## Introduction and Context

**Tunisia continues to face a difficult economic outlook four years after the Revolution.** This situation is mainly due to the absence to date of significant economic reforms combined with a political uncertainty that ended with the democratic election of a new Parliament. Preliminary estimates for 2015 suggest that the economic growth remains sluggish (GDP growth is expected at around 1.7 percent). Unemployment remains high, fiscal and external balances are elevated, and social tensions continue to burden economic activity. Security issues have impaired the tourism sector and adversely affected Foreign Direct Investments, while the recovery in the European Union remains lethargic. Moreover, the current macroeconomic situation does not allow for the continuation of expansionary policies making it more difficult for the newly appointed Government to maintain in 2015 the relatively weak growth rate experienced in 2013 and 2014.

**The financial sector is being affected by the economic situation.** While the economic slowdown has deteriorated the quality of the asset portfolios of the banks, it has also squeezed the liquidity of the banking sector. The terrorist attacks mid-2015 have aggravated the situation. Despite a timely Central Bank intervention to support the systemic liquidity, these two exogenous factors have restricted the capacity of the banking system to lend to the economy, especially toward MSMEs. The recent focus of the Government on the financial sector reforms agenda is therefore of primary strategic importance. It is underpinned by the necessity to strengthen the stability of the banking sector and to improve the capacity of the financial sector as a whole to provide resources to the economy and accelerate its recovery.

**The Tunisian financial sector is small and dominated by banks, with assets equal to about 115 percent of GDP.** As of April 2015, there were 21 onshore banks, including three large state-
owned banks with 34 percent of banking sector assets, three large private domestic banks with 34 percent of total assets, and six foreign-owned private banks with a 34 percent share. The nonbank financial sector is relatively small (about 20 percent of all financial system assets in 2014). The micro-finance sector accounts for only 0.2 percent of total financial sector assets. The equity and fixed-income markets are still relatively modest, with a market capitalization equal to 20 percent of GDP. Private equity remains small and the leasing sector, with nine institutions, accounted for only 1.6 percent of GDP. Tunisia has a nascent insurance sector, with more than 20 companies primarily focused on nonlife activities and annual premiums to GDP of about 1.8 percent.

The banking sector faces significant challenges owing to a fragile post-revolution economy and the legacy of the previous regime. Between 2010 and 2014, the average capital adequacy ratio of the banking system has declined from 11 percent to 9.7 percent, as a result of i) an increase of NPLs (from 12.5 percent before the revolution to 16 percent in 2014) and ii) an increase of the provisioning ratios (from 44 percent to about 60 percent). As a result, six banks—which cover 42 percent of the banking assets—have fallen below the new minimum capital requirements in 2013 (down to three banks in 2014, all State-owned). Also, different factors such as the economic slowdown, the depreciation of the TND, the security situation, and the development of the informal economy have been putting a downward pressure on the banking system liquidity, prompting the CBT to massively inject liquidity in the system. CBT refinancing operations reached TND 5.7 billion (i.e. 6.9 percent of GDP) in June 2015 (vs TND 5 billion in 2014).

Weak regulatory regime and poor corporate governance standards have long allowed the SOBs to remain major players despite their poor performance. Since 2001, the SOBs provide credit universally while financing Government sectorial development policies. In a context of weak corporate governance environment, this positioning has resulted in poor financial performance that was long hidden by a permissive regulatory and supervisory framework, characterized, inter alia, by i) low standards in terms of provisioning and capital adequacy and ii) loose on-site and off-site supervision. Between 2001 and 2011, SOBs maintained strong market shares (36 percent) despite higher NPLs (15.6 percent in 2010 vs 8.3 percent in private banks), lower provisioning ratios (38.2 percent in 2010 vs 74.2 percent in private banks) and lower solvency ratios (9.4 percent in 2010 vs 11.2 percent in private banks). After the revolution, the CBT has started implementing stricter regulation. In particular, a series of circulars issued between 2012 and 2014 have compelled the banks to significantly improve their corporate governance practices and increase their provisioning and capital adequacy ratios. Substantial efforts have also been made concerning on and off-site supervision with a revised reporting system and more frequent on-site examinations. For SOBs, this regulatory shift translated into large recapitalization needs in the amount of approximately TND 1 billion (i.e.

