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The World Bank

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Report No. 12017-TUN

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

NOVEMBER 17, 1993

Industry and Energy Division
Country Department I
Middle East and North Africa Region

CURRENCY AND EQUIVALENTS

Currency Unit - Tunisian Dinar (DT)
US$1.00 = DT 1.034 (average August 1993)
DT 1.00 = US$ 0.97

US$1.00 = DT 0.88 (average 1992)
DT 1.00 = US$ 1.14

WEIGHTS AND MEASURES

Metric System		US System
1 meter (m)	=	3.2808 Feet (ft)
1 kilometer (km)	=	0.6214 mile (mi)
1 square kilometer (km^2)	=	0.3861 square mile (mi^2)
1 metric ton (m ton)	=	0.9842 long ton (1g ton)
1 kilogram (kg)	=	2.2046 pounds (lbs)

ABBREVIATIONS AND ACRONYMS

ATB	-	Arab Tunisian Bank
BCT	-	Banque Centrale de Tunisie
BDET	-	Banque de Développement Economique de Tunisie
BIAT	-	Banque Internationale Arabe de Tunisie
BNA	-	Banque Nationale Agricole
BTEI	-	Banque de Tunisie et des Emirats d'Investissement
CFCT	-	Crédit Foncier Commercial de Tunisie
EFRSL	-	Economic and Financial Reforms Support Loan
FI	-	Financial Institution
PB	-	Participating Bank
PPF	-	Project Preparation Facility
STB	-	Société Tunisienne de Banque
STUSID	-	Société Tuniso-Séoudienne d'Investissement et de Développement
TL	-	Tunisie Leasing
UBCI	-	Union Bancaire pour le Commerce et l'Industrie
UTL	-	Union Tunisienne de Leasing

TUNISIA - FISCAL YEAR

January 1 - December 31

STAFF APPRAISAL REPORT
REPUBLIC OF TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

TABLE OF CONTENTS

Page No.

This report is based on the findings of an appraisal mission which visited Tunisia in March 1993, composed of Mmes/Messrs. L. Effron (Task Manager), L. Burakreis and B. Ledoux (Bank), J.M. Doublet (IFC), Lloveras, Malkin, and Mas Montanes (consultants).

<u>**In-text Tables**</u>

ANNEXES

<u>Map</u>: IBRD No. 24916R

REPUBLIC OF TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

Loan and Project Summary

Borrowers: Arab Tunisian Bank (ATB), Banque de Développement Economique de Tunisie (BDET), Banque Internationale Arabe de Tunisie (BIAT), Banque de Tunisie et des Emirats d'Investissement (BTEI), Crédit Foncier Commercial de Tunisie (CFCT), Société Tuniso-Séoudienne d'Investissement et de Développement (STUSID), Tunisie Leasing (TL), Union Bancaire pour le Commerce et l'Industrie (UBCI), Union Tunisienne de Leasing (UTL), and the Republic of Tunisia.

Guarantor: The Republic of Tunisia for the loans to the financial institutions (FIs).

Amount:

Republic of Tunisia	US$50 million
ATB	US$ 6 million
BDET	US$12 million
BIAT	US$ 8 million
BTEI	US$10 million
CFCT	US$ 7 million
STUSID	US$10 million
TL	US$ 6 million
UBCI	US$ 7 million
UTL	US$ 4 million

Terms: 17 years, including 5 years grace period for the Republic of Tunisia and 3 FIs and 4 years grace period for the other 6 FIs, at the Bank's standard variable rate.

On-lending terms: The Republic of Tunisia would on-lend a total of US$50 million equivalent, in Dinar denominated subsidiary loans to eligible FIs for a period not exceeding the maturity of the loan to the Republic of Tunisia at the money market rate plus 50 basis points.

The Republic of Tunisia would assume the foreign exchange risk for the direct loans to the nine FIs and for the subsidiary loans to eligible FI against payment of the difference (currently about 400 basis points) between the money market rate plus 50 basis points and the Bank's standard variable rate.

Project Objectives and Description: The project is designed to finance the needs of new and existing private enterprises by channeling funds through eligible FIs, including two financial leasing companies. The project would include: (a) direct lines of credit to nine FIs meeting minimum eligibility criteria to be on-lent for viable private investments; (b) a loan to the Republic of Tunisia: (i) to be passed as subsidiary loans to all FIs meeting minimum eligibility requirements; (ii) to refinance two PPFs put in place on behalf of STB, a large commercial bank, to install a new accounting system. The Central Bank of Tunisia (BCT) will be the executing agency for the loan to the Republic of Tunisia. The loans could also be used to finance technical assistance needs to the FIs to enable them to set up or strengthen appraisal procedures, portfolio monitoring and work-out capabilities, and to private enterprises to develop corporate strategies. The funds would be committed over a three year period, 1994-1996.

Project Benefits and risks:

Benefits of the project to the Tunisian economy include: (a) the provision of long-term resources to finance investment needs in the private sector and (b) the encouragement of increased competition among commercial banks, development banks and leasing companies. The on-going process of economic liberalization has increased the pressure on Tunisian private enterprises producing for the domestic market to become more efficient. Banks have traditionally played a passive role in financing enterprises, rarely taking the initiative in helping enterprises to modernize or diversify. The project would encourage and enable banks to take a pro-active role for the first time in advising clients, by offering financial resources and technical assistance to the banks and to enterprises through the banks for corporate planning. The risks are that: (a) several of the FIs requiring financial and institutional action plans may have difficulty meeting agreed targets, thereby losing their eligibility to participate -- this risk has been mitigated by ensuring strong commitment by the FIs to their action plans; and (b) commitments under the loan may be slower than expected if investment demand turns sharply down. This risk has been addressed by undersizing the loan compared to estimated demand for term credit, to ensure rapid use of the funds.

Estimated Disbursements:

IBRD fiscal Year:	94	95	96	97	98	99
	----------(US$ million)----------					
Annual	5	17	27	28	28	15
Cumulative	5	22	49	77	105	120

Economic Rate of Return:

Minimum of 10% for each sub-project.

Program of Targeted Interventions:

Not applicable.

REPUBLIC OF TUNISIA

STAFF APPRAISAL REPORT

PRIVATE INVESTMENT CREDIT PROJECT

I. INTRODUCTION

1.01 The Government of Tunisia has requested a Bank loan totaling US$120 million equivalent to provide access by financially sound banks and financial leasing companies to term resources at market rates to finance the investment needs of private sector firms. The Tunisian authorities have implemented a far-reaching trade liberalization program to increase efficiency across all sectors of the economy, thereby exposing Tunisian firms to increased competition from abroad. At the same time, the financial sector is in the process of adjusting and developing rapidly, but is not yet at the stage where adequate term resources are available through either the banking system or the bond and equity markets. This loan would thus provide resources to enable new private firms to take advantages of investment opportunities, as well as enable existing firms to modernize, diversify, and expand to face the increasing competition.

1.02 Since 1986, when Tunisia faced the threat of a balance of payments crisis, the Government has been implementing a far-reaching liberalization program to dismantle the protectionist and relatively dirigiste approach of the past. The economy has steadily improved since 1986, with a decrease in current account balance of payments deficits and a limited level of inflation (6%-7% per annum). This adjustment has been led primarily by the increase in exports and the decrease in public investments, while maintaining relatively heavy investments in human resource development. On most accounts, Tunisia is one of the superior performers among the Bank's member countries. The challenge for the future is to ensure sustained growth through the promotion of private sector investments and the increase in efficiency in those investments. An important factor in this process is the increased competition that domestic private industries and services will face as the result of the liberalization process and the dismantling of the administrative controls in the domestic markets. This will put pressure on these industries to become more competitive.

1.03 The financial sector will play a major role in the process of enabling the private sector to face the challenges of increasing efficiency and creating employment. Here, too, reforms have been introduced with the aim of establishing a financial sector that is deep enough and sufficiently solid to play an active role in identifying and meeting the various financing needs (for debt and equity) for private sector development. The banking sector, in particular, is just emerging from a heavily controlled environment with inadequate prudential regulations, and is in the process of restructuring to meet, over time, international standards of prudential regulations and capital adequacy. This loan will be made to those banks and financial leasing companies meeting minimum standards of financial structure and performance, and management and operational strength.

1.04 The proposed project would consist of direct lines of credit, comprising about 60% of the loan, to eligible financial institutions (FIs) to finance viable investments across a wide range of activities in the private sector. Excluded from financing are investments in farming and construction of housing and land development for housing which have a high degree of specificity and are covered by other Bank activities. To ensure flexibility and encourage competition in the use of the loan funds, about 40% the loan funds would be lent to the Republic of Tunisia in an apex loan for on-lending to eligible FIs. This would also permit other FIs that become eligible after the start up of the project to participate.

II. MACROECONOMIC AND SECTORAL FRAMEWORK

A. Recent Economic Reforms and Performance

2.01 Tunisia has been undergoing a major economic adjustment process that has been highly effective in correcting macroeconomic imbalances and creating good prospects for sustained growth of GDP and per capita consumption. From being a highly regulated economy with a dominant public sector, Tunisia is being successfully transformed into an outward-oriented economy led by the private sector.

2.02 The adjustment process began in 1986 as a response to a balance of payments crisis, exacerbated by persistent current account deficits and sluggish export growth. An underlying long-term problem facing the country was the depletion of Tunisia's oil reserves and the drop in world oil prices. The major elements of the stabilization and adjustment program were demand management through tight fiscal and monetary policies, exchange rate adjustment, trade liberalization and price reform (para. 2.03), liberalization of the financial sector (paras. 2.11-2.18), privatization of public enterprises, and tax reform.

Table 2.1: Economic Performance Before and After the Start of Adjustment
(in %)

	1980-85 Average	1986	1987-91 Average	1992
GDP Growth Rates	4.2	-1.4	4.4	8.0
Export Growth Rates	0.6	5.2	7.6	13.1
of which manufacturing	6.4	13.1	11.6	3.4
Imports Growth Rates	0.5	-2.1	5.6	12.6
Annual Inflation Rates	9.6	5.8	7.2	5.4
Government Deficit/GDP	-5.6	-5.5	-3.7	-2.6
Current Account/GDP	-7.9	-8.0	-2.6	-4.7
Resource Balance/GDP	-8.5	-7.3	-3.3	-5.8
Total DOD/GDP	48.3	66.9	66.0	53.3
Total Debt Service/XGS	18.6	28.2	24.0	22.9
Gross Fixed Capital Formation/GDP	30.3	23.5	22.5	25.9

2.03 The trade and price liberalization has included replacing quantitative import restriction with import tariffs. The maximum import tariff has been reduced to 43% and quantitative restrictions, which in 1986 applied to most imports and protected virtually all of manufacturing and agriculture, have been dramatically reduced and by the end of 1994 they should cover only about 5% of production in these two sectors (a few articles of basic consumption such as brown bread and vegetable oil). In addition, domestic producer prices and distribution margins have been liberalized. At the beginning of 1993, current account convertibility was introduced, removing administrative barriers to the use of foreign exchange for purchasing inputs, for borrowing on international markets, and allowing exporters to retain up to 30% of their export earnings in foreign exchange.

