and performance.[13]

The private sector, however, is not likely to start a new NPL market and coordination among all the stakeholders involved would be needed. In this context, IFIs can have an important facilitating role to play. They may advise the government and provide technical assistance to help revise the legal and regulatory framework. They may sponsor the establishment of an AMC by catalyzing specialized distressed asset managers and providing financing to the AMC, in the form of equity and/or debt and/or guarantees. By assisting in the ex-ante recapitalization of banks through straight equity and/or subordinated debt they can help strengthen the absorptive capacity of financial institutions, thus contributing to the success of the initiative. As a complementary initiative, IFIs might also contribute to capacity building in the area of credit risk management. The introduction of a successful, replicable, market-tested mechanism would provide a powerful demonstration effect and contribute to the development of an efficient secondary market for NPLs in the country.

5 Conclusions

Despite positive developments over the past few years, Tunisian banks continue to suffer from poor asset quality. Banks' balance sheets are expected to deteriorate further as a result of the economic slowdown as well as of the exposures related to the former ruling family. The combination of declining asset quality and mounting pressures on banks' capital positions might limit the credit intermediation capacity of the banking sector, acting as a drag on economic growth. It is, therefore, essential that banks, in conjunction with the authorities, take comprehensive action to resolve the large and growing stock of NPLs.

Given the extent and the nature of the problem, a coordinated private sector approach can be an effective mechanism for NPL resolution in Tunisia. Yet a specialized AMC requires a supportive legal and regulatory framework, including the right set of incentives. The private sector alone is not likely to start a NPL market and coordination would be needed. Against this background, IFIs have an important role to play by assisting the government and the banking sector in the design and execution of a market-based NPL resolution strategy.

[10] Miller and Holmes (2011).
[11] Klingebiel and Dado (2002).
[12] Casero and Varoudakis (2004).
[13] Klingebiel and Dado (2002).

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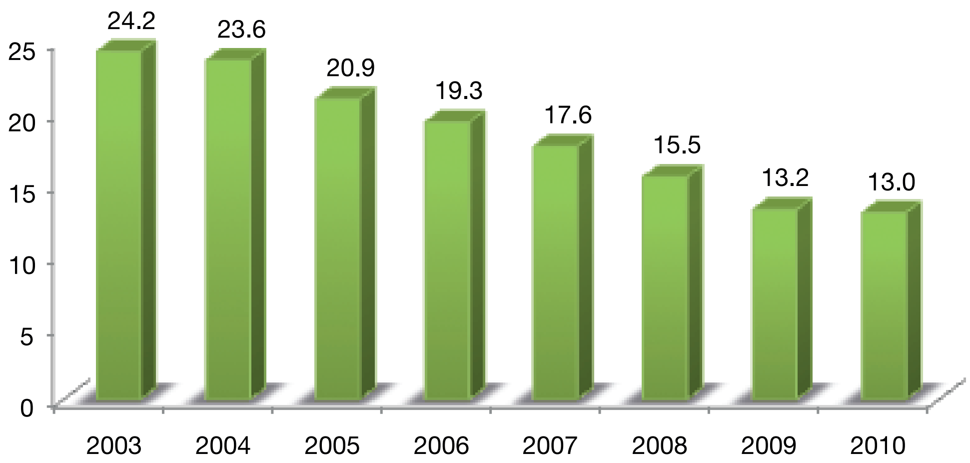
annex

Chart 1 NPLs in Tunisia (% of gross loans)



Source : Central Bank of Tunisia and IMF.

Table 1 Advantages and Disadvantages of Different AMC Structures

	Advantages	Disadvantages
Centralized public AMC	Gets NPLs out of non-viable banks Ensures uniform valuation criteria Provides for conditions to be attached to the purchase of NPLs Centralized ownership of collateral Can be given special legal powers	Management is often weaker than in private arrangements May entail high costs Subject to political interference NPLs and collateral may be "parked" and not liquidated
Bank Unit or Subsidiary	Knowledge of the borrower Access to borrower	Shortage of skills May divert focus from core business Does not clean up banks' balance sheets
Private AMC	Specialized skills Focus on restructuring Clean-up of banks' balance sheets	Lack of knowledge of the borrower

Source : Adapted from Ingves et al (2004).