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1 Below the minimum regulatory requirement of 10 percent.
2 23 percent with the NPLs transferred to non-consolidated recovery subsidiaries.
3 This also resulted from the application of new CBT circular imposing more conservative haircuts on the valuation of loan collateral.
4 They compete with the private banks on all the different segments of the firms and retail market. However, they are more active in some specific segments such as the financing of new investments for small firms (50 percent market share), the financing of the tourism sector (50 percent market share) and the financing of firms located in underserved regions (64 percent market share).
II. Program Development Objective

The proposed project development objective (PDO) is to improve the performance of the State Owned Banks. This PDO will support the overarching objectives of the Financial Sector Modernization Program (FSMP) put forward by the Government. Improving the performance of the SOBs will have a direct impact on financial stability and access to finance. Tentative PDO-level indicators would be: i) bringing SOBs back to compliance with the solvency ratios in a sustainable way, ii) an increase of their Return on Equity (ROE), and iii) a reduction of their NPLs.

III. Program Description

The PforR operation (the “Program”) will support key measures aiming at supporting directly and indirectly the restructuring of the SOBs. Among the FSMP priorities, the Bank has identified a set of measures from the pillars I and II of the FSMP as “core drivers” of the expected financial sector transformation. Indeed, it is expected that i) the implementation of restructuring plans for the SOBs, ii) the strengthening of their governance, and iii) the enactment of key pieces of legislation will improve financial stability, spur banking sector competition and, as a result of all of this, increase access to finance in the medium to the long run. The proposed Program will support a portion of the FSMP and will be limited to three years (out of the five years). The three-year funding window aims at aligning the PforR disbursements with the investment efforts to be made by the SOBs between 2016 and 2018. The PforR would cover the following measures:

- Restructuring of the SOBs. The PforR will support the whole restructuring process between 2016 and 2018. In July 2015 the SOBs have launched their respective recapitalization (including TND 757 million for STB and TND 110 million for BH). These recapitalization will allow the banks to implements their investment plans which include, inter alia, severance plans, and IT system modernization. The Program will also support critical governance changes (recruitment of new board members and key senior management staff, establishment of a State Ownership Agency (SOA). As part of the Program Action Plan, the PforR will support the delivery of board training sessions on corporate governance and capacity building for the SOA.

- Improved financial sector legal environment. In order to maximize the chance of success of the SOBs restructuring, the PforR will also support targeted reforms under the pillar 2. In particular, the PforR will support the adoption of a new banking law, as it will i) increase the independence of the CBT (and further reduce the risk of political interference in the restructuring process moving forward), ii) give the CBT more power to intervene banks (including SOBs) in case of difficulty, and iii) pave the way for the strengthening of the regulation. It will also support the adoption of a new bankruptcy law and regulations and, eventually, the revision of the excessive lending rate law.

IV. Initial Environmental and Social Screening
The reforms supported in this PforR operation are not expected to have any positive or negative effects on the environment, forest and other natural resources. The proposed operation supports policy actions that create the enabling environment to support poverty reduction, and which by themselves do not have any environmental impacts. However, an ESSA will be prepared to ensure that the on lending projects supported by the State Owned Banks benefiting from the restructuring will follow the core environmental and social principles of OP/BP 9.00. The ESSA will include, but not limited to, the following: (i) documentation of the environmental and social management procedures; (ii) assessment of State Owned Banks capacity to manage the likely environmental and social effects as per Tunisia's own requirements; and (iii) recommendation of specific actions for improving State Owned Banks's own procedures and process to address the relevant environmental and social issues involved in the project.

V. Tentative financing

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