2.04 The recent performance of the economy resulting from these reforms is shown in Table 2.1 above. The current account deficit of the balance of payments was brought down from 8% of GDP in 1986 to 4.7% in 1992 (in 1988 it was in surplus). The budget deficit was reduced from 5.5% of GDP to 2.6% over the same period. Inflation has averaged around 7% during the period and was down to 5.4% in 1992. Manufactured exports have grown rapidly over the last few years prior to the recent slowdown of the world economy. GDP growth has averaged over 4% in real terms, with an exceptional growth of 8% in 1992 facilitated by good weather and a rebound in tourism after the Gulf war. The lower current account deficits, coupled with steady export-led growth and a prudent external debt strategy have allowed debt indicators to improve markedly: the ratios of debt to GDP and of debt service to exports declined from about 67% and 28% in 1987 to 53% and 23%, respectively, in 1992. Unlike many other countries, Tunisia has been able to avoid debt rescheduling.

2.05 Development objectives and strategies. The recent Country Assistance Strategy identifies the Government's objectives as sustaining GDP growth rates averaging at least 5% per annum, increasing competition, attracting private investment and better integrating the economy into the world markets, especially the EEC. This strategy presupposes an improvement in the economic efficiency of investment (i.e., a decrease in the ICOR from 6.7 in the 1980s to 4.0-4.5). It relies on the private sector to play the leading role in an outward oriented economy, and requires that the financial sector be both sufficiently solid and deep to play its role of intermediating resources to finance the necessary investments. The financial sector is discussed in paras. 2.07-2.18. A discussion of the manufacturing sector, where most of the investment under this project is expected to take place, is in Annex 3. A substantial agenda for private sector development remains. A number of issues pertaining to private sector development are being addressed in the forthcoming Private Sector Assessment report and in preparation work for a private industry competitiveness project planned for FY95. In addition, the proposed project should be seen as a signal of World Bank support of the Government's policy and as an important step in a larger-scale effort to enable the financial sector to face the challenge of financing enterprise competitivity and employment-creating investments; it supports the efforts of the private sector to adjust to a newly liberalized environment.

2.06 Challenges for the future. While the Government has given top priority for over seven years to carrying out a program of fundamental and far-reaching reforms, much practical work remains to be done. The process of public enterprise reform is far from complete and needs now to move more quickly and efficiently on the process of privatization and improving the performance of utility companies and other public enterprises which have not yet been privatized. The pressures to prevent an increase in the unemployment rate and the absence of a Government policy on severance pay and unemployment insurance makes closure or restructuring of some public (as well as private) enterprises particularly difficult. The administrative system must still develop the institutions and skills to perform a greater regulatory and supervisory role, while the regulatory environment, particularly with respect to bankruptcy and labor laws, still needs improvement. The private sector must adapt to a more highly competitive environment. The commendable emphasis on social sectors has resulted in a relatively low incidence of absolute poverty (6.7%), but the system of social protection needs to be reformed to render it more efficient and cost-conscious through better targeting and linking contributions to benefits; otherwise, the system is in danger of becoming seriously underfunded, forcing a decrease in the quantity and the quality of the services.

B. The Financial Sector

1. Overview of the Financial System

2.07 Institutional framework. Tunisia's banking system is comprised of the Banque Centrale de Tunisie (BCT), twelve deposit (commercial) banks, eight investment (development) banks, one specialized savings institution, and eight off-shore banks. The Government holds a majority share in four of the five larger commercial banks; two private commercial banks are subsidiaries of foreign banks, and several other private commercial banks have significant portions of their capital held by foreign interests. Government holds a 50% share in many of the development banks, and foreign governments (Kuwait, Qatar, Saudi Arabia, United Arab Emirates) hold the other 50%. As of 1992, the commercial banks represented about 82% of total assets of the banking system. In 1992, there were two financial leasing companies, with total assets equal to DT 64 million, or less than 1% of the total assets of the banking system. Potential for expansion is considerable,[1] and several new financial leasing companies, subsidiaries of banks, are being established. Other financial institutions (FIs) include a number of insurance companies, a postal checking center, several mutual funds, and investment firms. The capital market is just emerging and the stock market is limited in size, with only twelve companies listed permanently, of which nine are banks. It is, however, testimony to Tunisian entrepreneurship that FIs, such as factoring companies and investment firms, and financial instruments are continually being created in response to emerging opportunities.

Table 2.2: Distribution of Credit to the Economy, 1986-92

	1986	1987	1988	1989	1990	1991	1992
	DT millions						
Commercial Bank Lending	2953	3218	3527	4688	5161	5649	6495
of which Special Resources	411	436	472	547	618	698	784
Development Bank Lending	1026	1185	1292	848	984	1195	1415 [2]
of which Special Resources	371	442	554	337	387	455	526
Total Lending	3979	4403	4819	5536	6145	6844	7910
of which Special Resources	782	878	1026	884	1005	1153	1310
	%						
Commercial Bank Lending							
Short Term	73.7	72.2	72.6	68.1	68.5	62.3	74.9
Medium Term	18.7	19.5	18.8	19.2	18.7	24.5	18.6
Long Term	7.6	8.4	8.6	12.7	12.8	13.2	6.5
	100	100	100	100	100	100	100
of which [1]							
ST Special Resources	4.3	4.0	4.0	3.5	5.5	4.4	n.a.
MT Special Resources	14.9	16.9	14.4	16.5	9.1	12.3	n.a.
LT Special Resources	82.1	72.7	76.9	47.9	50.4	49.3	n.a.
Total Special Resources/ Total Comm. Bank Lending	13.9	13.5	13.3	11.7	12.0	12.4	12.1

[1] The percentages represent the proportion of short, medium and long term lending financed from special resources.
[2] Includes DT 54 million from leasing companies.

[1] The potential market for leasing activities in middle-income countries is considered to be 2-2.5% of GDP; based on this assumption, excluding public sector activities, the potential market in Tunisia in 1992 was DT 200-250 million.

2.08 Structure of credit. As indicated in Table 2.2 above, total credit to the economy grew at about 12% p.a. over the period 1986-1992, and the role of commercial banks continued to expand, their share in total outstanding credit increasing from 74% to 82%. In addition, the share of medium and long term credit in commercial bank lending increased from 26% in 1986 to 38% in 1991, testifying to an increasing role in term lending where development banks have traditionally been prominent; this increased rate slackened in 1992, probably due in turn to a slackening of investment demand (see para. 5.05 for a discussion of estimated future investment demand). Another structural change has been the reduced reliance of the banking system on special resources for long term lending. Special resources comprise Government funds targeted to priority activities (e.g., agriculture, small-scale industries) and long term external resources from bilateral and multilateral sources, often at below market rates. The share of special resources in medium and long term credit extended by commercial banks decreased from 34% in 1986 to 25% in 1991, and should further decrease markedly when the new unified investment code becomes effective (para. 2.14).

2.09 Economic and Financial Reforms Support Loan (EFRSL). In FY92 the EFRSL (Loan 3424-TUN) was put in place to support Tunisia's program of economic reforms, particularly in the areas of external trade and prices, financial markets, banking supervision and regulation, special incentives (including a new investment code), and the social security system. For the first tranche release of US$100 million in December 1991, the EFRSL supported the following reforms in the financial system: (a) Government's issuing Treasury bonds of at least two different maturities at market rates; (b) a program of redemption over 1993-1996 of financially unattractive Government bonds which had been force-placed; (c) removal of the requirement of banks to hold 20% of their deposits in Treasury bonds (para. 2.12); (d) improved taxation of financial instruments (para. 2.15); and (e) replacement of the cap on deposit banks' spread of lending rates by a cap on the average spread (para. 2.13). In banking supervision and prudential regulation, the BCT issued satisfactory provisioning and loan classification rules and other prudential ratios (para. 2.16), defined acceptable audit and reporting practices for FIs, and adopted a program to reinforce its supervision services. For the second tranche release of US$70 million in August 1993: (a) a new draft banking law has been submitted to the Chamber of Deputies, putting the commercial and development banks on a more level playing field; (b) banks representing at least one-third (in fact, over 40%) of the assets of the banking system had been audited and, where necessary, action plans approved to ensure adequate provisioning and recapitalization (para. 2.18); and (c) agreement was reached on the new unified investment code which, inter alia, eliminates subsidized, targeted investment credits from domestic resources (para. 2.14). For the final tranche release of US$80 million in early 1994, all lending rates will be free (para. 2.13), over two-thirds of the FIs will have been audited and necessary action plans agreed, a program of audits agreed to complete the coverage of the banking system, and the unified code of investments will be adopted. The matrix of conditions to be met for tranche releases is contained in Annex 2. Those reforms already undertaken and those in progress under the EFRSL will bring about a more liberalized, unsubsidized financial sector, whose institutions will progressively reach international standards of capital adequacy; it is within this framework of reform and liberalization of the financial sector that the proposed project has been formulated and appraised. Project supervision will continue to review the situation in the financial sector to ensure that there has been no reversal of key policy reforms (para. 6.19).

2.10 Rationale for the proposed project. The EFRSL serves to strengthen the prudential framework, remove remaining distortions in the distribution of credit and tax treatment of financial instruments, and put commercial and development banks on a more equal footing in meeting the demand for long-term credit. Nevertheless, it will be some time before the equity and bond markets develop fully to play their part in mobilizing long-term resources. At the same time, the amounts of special resources and BCT rediscounting will decrease as the unified investment code sharply reduces subsidized long-term resources. Until such time as the markets are sufficiently developed to replace these funds, development banks (the traditional source of term lending) and commercial banks and leasing companies will need to mobilize new term resources to balance the maturities of their assets and liabilities. The Bank loan will provide, at market prices, part of the term resources needed by the banking system during this transitional period. Moreover, this will enable new FIs, i.e., financial leasing companies, to have access to term resources and to meet the credit needs of private enterprises, and will encourage competition among the participating FIs.

2. Financial Sector Reforms

2.11 Deepening the financial markets. Since 1987 the Government has undertaken a broad-based liberalization program in the financial sector. One of the objectives of this program was to create conditions for more effective indirect monetary management. The development of the money market, virtually non-existent prior to 1987 (interbank operations were not allowed), was an essential step in this direction. In 1987, the BCT limited rediscounting, which had been its primary means of regulating the banks' liquidity, to preferential credits and to providing liquidity at penalty rates. Certificates of deposit and commercial paper were introduced in 1987/88 with maturities of up to five years, and in 1989, Treasury bills were introduced with yields that made them attractive to the general public. The money supply is now managed through the BCT's weekly provision of liquidity through an auction process on the money market, and the money market rate (TMM = taux de marché monétaire) is the inter-bank rate (currently 10.825%). The BCT does not normally impose reserve requirements. These developments are creating new competition in the financial sector and gradually widening the array of financial instruments available.

2.12 Prior to 1987, the Treasury issued bonds with unattractive yields, with mandatory placement by banks of up to 20% of their deposits, and most of the remainder in mandatory placements in insurance companies and social security funds. Because of their unattractive yields, these placements represented a tax on the financial system. Since 1992, mandatory placements have been abolished for banks, and mandatory placements in insurance companies and social security funds are being addressed as part of the investment guidelines to be adopted in the reform of the social security system (see EFRSL Matrix, Annex 2). In addition, by 1996 Government will have redeemed all its low-yielding bonds (bons d'équipement) issued since 1988 (the few bonds issued prior to 1988 and still outstanding will mature by 1997). These measures further free FIs in the use of their resources.

2.13 Interest rate liberalization. Until 1987, the BCT regulated closely a detailed structure of interest rates for deposits, by term, by corporate vs. individual, and by size. It regulated a similarly detailed structure of interest rates for lending, by sector, by purpose, by size of loan and by whether the loan was rediscountable. Because real rates were largely negative, credit was rationed administratively. BCT required prior authorization on loans and refinancing, involving cumbersome procedures and long delays. Among other requirements on the use of their funds, commercial banks were required to allocate at least 18% of their deposits to medium and long-term lending, of which 2% to small and medium scale enterprises. In 1988, rates on deposits were completely deregulated, and, notwithstanding attempts by commercial banks to agree on ceilings on deposit rates, competition for deposits is strong. Prior authorization on loans and rediscounts was abolished in 1988, thereby introducing greater accountability and the need for stronger appraisal capacity in the banks. Furthermore, lending rates for deposit banks were liberalized, subject to a ceiling of 300 basis points over the money market rate. Under the EFRSL, as a transitional measure, lending rates were further liberalized to allow for each bank's lending rates being an average spread of 300 basis points over the money market rate. This last administrative constraint will be removed and lending interest rates fully liberalized by the third tranche release in 1994 (see EFRSL Matrix, Annex 2). Interest rates are now strongly positive, with lending rates at 12.5%-14%, and estimated inflation rates for 1992 and 1993 of 5.4%-5.7%. In response to these measures, commercial banks in particular have developed departments specialized in analyzing credit risks and are beginning to differentiate their risks through the interest rates charged on loans.

2.14 Targeted credit. Prior to 1987, targeted credit was an important feature of the controlled financial sector; preferential rediscounts at the BCT and subsidized loans available to investors through the banking system (funded by State loans and bilateral and multilateral sources) accounted for 40% of total lending in the system. Investments in tourism were the major beneficiaries of subsidized lending, with total subsidies amounting to about 27% of the investment cost (including benefits in the form of tax holidays, etc.). Since 1987, these programs have decreased in importance to about 24% of total credit to the economy in 1992 of which 40% is from external resources. It should be noted that preferential rediscount rates at BCT are positive in real terms (6%-9.5%, depending on the sector), and rates to final borrowers from rediscounted funds and state loans are typically 6.5%-12.4%, also positive in real terms. Under the EFRSL, the new unified investment code replaces subsidized lending for investments with fiscal benefits and other investment subsidies on selected investments; it allows subsidized interest rates only for investments by farmers in rainfed areas, micro enterprises, and other small groups of beneficiaries, which together account for a maximum of 5% of total lending to the economy. This compares well with other developing countries.

2.15 Fiscal framework. Prior to 1992, taxation on financial instruments introduced fiscal distortions which favored special savings accounts over less liquid instruments, discouraged resale of bonds and equity shares, and discriminated against open-end mutual funds. In addition, there were strong fiscal incentives to holding onto Government bonds and equities, but strong disincentives to trading them. The tax system has been substantially improved with the elimination of a number of taxes on financial instruments. A greatly improved fiscal framework now puts investments in equities and bonds on a more equal footing and enables open-end mutual funds to compete with closed-end funds. A number of such funds has been created since the change in the tax laws.

2.16 Regulation and Supervision of the Banking System. Since 1991, the Government has given renewed impetus to strengthening the supervision and prudential regulation of banks so as to conform closely to international standards. BCT issued circular 91-24, effective January 1, 1992, which introduces strict guidelines for loan classification, provisioning for potential loan losses, suspension of interest accrual, and the ratio of capital to risk-weighted assets. Loan classification is now based on seniority of arrears (90, 180, 360 days), availability of timely financial information on borrowers, and the financial situation of the borrower. Minimum provisioning rules (20%, 50%, 100% of the total loan and accumulated interest, less the value of acceptable guarantees, evaluated according to strict standards) now apply to all categories of classified loans. Details of these new standards are in the Project File. In addition, the circular sets out requirements for capital adequacy (defined as net equity and reserves (tier one) and general provisions (tier two)), consistent with the Bank of International Settlements (BIS) standards, with a minimum 5% ratio of capital to risk weighted assets. Finally, limits on risk concentration were introduced in the 91-24 circular. Exposure to a single client or to a group of related borrowers was set at a maximum of 40% of net equity for 1992; it was reduced to 35% for 1993 and will be further reduced to 25% for 1994. Once Tunisian banks are in compliance with these regulations, they will present a financially solid, better-capitalized sector, heading toward international standards of capital adequacy. This is expected to be achieved by end-1995.

2.17 Applying the prudential regulations. All Tunisian banks are undergoing international audits, applying BCT circular 91-24 and measuring the impact of the circular on the level of provisions, capital adequacy, and risk concentration. In addition, international auditors are examining and making recommendations for improving the banks' internal procedures and controls. Although many banks may have to increase their provisions to comply with the 91-24 circular, a number of banks, after increasing provisions, are already close to meeting, or are above, the minimum capital adequacy requirements and to respecting limits on risk concentration. The banks participating in the proposed project are in this latter group. A number of public commercial banks, however, will need financial and institutional action plans to recapitalize them, as outlined in para. 2.18 below.

2.18 As of September 1, 1993, special long-form audits had been carried out by international auditors on twelve banks together representing about 75% of the total assets in the banking system. The results have been reviewed by the BCT and the Bank. Action plans on nine of these institutions have been agreed. They include measures on the banks' financial structure to increase their risk-weighted capital ratio to at least 5% by no later than December 31, 1995 (the banks participating in this project will reach this level by December 31, 1994 - para. 4.03), except BNA, which will reach this level of capital by June 30, 1996. For the two largest public commercial banks, BNA and STB, the capital will come from retained earnings, from Government, and from private sources. For the other banks, including for BDET, the increases in capital will be from retained earnings and private sources only. On internal procedures, banks will introduce measures, where necessary, to: (i) strengthen appraisal capacity; (ii) reinforce portfolio monitoring procedures, for both the loan and equity portfolios; (iii) establish internal controls; and (iv) update their procedures and accounting manuals. In addition to ensuring a significantly strengthened banking sector meeting international standards of capital adequacy, this process has highlighted the extent of the exposure of the banking system to public enterprises and the impact on the measure of banks' capital adequacy as a result of provisioning requirements for loans to these enterprises. This in turn may provide new impetus to the privatization process underway.

III. BANK EXPERIENCE IN THE FINANCIAL AND INDUSTRIAL SECTORS AND LESSONS LEARNED

A. Past Lending in the Industrial and Financial Sectors

3.01 The Bank's support to Tunisia's industrial development has evolved over the past thirty years, since the mid 1960s, with a series of lines of credit aimed first at general support to industrial development, and then increasingly at financing what were considered high priority industries, such as small-scale, engineering, and export industries. In addition, since 1987 the Bank has made a series of adjustment loans addressing issues in trade, industry, price liberalization, public enterprise reform and financial sector reform. A more detailed description of each of the most recent loans is contained in Annex 9. This section outlines some of the broad characteristics of the lines of credit and adjustment loans and Section B describes lessons learned.

3.02 The three most recent lines of credit are: Export Industries Project, Loan 2522-TUN (FY85), Second Electrical and Mechanical Industries Project, Loan 2554-TUN (FY86), and Second Small and Medium Scale Industries Development Project, Loan 2911-TUN (FY88). As the names suggest, each of these lines of credit was targeted at a narrowly defined sector and was therefore sensitive to changes in the sectoral demand for credit. All of them faced competition from preferential lines of credit. Ultimately, half of the loan amounts for the first two loans were cancelled. The most recent Loan, 2911-

TUN, has been, by contrast, fully committed well before the closing date and disbursements are ahead of appraisal expectations. The success of this loan was due to several factors. First, the scope of the project beneficiaries was more broadly defined, and therefore less vulnerable to downturns in the targeted sectors. Second, the first two loans became effective just as the Tunisian economy was experiencing a downturn in investment demand, while Loan 2911-TUN was put in place during a more robust period. Third, five banks participated in Loan 2911-TUN, including three commercial banks, as opposed to only three banks under the first two projects. Finally, the loan amount was modest by comparison with the first two loans (US$28 million for 2911-TUN compared to US$50 million and US$54 million for the other two loans). Under all three loans, the performance of the participating banks was varied and Bank supervision was weak. While no evidence exists to suggest that sub-project investments were not properly appraised, evidence does suggest that the investments were not well supervised by some of the participating banks.

3.03 The success of Bank lines of credit is dependant on the macroeconomic environment overriding both investment demand and financial intermediation. Of the six adjustment loans made to Tunisia, four have focussed on various aspects of trade and price liberalization, public enterprise restructuring, and financial sector strengthening. Overall, performance under the adjustment loans has yielded satisfactory results. In 1988, the Bank phased out quick-disbursing adjustment lending, although one final adjustment loan, the EFRSL, was approved on an exceptional basis in December 1991, because of the severe shock to the balance of payments resulting from the Gulf crisis. Its objectives, content, and timetable are described briefly in para. 2.09 and in more detail in Annex 2.

B. Lessons Learned

3.04 Over the years of financial intermediation lending to Tunisia it has become clear that:

(a) targeted lending is particularly vulnerable to changing economic conditions, when the demand for investments in the targeted sector falls off sharply. In addition, the rationale for the targeting may be found, ex post, to have been misjudged, as notions of priority sectors change or the reasons for market failures are miscalculated. The proposed loan will finance a broad range of activities, and should therefore be less vulnerable to downturns in the economy;

(b) the existence of preferential or subsidized lines of credit can effectively crowd out savings mobilization as well as use of Bank funds priced at market rates; it is therefore important to ensure that Government is committed to phasing out the subsidized lines of credit or, at a minimum, ensuring that they are targeted to subsectors that will have minimum impact on the demand for market-priced loans. The new investment code eliminates subsidized investment credits from domestic resources (para. 2.14);

(c) as the financial institutions (FIs) must be relied on to appraise and supervise investments financed with Bank funds, as well as sub-loan repayments, the strength of the participating institutions is important to ensure that investments meet minimum acceptable standards; in addition, FIs must have adequate supervisory capacity, an area in which many Tunisian banks have been lax in the past. For this loan, eligibility criteria have been established for FIs' financial performance and structure as well as management and operations (para. 4.02);

(d) in the past, financial analysis of Tunisian banks was based on tax regulations, profitability was overstated, and debt-equity ratios, on which the Bank relied to ensure financial soundness, proved irrelevant where banks systematically under-provisioned for loan losses. The importance of strict prudential regulations and of their consistent application has now become clear. After the promulgation of internationally accepted standards for loan classification and loan loss provisioning, the preparation and appraisal of this loan relied on international audits for all participating FIs, which already meet minimum criteria for eligibility. Action plans will be carried out to ensure that the FIs comply fully within two years (para. 4.03). Project supervision will monitor compliance with the action plans, and such compliance will be a condition for continued participation in the loan.

IV. ELIGIBILITY CRITERIA AND PARTICIPATING FINANCIAL INSTITUTIONS

A. Eligibility Criteria for Banks

4.01 The prudential regulations in place for banks in Tunisia prior to 1992 did not have strict criteria for loan classification or provisioning. Furthermore, the notion of a minimum standard for risk-weighted capital adequacy, which is relatively recent throughout the world, was absent from Tunisian prudential regulations. The application of the new circular of the BCT on prudential regulations (para. 2.16) shows, for some banks, a cumulative effect of under-provisioning over the past years; it may take several years before these banks are in full compliance with the new regulations. The banks eligible to participate in this project, however, all comply with minimum criteria (para. 4.02), after applying the stricter prudential regulations.

4.02 All participating banks (PBs) in the direct lines of credit under the proposed project meet the following minimum criteria:

(a) have completed an audit for either the 1991 or 1992 fiscal year, carried out by an independent auditing firm which is a member of one of the big six international auditing firms, applying the prudential regulations of the BCT circular 91-24.

(b) after application of the 91-24 circular, each PB has a risk-weighted capital ratio of at least 2.5% as of end-1992, or is taking actions to meet this ratio by loan effectiveness; the audits have in fact shown that most of the PBs are above this ratio, and the others are in a strong position to meet the 2.5% by the end of 1993, before loan effectiveness;

(c) each PB has management acceptable to the Bank;

(d) each PB has an acceptable medium-term strategy and policy statement, and/or will develop them by project effectiveness, including limitations on sectoral exposure for their medium and long-term portfolios (BDET's specific case is discussed in para. 4.29);

(e) procedures for appraisal, supervision, and internal control, as appraised by the Bank, are adequate or being rapidly strengthened; most of the PBs have sound practices, although some will need to be improved in the context of the PBs' action plans;

(f) each PB has a minimum pipeline of investments eligible for financing under the project. For development banks, this pipeline must be no less than US$10 million equivalent in potential loans; for commercial banks, no less than US$4 million equivalent.[2/]

[2/] Commercial banks usually have smaller portfolios of term loans and shorter processing times than development banks.

4.03 The audits detail the level of provisions required by the BCT circular and measure the risk-weighted capital adequacy. While several PBs are fully provisioned and adequately capitalized, others need to increase their provisions and capital to be in full compliance with the BCT circular; for these PBs, action plans were agreed at negotiations to ensure that each PB has a risk-weighted capital ratio of no less than 5% by end-1994.

4.04 The audits also detail the areas where improvements are called for in day-to-day operations and internal controls. The emphasis is on credit operations, and in particular on appraisal and portfolio supervision procedures, on a comprehensive information system, and on adequate internal controls. With the exception of the information system (which often takes a long time to be installed and become operational), actions to strengthen internal procedures should take no longer than one year to implement. Action plans for each bank, as agreed at negotiations and reflected in the legal documents, are also found in the Project File.

4.05 Continued compliance with the eligibility criteria, including acceptable progress in implementing the action plans where necessary, will be monitored regularly in the course of project supervision and will be one of the objectives of the mid-term review (the supervision plan is described in para. 6.19 and detailed in Annex 8). Should any PB fail to meet the criteria at any time, the Bank will have the option of suspending further commitments and disbursements to that PB under the loan. Agreement on these eligibility criteria were obtained during negotiations with all PBs having direct credit lines, and with the Republic of Tunisia for all PBs which will participate in the apex loan.

B. Eligibility Criteria for Financial Leasing Companies

4.06 Financial leasing companies are a relatively new type of financial institution in Tunisia. As of September 1993 there were only three in operation, the first one created in 1985, the second in 1990, and the third in 1993. Several more will begin operations in the near future. Participating leasing companies in the direct lines of credit meet the following minimum eligibility criteria: [3/]

(a) profitable operations for at least the last fiscal year;

(b) according to an independent external audit, compliance with respect to classification of risk assets (loans) and provisioning for risk assets and the minimum capital requirement as specified in the BCT circular 91-24;

(c) an acceptable appraisal and supervision capacity, and an adequate information system;

(d) a medium-term statement, including sectoral limitations on leasing activities;

(e) expected annual approvals of at least US$2.0 million in eligible sectors.

4.07 Continued compliance with eligibility criteria as described in para. 4.05 applies equally to the financial leasing companies. Assurances on these matters were obtained at negotiations.

[3/] Only financial leasing companies (as opposed to operating leasing companies) are eligible to participate: they are subject to regulation and supervision by the BCT, and have general conditions that ensure that the financial leasing company will provide only financing for equipment and/or vehicles; the equipment and vehicles are to be selected, procured, operated, and maintained (and eventually purchased at the end of the lease contract) by the investors. These financial leasing companies maintain no fleet or stock of their own equipment for leasing.

C. Participating Financial Institutions

1. Overview of the participating financial institutions (FIs)

4.08 Under the proposed project, Bank funds will be channelled initially through four private commercial banks, two private financial leasing companies and three public development banks. All nine financial institutions (FIs) participating initially in the project meet the minimum eligibility criteria set out in paras. 4.02 and 4.06. The FIs represent a range of types, ownership structures, and sizes within the Tunisian financial landscape, and are described briefly below (paras. 4.12-4.39) and in Annex 1.1. The full analysis of each FI with accompanying financial statements for the last three years and financial projections is in the Project File.

4.09 As shown in Table 4.1 below, participating FIs account for about 33% of total assets of the banking system, which comprises 22 banks and three financial leasing companies in total. While most development banks are small in asset size relative to the commercial banks, accounting for about 17% of total assets, they account for about 65% of total medium and long-term lending in the banking system. In order to reach a significant number of enterprises in need of term loans, it was thus important to include a number of development banks in the loan. By contrast, although the two financial leasing companies represent only 2% of term financing available through the financial system, they were also included in the project to expand financing options for enterprises, and to encourage competition among different kinds of financial institutions.

4.10 With the liberalization of the financial sector in Tunisia and the increasing competition among financial institutions, there is a need to work out the future strategy of a number of public banks, particularly the development banks. Given the relatively small size of the Tunisian economy, and the large capitalization of the development banks (whose capital exceeds that of the commercial banks by a large margin), it is unlikely that all development banks would be sustainable if they operated with leverages similar to those of the commercial banks. Options for these banks include: remaining as they are and continuing to mobilize their own long term resources for investment financing; modifying their roles to become commercial banks, investment banks, wholesale banks, etc; merging or closing. The Government has agreed to review the future strategy for the development banks, and consultants are preparing a preliminary paper for discussion with Government by end November 1993. Government's strategy will be reviewed during a mid-term review of the project (paras. 5.10 and 6.19).

4.11 The subsidy dependance index (SDI). The SDI is a measure of the total amount of subsidies received by a development financial institution, including the interest paid for its resources and the rate of return earned on its equity compared to a market interest rate, as well as other subsidies received by or passed through the institution. The index is a measure of how much the average interest rates charged on the institution's loans would have to increase by in order for the institution or the beneficiaries to be completely unsubsidized: an SDI of 100% means that lending interest rates would have to double for the beneficiaries to be paying a market rate on their loans. The index does not distinguish between subsidies received by the financial institution versus those enjoyed by the final beneficiaries. SDIs have been calculated for the development banks and are found in Annex 1.2.[4/] The market interest rate used in the calculation was 11.5% p.a. The SDIs vary between 23% for BDET and 108% for STUSID. For these banks, two sources of subsidies emerge: (a) special resources, which are

[4/] An SDI was not calculated for the commercial banks because their use of either special resources and preferential rediscounting at the BCT accounts for only about 10% of their total resources, and detailed information is not available on these resources. The remaining resources come mainly from deposits, which are mobilized in a highly competitive market at liberalized interest rates, and in the money market where they pay the market rate used in the analysis.

either state loans or funds from multilateral or bilateral agencies, where the interest rates are often below-market; these rates, which are positive in real terms, are passed on to the beneficiaries, who are usually targeted; and (b) below-market rate of return on equity. A breakdown of the sources of the subsidy shows that for BTEI and STUSID, 95% of the subsidy comes from the below-market return on equity; for BDET, about 34% of the subsidy comes from this, the rest from the below-market special resources. The differences in the SDI among the banks come essentially from the gap between their rates of return on equity and the market interest rate: the SDI is highest for STUSID, which had in 1992 by far largest amount of equity of the three and a return on equity that was eight percentage points below the market rate; the SDI was lowest for BDET, with the lowest amount of equity and highest return. The SDI will be measured again at the mid-term review. To the extent that the resources continue to come primarily from external donors, however, this source of subsidy is unlikely to decrease in the near future. In addition, given the need to make higher provisions than in the past, it is also unlikely that the banks will make significant improvements in their return on equity in the near future. For these reasons the SDI is unlikely to decrease over the next one to two years. As noted in the preceding paragraph, however, the Government's strategy for the future of development banks will be reviewed during the mid-term review, with the aim of increasing their overall efficiency and profitability in the longer term.

Table 4.1: Participating Financial Institutions(FIs) [1/]
(as of December 31, 1992, in DT millions)

	in DT millions					%		
	Capital	Deposits	Assets	Loans (Net)	Equity Investments (Net)	Risk-wgtd capital ratio	ROA	ROE
Commercial Banks								
ATB	26	249	406	243	2	5.4	1.0	16.1
BIAT	52	821	1264	647	24	1.6	.7	18.7
CFCT	36	337	600	388	7	1.9	1.0	17.0
UBCI	42	326	685	393	9	2.9	1.2	20.5
Total PCB	156	1733	2955	1671	42		0.9	17.5
As % of all CB	31.4%	34.6%	30.6%	25.7%	16.4%		0.7	15.1
Development Banks								
BDET	56	8	563	419	38	7.4	1.4	14.1
BTEI	68	1	94	61	11	58.8	1.9	2.6
STUSID	162	7	219	136	58	62.8	2.7	3.5
Total PDB	286	16	876	616	107		1.8	5.4
As % of all DB	40.5%	4.8%	41.9%	43.5%	42.3%		1.4	4.2
Leasing Companies								
TL	5.4	n/a	49	33	n/a	n/a	3.2	16.9
UTL	4.0	n/a	23	21	n/a	n/a	4.3	18.5
Total PFI	451	1749	3903	2341	149			
As % of total FIs	37.5%	32.7%	33.2%	29.6%	29.3%			

[1/] PCB = Participating Commercial Banks; CB = Commercial Banks
PDB = Participating Development Banks; DB - Development Banks
PFIs = Participating Financial Institutions; FIs = Financial Institutions

2. Commercial Banks

Arab Tunisian Bank (ATB)

4.12 ATB is a subsidiary of the Arab Bank, PLC, headquartered in Jordan. It is a small, private, well-managed commercial bank that has consistently earned a return on equity of about 19%. Its primary business was initially short term trade financing, serving small and medium sized businesses. In the last several years, it has developed a medium-term portfolio: because of its rapid approval process, it has attracted clients of development banks for medium-term loans, which have doubled in three years. Although the bank's assets have grown by 14.8% p.a. over the last three years, the bank has only modest plans for further expansion.

4.13 The results of the 1992 audit and action plan. The international audit of ATB financial statements shows that actual provisions as of end 1992, of DT 9.8 million, represent 3.7% of its gross loan portfolio. The application of the new prudential regulations to ATB's financial statements shows a shortfall in provisions, which its action plan is designed to eliminate by the end of 1994, through a combination of additional provisioning from ATB's expected cash-flow in 1993 and 1994 and the allocation of DT 4.5 million of freed-up reserves to provisions.[5/] With a risk-weighted capital adequacy of 5.4%, taking into account the shortfall in provisions as of end-1992, ATB already meets the BCT's minimum standard for capital adequacy.

4.14 In addition to the measures to be taken to make up the shortfall in provisions, ATB also has an effort to make to respect the single borrower limits, which includes consolidating its exposure to certain groups and encouraging some of its more important clients to seek long term financing in the bond market. On institutional aspects ATB will focus its efforts on developing and implementing a procedural manual for assessing credit risks, and will be using technical assistance, to be financed under the project, for this purpose. ATB also plans to strengthen its accounting and information systems and to develop a centralized system for monitoring its entire risk portfolio, and has requested financing for technical assistance for these aspects as well. Objective criteria have been developed to monitor progress in strengthening credit operations, and these are presented in ATB's action plan, which forms part of the legal documentation for its line of credit.

Banque Internationale Arabe de Tunisie (BIAT)

4.15 BIAT is a privately held commercial bank, 66% owned by Tunisian interests, and 34% by foreign interests, including several banks (French, Italian, Moroccan). Its shares are widely held, with only two foreign banks holding more than a 5% interest each. BIAT is the largest private commercial bank in Tunisia, with a sizable medium term loan portfolio. The majority of its clients are private businesses, but it has provided relatively more credit and taken more equity in public enterprises than other private commercial banks. It has realized a consistently strong return on equity over the past four years (18.5%-20%), due in part to high leverage. Over the last three years the loan portfolio has grown by 16% per year.

5/ Many banks, including ATB, have reserves constituted from profits realized on investments that benefit from fiscal incentives. These reserves (réserves à régime spéciale" or "réserves de réinvestissements exonérés" are to remain unused for a period of five years; once "liberated," the General Assembly may vote, as ATB has done, to use the reserves for provisioning.

4.16 Results of the 1992 audit and action plan. The international audit of BIAT's 1992 financial statements shows that actual provisions, at DT 46.6 million, represent 5.9% of the total gross loan portfolio. About 35% of the total required provisions relate to BIAT's exposure to public enterprises, primarily for non-guaranteed short-term loans. BIAT's risk-weighted capital adequacy ratio at end-1992 was 1.6%.

4.17 BIAT's efforts to meet the BCT's minimum capital requirements and to become eligible to participate in the project include an increase in the capital of the bank by its shareholders of DT 16 million by the end of 1993. This will raise its capital ratio to an estimated 3.1%. It will have a further increase in capital during 1993, with an objective of reaching a capital ratio of 6.1% by end-1994. Its action plan also includes a series of measures to eliminate the shortfall in provisions by the end of 1994. BIAT will: (a) transfer "liberated" reserves to provisions as they become available (estimated DT 12 million in 1993); (b) constitute a total of DT 12 million in provisions each year during 1993 and 1994; (c) decrease the level of provisions required on their private sector clients by improving repayments and reducing arrears, obtaining financial information, and reducing their exposure to certain clients; and (d) reduce their exposure to Groupe Chimique, a large group of public enterprises, through the Government's restructuring program, which in turn will reduce provisioning required on Groupe Chimique. As provisioning required will change each year with the evolution of the bank's activity, the shortfall in provisions will be monitored particularly carefully during supervision. BIAT will also reduce its exposure to certain groups, in order to comply with the BCT single borrower limits.

4.18 From an institutional point of view, BIAT is a relatively strong bank, although its audit identified several areas that require strengthening. The action plan addresses the need to: strengthen BIAT's procedural manual, with technical assistance; upgrade its accounting system and strengthen its information system to improve its portfolio monitoring; and reinforce internal control activities. It has also developed a series of objectives for the next year for staff to work towards improving portfolio quality, reducing arrears, and improving results of loans in litigation. The action plan, attached to the legal documents for BIAT's line of credit, presents these measures in detail.

Crédit Foncier et Commercial de Tunisie (CFCT)

4.19 CFCT was a French commercial bank, purchased by private Tunisian investors led by a family-owned group in the late 1960s; this group continues to hold the majority of its shares and to manage it. The bank lends almost exclusively to the private sector and a large portion of its credits are extended to small businesses. Its branch network has grown rapidly in the past few years, and its loan portfolio has grown at about 13% p.a. since 1990. CFCT's current strategy is now focussed on diversifying its activities through establishing subsidiaries in leasing, factoring and an open-end mutual fund. Its return on equity has been 16%-22% over the past four years. However, the quality of its portfolio has been weakened by its rapid expansion.

4.20 Results of the 1992 audit and action plan. The international audit on CFCT's financial statements for 1992 showed total provisioning at DT 21 million, representing 5.2% of total gross loan portfolio. As of end-1992, CFCT's risk weighted capital ratio, taking into account the shortfall in provisions, was 1.9%. CFCT has already authorized a capital increase which, once realized by the end of 1993, will increase its capital by DT 12 million, and bring its capital ratio to 3.8%. This will enable it to meet the eligibility requirement for participation in this project.

4.21 In addition to the increase in capital in 1993, CFCT is prepared, if necessary to call for a further increase from its shareholders. CFCT will also use the "liberated" reserves, of at least DT 5 million, to constitute additional provisions, along with allocating additional amounts from its cash flow in 1993 and 1994 to eliminate the shortfall in required provisions. Because provisioning requirements and potential shortfalls will change each year, progress towards eliminating the shortfall will be monitored closely during supervision. In addition, as for the other commercial banks in Tunisia, CFCT will make a particular effort to limit its exposure to large groups so as to respect the BCT's single borrower limits.

4.22 Due to its recent expansion, CFCT requires strengthening on institutional aspects. Its action plan calls for finalizing its organizational structure (filling certain higher level positions), updating the operational manual, reinforcing internal controls by instituting systematic inspections followed by internal audit reports, and developing and making use of cost accounting to analyze branch operations. As in other banks, CFCT's action plan includes a series of quantified objectives to measure progress in improving credit operations, including decreasing arrears and reducing the loan amounts under litigation.

Union Bancaire pour le Commerce et l'Industrie (UBCI)

4.23 UBCI was founded in 1961 and subsequently bought by the Banque Nationale de Paris Intercontinentale (BNPI) which still retains 50% ownership; private Tunisian interests hold the other 50%. Its management is influenced by BNPI, with a number of French nationals in managerial positions. UBCI lends to small and medium size private businesses. Like many private commercial banks, however, a large part of its credit exposure is to the forty large private groups in Tunisia. UBCI's management has been quick to respond to emerging opportunities for generating income, and it has had a strong performance over the past four years, with a return on equity of 16%-21%.

4.24 Results of the 1992 audit and action plan. For 1992, the international audit showed that UBCI had provisioned a total amount of DT 41 million, representing 7.9% of its total gross loan portfolio. Taking into account its shortfall in provisioning, UBCI had, at end-1992, a risk-weighted capital ratio of 2.9%, thus meeting the eligibility requirement for participating in a direct line of credit.

4.25 UBCI plans to allocate about DT 5 million to provisions every six months throughout 1993 and 1994 to provision for additional risk assets acquired during this period and to eliminate the shortfall in provisions. In addition, its action plan calls for an increase in capital of DT 5 million by the end of 1994, which, combined with additional retained earnings, will bring its capital ratio up to an estimated 9%. In terms of its institutional capacity, UBCI is relatively strong. As with other commercial banks, however, certain weaknesses were noted by the auditors in terms of respecting internal procedures, and there is room also to improve the information system and internal controls. The action plan calls for adopting software that will improve UBCI's loan classification system, expanding the activities to be subject to internal controls, and meeting quantified objectives in terms of ensuring that an increased percentage of operations are carried out and monitored according to proper procedures. UBCI also aims to maintain its high loan recovery rate of 98%, to reduce its loans under litigation, and to improve its annual recovery of loans under litigation.

3. Development Banks

Banque de Développement Economique de Tunisie (BDET)

4.26 BDET is the largest and oldest development bank in Tunisia, 63% owned by Tunisian interests (Tunisian Government owns 41% of the capital) and 37% by foreign interests, including IFC (with 4% of the capital). In spite of the proliferation of development banks over the last ten years and the expansion of commercial banks into medium term lending, BDET still accounts for 15% of all term lending to the economy. More than 95% of its portfolio is in the private sector. BDET has borrowed from the Bank since 1966 and participated in eleven Bank loans. According to BDET's audited financial statements, return on equity was strong in 1989 and 1990, at 13.9% and 15.3%, respectively. Income figures must be treated with caution, however. According to a special audit on BDET's 1991 accounts, BDET did not provision adequately for the overdue interest accrued in its income statement.

4.27 Results of the 1992 audit and action plan. According to the audit of BDET's 1992 financial statements, BDET's actual provisions at the end of 1992 were DT 27.8 million, representing 5.8% of the gross loan portfolio. Taking into account the shortfall in provisions, BDET was estimated to have a risk-weighted capital ratio of 7.4%, thus meeting BCT's requirement for capital adequacy as well as the eligibility requirement for participation in the project (para. 4.02).

4.28 BDET's action plan includes an allocation to provisions of DT 8 million in 1993 and DT 7 million in 1994 to provision for additional risk assets during this period and to eliminate the shortfall in provisions, an increase in capital of DT 5 million in 1993 and 1994 to continue to strengthen its capital base and a number of measures designed to improve its operations. The supervision functions are to be strengthened through a reorganization and by additional personnel; a plan for recovering loans overdue by more than 90 days has been established; for the information systems, BDET plans to introduce in 1993 and 1994 specific computer software to help its departments monitor their portfolios and to install a new management information system by end-1995. BDET has also established a loan recovery target for the period 1993-96 of 95%, and set a target for the end of 1994 of 65% recovery of loan amounts currently under litigation. Progress in all of these areas will be closely monitored during project implementation.

4.29 On ownership structure and long-term strategy, BDET and Government agree that all future capital increases will come from the private sector, thus diluting Government's ownership. BDET plans to double its capital in the medium term, and this would reduce Government ownership to about 20% of the capital. In addition, agreement was reached at negotiations that BDET will develop, by June 30, 1995, a long-term strategy which will take into account BDET's role as a development bank and consider the potential for BDET to be transformed into another sort of bank (commercial, investment, holding company, etc.). This would be consistent with the agreement between the Bank and the Government to review the role of all development banks in Tunisia with a view to outlining a long-term strategy for the banks (para. 4.10). BDET's plan will be reviewed during the mid-term review (para. 6.19).

Banque de Tunisie et des Emirats d'Investissement (BTEI)

4.30 BTEI was established in 1982 and is jointly owned by the Governments of Tunisia and the United Arab Emirates. BTEI lends almost exclusively to private enterprises in all sectors of the economy, and mostly long term, with maturities from seven to twelve years. It is one of the smallest development banks in Tunisia, and almost always co-finances its investments in consortium with other development banks. It has its own loan appraisal and supervision staff. Its rate of return on equity was 4.5%-5.3% over the 1988-91 period, and fell to 2.8% in 1992 (audited financial statement).

4.31 Results of the 1992 audit and action plan. According to BTEI's international audit of its 1992 accounts, provisioning at end-1992 was DT 15.9 million, of which DT 10.6 was for the loan portfolio, representing 14.6% of its gross loan portfolio. Taking into account a shortfall in provisions, BTEI had a risk-weighted capital ratio of 59%, well above the minimum capital requirement of 5% as stipulated by the BCT.

4.32 BTEI's action plan calls for constituting total provisions in 1993 of about DT 5 million and in 1994 of about DT 6 million, to take account of additional risk assets acquired during this period and to eliminate the shortfall in provisions. If, at the end of 1994, any shortfall remains, BTEI's General Assembly has indicated its willingness to allocate the necessary reserves to ensure that BTEI is fully provisioned. This will be monitored during project supervision. In addition, in terms of institutional aspects, BTEI has already taken a number of measures to strengthen its credit operations, including finalizing the procedural manual, strengthening the accounting of interest payments, and instituting more regular site visits, ensuring an updated inventory of all guarantees. In addition, BTEI has fixed objectives of increasing loan recoveries and recoveries of loans in arrears for the 1993-95 period.

Société Tuniso-Séoudienne d'Investissement et de Développement (STUSID)

4.33 STUSID was created in 1981 by the Governments of Tunisia and Saudi Arabia, each with a 50% share in the capital. STUSID is a medium-size development bank, ranking fourth among development banks. In keeping with its objective of promoting new enterprises, STUSID has a relatively heavy concentration (35%) of its portfolio in equities. Like BTEI, STUSID has considerable room to expand its borrowing and increase its lending: in 1992 its risk-weighted capital ratio was 63% (audited financial statement). Its return on equity has been modest, decreasing from 5.3% in 1989 to 3.3% in 1991 and 3.5% in 1992. This is due mainly to increases in specific provisions and to poor performance of the investment portfolio, which has had a particularly low rate of return (in 1991 it was less than 1%). STUSID needs to improve its project selection criteria and its policies for monitoring and managing its investment portfolio.

4.34 The results of the 1992 and action plan. The audit of STUSID's accounts showed, at end-1992, total provisions of DT 30.5 million, of which DT 18 million were for loans, representing 11.6% of total gross loan portfolio. As noted above, even taking into account the shortfall in provisions, as of end-1992, STUSID had a capital ratio of 63%, and thus was far above BCT's standard for capital adequacy.

4.35 STUSID's action plan includes constituting the maximum provisions from cash flow in 1993 and 1994, on the order of DT 9 million in each year, to account for the additional risks incurred in 1993 and 1994 and to make up the shortfall in provisions; this approach was chosen in order to attenuate the impact that constituting provisions from reserves would have on the capital. From the point of view of capital adequacy, STUSID will remain well above the minimum ratio of 5%. Eliminating the shortfall in provisions will be carefully monitored during supervision of the loan.

4.36 More important for the future of STUSID is the need to ensure that improvements in the quality of its portfolio. The following areas have been addressed in the action plan: (a) improving the procedural manual for credit operations, for which outside consultants are being recruited, and ensuring its application and use; (b) strengthen supervision of loans and equity investments, of the use of loan proceeds, of the reliability of clients' financial information; this will be done through increasing site visits, ensuring the availability of timely financial information on clients, and monitoring more closely loan reimbursements; and (c) installing an integrated information system; and (d) creating and making operational an internal audit unit. STUSID's action plan will be closely monitored during project supervision.

4. Financial Leasing Companies

Tunisie Leasing (TL)

4.37 TL was founded in 1985 as the first financial leasing company in Tunisia. Crédit Lyonnais is the largest shareholder, with 24% of the capital, private Tunisians own another 20%, and the remainder is owned by Tunisian and Arab financial institutions (IFC owned shares until recently). Performance has been strong. While its cost of funds is considerably higher than for banks, TL has been able to pass on the higher costs to its borrowers. Return on equity has been above 21% for three of the last four years, dropping to 16.9% in 1992 as a result of the decreased leverage from a significant capital increase (DT 4 million). In the face of increasing competition from other financial leasing companies being formed in Tunisia, TL may be unable to maintain such a strong return on equity in the future. Currently specific provisions represent 75% of loans in arrears. The audit of TL's 1992 accounts applied the BCT circular 91-24 and showed that it had adequate provisions. TL's one area of weakness is in its monitoring of repayments, which is at present being done manually; TL plans to install an enhanced software system by end-1993.

4.38 Since no specific legal or regulatory framework exists as yet in Tunisia to govern financial leasing activities, BCT established a specific requirement for a maximum debt-equity ratio (4:1) and for effective interest rates that could be charged by TL. TL is in compliance with these requirements and meets the eligibility criteria for financial leasing companies to participate in the project (para. 4.06). In addition, BCT has required the financial leasing companies to apply the 91-24 circular in terms of loan classification and provisioning. Agreement was reached at negotiations that the 91-24 circular will continue to be applied to both Tunisie Leasing and UTL (para. 4.39) for provisioning throughout project implementation.

Union Tunisienne de Leasing (UTL)

4.39 UTL is a subsidiary of UBCI, which holds 40% of the capital of DT 4 million; BNP holds another 20%, and the rest is owned primarily by Tunisian interests. It was founded in 1990. Its strength is that as a subsidiary of a strong commercial bank, it relies on UBCI's branch network and knowledge of the market place. UTL also relies on UBCI's logistical support for its information system and on its financial support for access to funding. It became profitable in 1991, its second year of operation, and in 1992 realized 18.5% return on equity. Since it has a young portfolio, it has no loans in arrears and it has not yet begun to take specific provisions for loans in arrears. UTL also meets the eligibility criteria for financial leasing companies to participate in the project (para. 4.06).

5. Other participating FIs

4.40 In addition to the FIs described above, other FIs may become eligible during the course of project implementation. Once an acceptable audit is available for these FIs, they will be appraised by Bank staff. The FI will be eligible to participate in the apex loan (para. 5.03), if it is shown to meet the agreed eligibility criteria and to have satisfactory management, internal policies and procedures, and an acceptable medium-term strategy, including limits on sector exposure for medium and long-term portfolios. Any action plan necessary to meet acceptable standards of capital adequacy and operations would be incorporated into a subsidiary loan agreement, acceptable to the Bank, between the Republic of Tunisia and the FI concerned.

V. THE PROJECT

A. Project Rationale and Objectives

5.01 Project Rationale. The proposed project complements the trade and financial reforms underway, supporting the adjustment of the private sector to the liberalized, more competitive economy. The proposed project provides term resources to strong, commercially viable financial institutions operating in a liberalized sector which has not yet developed sufficient instruments to mobilize and intermediate term resources. This will enable the FIs to play an important role in financing the investment needs of the Tunisian private sector at a critical juncture in the adjustment of the economy. In support of the dual objectives of promoting greater efficiency and competition, this project will provide term resources to the private sector for productive investments across a wide range of activities. As the funds will be available for on-lending by a number of private commercial banks and private financial leasing companies as well as by development banks, the traditional source of term financing, the project will also promote competition within the financial sector. Finally, the loan funds may be used to finance technical assistance to: (a) the participating FIs to help strengthen appraisal techniques and portfolio monitoring and setting up or strengthening work-out units; and (b) private enterprises to finance engineering and management consultants to develop corporate strategies for enterprises wishing to reorient or adjust their activities to a more competitive environment.

5.02 Project Objectives. The proposed project will provide financially sound banks and financial leasing companies access to term resources at market rates, for the current transitional period during which the long term capital markets will progressively emerge, for financing private firms. By including a wide range of FIs using project funds according to Bank standards, the project will encourage medium and long term lending on a sound basis, as well as greater competition within the financial system.

B. Project Description

5.03 In line with the above rationale and objectives, the proposed project would consist of:

(a) direct lines of credit, totalling US$70 million to nine eligible FIs having completed the necessary audits by negotiations; the amount of each direct line of credit has been made on the basis of the FI's lending program and financing needs of their clients;

(b) an apex loan of US$50 million to the Republic of Tunisia for: (i) on-lending through subsidiary loans to eligible FIs. This would permit flexibility and competition in the use of the funds by each FI; it would also allow additional FIs not yet identified and reaching eligibility after negotiations, to participate in the loan; and (ii) refinancing two Project Preparation Facilities (PPF), totalling US$0.7 million, made earlier to the Government for the benefit of the Société Tunisienne de Banque (para. 5.08) to finance technical assistance and software for the computerization of its accounting system;

(c) technical assistance and training for the participating banks (PBs), to strengthen their capacity to assess risk, monitor their risk assets, establish an early warning system to identify problem loans, and help prepare terms of reference for enterprise diagnoses of clients in need of a new corporate strategy (para. 5.07). The amounts allocated (US$ 1.7 million) reflect the needs of each bank and will be financed from the lines of credit to each bank and from the apex loan.

1. Direct Lines of Credit and Subsidiary Loans to FIs

5.04 Both the direct lines of credit and the subsidiary loans from the apex loan to the participating FIs would finance sub-loans, equity investments and leases to new or existing private enterprises. The amounts of the direct lines of credit for each FI are in Annex 1.0. The sub-loans and leases would be committed by the FIs during a period of up to three years, 1994-1996. The Bank funds would finance: (a) sub-loans by PBs to eligible enterprises for investments and incremental permanent working capital; (b) lease financing by the financial leasing companies for vehicles and/or equipment to be leased to eligible enterprises; and (c) a limited amount, up to 5% of each direct credit line and of the apex loan, of equity investments by PBs to sub-borrowers (para. 6.06). Incremental permanent working capital not associated with investments would be eligible on a case by case basis (para. 6.05).

5.05 Total demand for investment credit from the private sector. The appraisal mission estimates of investment demand from the private sector for the period of loan commitment for the proposed project (1994-96) are about DT 3.2 billion (US$3.26 billion) from the manufacturing and services sectors,[6] assuming an annual growth rate of 8% over the Government's estimates of investment for 1993. Typically about 25% of investment is financed through bank term loans, the remainder being financed through a combination of self-financing, capital increases, and suppliers' credits. Demand for term loans from banks would thus total about US$820 million, and the Bank loan of US$120 million equivalent (of which about 15% will likely be used by the financial leasing companies for equipment financing) would represent 15% of this amount. The loan would thus be a significant contribution to supporting private investment in Tunisia, by making longer term resources available to enterprises through a financial sector which is still developing (paras. 2.11-2.18). At the same time, the loan has been deliberately undersized to encourage competition in use of the funds among the FIs. The eligibility criteria for participating FIs are in paras. 4.02-4.07, and the eligibility criteria for beneficiaries and sub-projects, as well as sub-loan selection and on-lending arrangements are in paras. 6.03-6.08.

5.06 The apex loan would be made to the Republic of Tunisia to be passed on to any FIs meeting the eligibility criteria. For FIs not yet appraised by the Bank, satisfaction of eligibility would be determined on the basis of both the availability and contents of the audit and an appraisal by Bank

[6] This excludes agriculture, housing and non-manufacturing industries (e.g., mining, hydrocarbons, electricity, etc.) and transport; these latter two categories are primarily in the public sector domain.

staff. The terms and conditions of the subsidiary loans to be passed on to eligible FIs from the apex loan would be the same as for the direct loans (para. 6.02).

2. Technical Assistance and Training to PBs

5.07 The proposed project would support provision of technical assistance to PBs, in order to: (a) establish or strengthen procedures for appraisal of clients and sub-projects; (b) reinforce their capacity and methods of monitoring their portfolio of risk assets, particularly by developing an information system; (c) establish criteria for identifying problem loans by installing an early warning system; (d) strengthen work-out departments in dealing with problem loans; (e) develop the capacity to establish terms of reference for comprehensive corporate strategies for client enterprises. The project would support provision of training PB staff through contacts, visits, and exchange of staff with other financial institutions that have experience in dealing with restructuring enterprises. Technical assistance and training programs have been discussed and agreed in principal with several PBs. US$1.7 million have been allocated for this purpose under the lines of credit.

3. Technical Assistance to Société Tunisienne de Banque (STB)

5.08 In 1990, when it was expected that STB would participate in a future project, the Bank put in place a PPF to finance the development of a new accounting system for STB; in 1991, a second PPF was put in place to finance the purchase of an accompanying software package (STB has developed a new accounting plan, installed the software, developed a new accounting manual and is training its staff on the new system). With the introduction of the new prudential regulations, the program of international audits of banks, and the establishment of minimum eligibility criteria for FI participation in the project, STB did not meet the eligibility criteria for a direct line of credit, but it may meet the criteria for participation in the apex loan in the near future. This component of the loan refinances the two PPFs (US$700,000).

4. Retroactive Financing

5.09 During the preparation of the project, a number of eligible participating banks began to identify potential clients and investments. A number of eligible projects may be ready before loan signing, expected during the first quarter of 1994. Retroactive financing would be included for expenditures made on eligible investments after March 31, 1993, and prior to loan signing, up to a total of 10% of the direct line of credit to each FI.

5. Strategy for Development Banks

5.10 In view of Tunisia's economic size, the number of well-capitalized publicly owned development banks appears to be quite large. Because of the changing framework for financial institutions, development banks will face increasing competition, from both commercial banks and financial leasing companies, each offering services or advantages that development banks are not in a position to provide. It is therefore important that the Government, as principal owner or co-owner of these banks, take stock of their potential and develop strategies for their future. Major options are: (a) to remain as they are, mobilizing their own long-term resources; (b) to be transformed into commercial banks, or investment banks; (c) to merge or to close. The Government and the Bank have agreed to carry out an analysis of the situation and future prospects of the development banks. The results of the study will be available by the end of November 1993 and will form the basis for discussion between the

Bank and Government on an acceptable strategy for these banks. Agreement was reached at negotiations that Government will prepare its strategy for these development banks, to be discussed at a mid-term review, by June 30, 1995.

VI. PRINCIPAL FEATURES OF THE LOAN

A. Loan Amount, Allocation of Funds, and Implementation

6.01 The proposed Bank loan of US$120 million will be made in several parts. US$70 million equivalent will be made in direct loans to the nine eligible FIs (see Annex 1.0 for individual amounts to FIs) that meet the eligibility criteria (paras. 4.02-4.07). The remaining US$50 million equivalent will be in the apex loan to the Republic of Tunisia; of this amount US$0.7 million will refinance the two PPFs (para. 5.08); the remainder will be available for use by eligible FIs, with a maximum of 35% of the amount in the apex loan available to any one FI. The BCT will be the implementing agency for the apex loan, monitoring compliance with loan covenants and the use of the funds.

B. Lending Rates, On-lending Rates, and Foreign Exchange Risk

6.02 The loan will be made at the Bank's standard variable rate for 17 years, including five years of grace for the Republic of Tunisia and three of the FIs, and four years of grace for six of the FIs. The Republic of Tunisia will assume the foreign exchange risk on both the direct lines of credit and the subsidiary loans to the FIs from the apex.[7/] For both the direct lines of credit and the subsidiary loans, the variable interest rate paid by the FIs will be set at the money market rate plus 50 basis points to account for the long-term nature of the funds, the setting of interest rates on these loans and the methods of interest payments being the same as those currently used for money market transactions. The variability of the money market rate would be passed on to the final borrowers. The difference between the interest rate to be paid by the FIs on the Bank funds and the standard variable rate charged by the Bank is at present 400 basis points. This would be the margin available to the Republic of Tunisia to cover the foreign exchange risk between the Dinar and the currencies in the pooled funds.[8/] In light of the payment by the FIs of a market based interest rate on the Bank funds, the FIs are not being subsidized.

C. Loan Administration

6.03 Eligible Beneficiaries. Proceeds of the loan would finance enterprises which are: (a) in private ownership, defined as enterprises where at least 50% of the outstanding voting stock or other proprietary interest is owned or effectively controlled by individuals or private sector entities; and (b) operating in all economic sectors, except farming and construction of housing and land development

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7/ The option of putting in place single currency loans was explored; based on information on export markets, the demand was likely to be strongest for French francs, US Dollars and Deutschmarks. For the time being, however, enterprise clients proved reluctant to borrow in other than the local currency, and the single currency option was not chosen for the present loan. In the future, however, there may be a demand for single currency loans, and this option may be further explored in for future loans to Tunisia.

8/ The FIs will also pay the usual commitment fee on the undisbursed funds in the direct lines of credit. In order to make the cost of the apex funds approach that of the funds in the direct lines of credit, a commitment fee, based on the FI's unwithdrawn amount of the apex loan, will be charged. This was agreed at negotiations.

for housing, subject to the limit on the FI's exposure in any one sector as reflected in its policy statement or medium-term strategy (para. 4.02 (d)). In addition, borrowing enterprises must be financially sound and profitable, have no other loans or payments of leasing financing in arrears, or have a plan for repaying them, and be able to repay the proposed sub-loan. The projected indicators to be met by borrowers are a debt/equity ratio not exceeding 70/30, and a debt service coverage of no less than 1.3 by the first year of full development of the sub-project. In addition, Bank financing of sub-loans for any one sub-project will not exceed 70% of the total cost of that sub-project.

6.04 Eligible sub-projects. Total project cost of a single sub-project to be financed by the Bank loans will not exceed US$25 million (excluding the cost of land). In addition, sub-projects must yield a projected financial rate of return of at least 12% and a projected economic rate of return of at least 10%. For certain existing enterprises in need of revising their corporate strategy, appraisals would be based on a full enterprise diagnosis, covering competitiveness of current and/or prospective markets, level of technology, quality of the products and packaging, marketing strategy and prospects, level of training and expertise of the staff, organization and management, environmental, health and safety aspects of production, and environmental standards of current or prospective markets. The specific content of the appraisal reports, above and below the free limits (para. 6.09), are presented in Annexes 5 and 6, respectively. The sum of all sub-loans financed by the Bank through any one FI to the same sub-project will be limited to US$3 million; the total amounts financed by the Bank under this project to a single sub-project will be limited to US$10 million.

6.05 The loan would finance the credit demand for investments and associated incremental permanent working capital from new and existing private enterprises; specific technical assistance needs of individual PB and/or enterprises would also be financed under the loans. In addition, incremental permanent working capital would be eligible for financing, even where no capital investment occurs, where its need could be shown to support an expanded capacity or increase in capacity utilization and to have a significant impact on the financial return to the enterprise.

6.06 Because many Tunisian firms are undercapitalized, banks often play an important role in providing equity participation. Under the loan, equity investments by the PBs could be financed. Financing of equity under the loan would be limited to an aggregate of 5% of the amounts of direct lines of credit to each PB and of the apex loan, provided that such equity investments were associated with additional capital investments. Agreements to this effect were reached at negotiations.

6.07 On-lending terms and conditions. On-lending rates in Tunisia are determined by PBs in accordance with their lending policies and procedures; for deposit banks the average on-lending rates are currently subject to an average ceiling of three hundred basis points over the money market rate, and vary between 12.5% and 14%. This ceiling will be removed in 1994. Development banks are free to set their on-lending rates. Financial leasing companies are also free to set their rates, which currently vary between 17% and 19%, depending on the term (typically 3 to 5 years). On-lending rates are legally variable according to the loan contracts, although in the past, banks generally kept the interest constant for the life of the loan, because the banks' borrowing rates had been relatively stable. More recently, banks have begun to charge variable interest rates.

6.08 The sub-loans would have maturities, depending on the needs of the particular sub-projects, of up to 15 years (medium term is two to seven years, long term eight to fifteen years) with up to three years grace period. The leases may have repayment periods of up to seven years, with up to six months' grace period. The FIs would be authorized to use pre- and re-payments of sub-loans and lease financing and proceeds from the sale of equity investments to finance additional eligible sub-projects; the use of the pre- and repayments would be monitored during the life of the loan (para. 6.19). Agreement on these matters was reached at negotiations.

6.09 Free limits and sub-loan approval. For sub-loans and lease financing below the free limit of US$1 million equivalent, the FIs will request authorization from the Bank in a simplified form showing that the sub-project satisfies the eligibility criteria and explaining sub-loan conditions. The sample format of requests for sub-project approval below the free limit is found in Annex 6. For sub-loans and lease financing exceeding the free limit, the FIs will forward to the Bank, for its review and approval prior to commitments made by the FIs, the complete appraisal report together with information on sub-loan and lease financing conditions. Amounts below the free limit are estimated to cover about 30% of total commitments, and about 70% in number of eligible sub-loans.

6.10 For first-time borrowers from the Bank (commercial banks and financial leasing companies), however, the first three sub-projects from each FI, irrespective of their size, will be submitted to the Bank for approval on the basis of satisfactory appraisal reports, prior to commitment by the FIs. After approval of the first three sub-projects, appraisal reports for sub-projects below the free limit will be sent to the Bank for information only. Agreements on these matters were reached at negotiations.

6.11 Bank funds are expected to be committed over a three year period, 1994-96. The final date for submission of investment sub-projects to the Bank will be December 31, 1996.

D. Procurement and Disbursements

6.12 The investment cost of most sub-projects is expected to be on average about US$2.5 million equivalent. Individual contracts for procurement of goods and services will generally be less than US$1.0 million equivalent. Procurement of contracts below US$5.0 million will take place under the supervision of FIs through existing local channels according to established commercial practices in Tunisia, where the self-interest of the entrepreneurs has led to efficient procurement. In addition, with current account convertibility of the Tunisian Dinar, international transfers of funds have been liberalized for private enterprises procuring foreign goods and services, removing the last administrative constraint to ensuring efficiency in procurement. For any contract exceeding US$5.0 million, procurement will follow the Bank's guidelines on ICB procedures. The FIs will maintain, for Bank supervision, records on the methods of procurement used.

6.13 Consultants for technical assistance with qualifications, terms and conditions of employment satisfactory to the Bank would be appointed following Bank Guidelines on the use of consultants published in August 1981. For consultants' contracts estimated to cost less than US$100,000 equivalent each, prior review or approval by the Bank of budgets, short lists, selection procedures, letters of invitation, proposals, evaluation reports and contracts will not apply.

6.14 The Bank loan will disburse 100% of the amounts disbursed by the PBs for the sub-loans and equity investments, and 100% of the amount disbursed by participating financial leasing companies for leases of vehicles and equipment. The PBs disbursements against invoices for sub-project costs would represent up to 70% of the total sub-project cost (as most term lending is by consortium, the percentage financed by a given PB is likely to be far below 70%), since at least 30% of the sub-project costs will be financed by equity (para. 6.03). The Bank would thus finance up to 70% of the cost of investment projects financed by PBs and 100% of the cost net of taxes of the vehicles and equipment purchased by the leasing companies for the purpose of leasing; taxes and duties on investment projects are estimated to be no more than 20% of the total cost, and 15% of the total cost of equipment alone. Disbursements will be made on the basis of statements of expenditures (SOEs) for sub-loans made by PBs, for lease financing made by leasing companies, and for technical assistance and training for PBs for contracts valued below US$100,000, with the supporting documentation being retained by each FI and made available for review by Bank supervision missions. Where construction works are executed directly by the investor concerned, this documentation may consist of an independent technical report with a valuation of the works executed. Use of the SOEs was confirmed during negotiations. The Bank will also disburse 100% of the total expenditures for consultants' services and training needs for the PBs.

6.15 Special Accounts. To permit timely implementation of the project, special accounts have been foreseen. Each participating FI[9] will have a special account at one of the PBs and the Republic of Tunisia will have its special account at the BCT. Use and replenishment of the special accounts will follow usual Bank procedures.

6.16 Closing date. It is anticipated that the Bank loan will be completely disbursed over a five and a half year period, that is, by June 30, 1999, as specified in the disbursement schedule given in Annex 4. This is consistent with the disbursement profiles for industrial projects in Tunisia, and compares to a disbursement profile for all sectors of an average of eight years. The final date for submission of sub-projects to the Bank will be December 31, 1996, and the closing date of the loan will be December 31, 1999.

E. Accounting, Auditing and Reporting Requirements

6.17 At least once a year, each FI will be audited in accordance with terms of reference found in Annex 7. For the banks carrying out action plans, the audit reports will summarize the measures that have been taken, compared to those in the action plan. The audit will also review compliance with the BCT circular 91-24, and will report on the required level of provisions, any shortfall, and the quality of the loan and equity portfolios as reflected by the percentage of each portfolio in loan categories 2-4 as defined in the circular, and the percentage of the gross loan and equity portfolios requiring provisioning. The audit will also review the FI's compliance with the BCT regulations on single borrower limits and measure the risk-weighted capital adequacy. The FIs will maintain separate accounts for the use of funds under the project. The auditors will review these accounts and issue a separate opinion as to whether the Bank funds have been used for purposes intended.

6.18 Financial statements of FIs will be audited by independent external auditors acceptable to the Bank and furnished to the Bank within six months of the end of each fiscal year. Auditors acceptable the Bank will prepare audit reports of the Statement of Expenditures (SOEs) and make them available to the Bank within six months after the end of each fiscal year. Agreements on auditing requirements were reached during negotiations.

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[9] Except for BTEI, which has opted not to have a special account.

F. Supervision

6.19 Bank supervision input for supervision missions is indicated in Annex 8. This is in addition to supervision needs in Washington for the review of sub-project appraisals, annual reports, correspondence, etc., as well as for analysis likely to be required to appraise other FIs to determine their eligibility to participate in the project. The annual supervision input in Washington is estimated at 18 staff weeks per fiscal year, starting in FY94. For the total project implementation period of three years, including an early start-up supervision mission before loan effectiveness and a mid-term review, supervision needs are estimated at 100 staff weeks. An additional staff week per fiscal year for at least seven years following loan closing will be necessary to monitor use of reflows (see below). The focus during supervision would be: (a) to work with first-time borrowers on the analytic and document requirements of sub-loans and lease financing; and (b) to focus on progress under the action plans for those FIs requiring them and continued adherence by all FI to eligibility criteria. Eighteen months after loan effectiveness, or around September 1995, a mid-term review would be carried out, which would focus on: (a) commitments by FIs of the direct lines of credit and the apex loan, with a view to cancelling uncommitted funds, if appropriate; (b) review of the FIs' progress on action plans; (c) review of the situation in the financial sector to ensure that there has been no key policy reversals, with a view to suspending additional commitments under the loan if such policy reversals have occurred, in particular, on interest rate liberalization, reduction in domestic special resources as a portion of term lending, and on continued application of prudential regulations. Agreement was reached at negotiations that Government will prepare a report on the state of financial policy implementation two months prior to the mid-term review; (d) review of the Government's strategy for the future of the development banks; (e) recalculation of SDIs for the development banks; and (f) review of BDET's business strategy for the long term. After project closing, attention would continue to be paid to the use of pre- and re-payments of sub-loans and lease financing, and proceeds from the sale of equity investments. These aspects were agreed at negotiations, and recorded in the legal documents.

G. Environmental Aspects and Arrangements

6.20 Tunisia's environmental protection agency, l'Agence Nationale pour la Protection de l'Environnement (ANPE), oversees the regulatory provisions and guidelines governing the environmental impact of agricultural, industrial, and commercial activities. These guidelines, criteria and the monitoring mechanism developed and followed by ANPE are satisfactory. They include a list of industries and activities that require environmental assessments (EAs - the list of such activities and industries is found in the Project File), the process to follow for the preparation of the EAs to be carried out by the enterprises, and technical criteria to be applied in the EAs. ANPE also has a list of local consulting firms who have the capacity to carry out acceptable EAs, although local capacity is limited and needs reinforcement.

6.21 Under the project, all sub-projects that require EAs according the ANPE requirements would have EAs carried out as part of the appraisal process. For sub-projects above the free limit (para. 6.09), EAs would be sent to the Bank as part of the appraisal report. For sub-projects below the free limit, the EAs would be kept on file for review by supervision missions. The PBs will ensure that the sub-borrowers are aware of ANPE's requirements for an EA, and will finance only those investments that fulfill ANPE's requirements. In addition, each sub-project would be designed in accordance with appropriate safety, health and environment guidelines satisfactory to the Bank. Agreements to this effect were reached at negotiations. A beneficiary requesting a sub-loan from a PB would be responsible for bearing the cost of the EA, which could be financed by the PB as part of the pre-investment analysis.

Local consulting firms would carry out the EA, supplemented by international technical assistance where required. Bilateral grant funds are available to finance international technical assistance, in the context of investments for pollution control. METAP funds may also be available for technical assistance and training of staff from local consulting firms to carry out EAs.

VII. Project Benefits and Risks

7.01 Benefits. The Government considers private sector development crucial for the transformation, growth, and sustainability of the economy. Through the provision of financing for projects in the private sector, the project will make a significant contribution to industrial and export growth, to the generation of additional employment, and to industrial diversification, which, in turn, will help sustain economic growth. The ongoing process of economic liberalization and the dismantling of administrative controls in Tunisia's domestic markets have increased competition, with a growing number of private enterprises facing major challenges. At the same time, banks have traditionally played a passive role in financing enterprises, rarely taking initiative in helping enterprises to modernize or diversify when necessary. The project will assist these enterprises by providing to commercial banks and financial leasing companies as well as to development banks term resources required to broaden the financing options for enterprises. Overall, the project would contribute to enhancing private sector competitiveness in the Tunisian economy and to encouraging competition in the financial sector.

7.02 Risks. A number of risks exist to the successful implementation of this project. First, it is possible that a few of those FIs requiring action plans may have difficulty in meeting the agreed targets and measures, and would thereby lose their eligibility to participate in the project. This risk has been mitigated by ensuring strong commitment by the FIs to a carefully designed action plan. A second risk is that commitments under the loan may be slower than expected if investment demand turns sharply down. The estimates of demand for credit show that with a zero growth over the estimated 1993 level of private investment, the loan would still represent a modest proportion, or 17%, of total expected demand for credit. In addition, the loan has been deliberately undersized, bearing in mind the needs of the FIs for term resources for financing eligible activities, in order to ensure competition and rapid use of the funds.

VIII. Agreements Reached and Recommendation

8.01 Agreement was reached at negotiations for each participating FI that:

(a) an action plan, as agreed with the BCT and the Bank, will be carried out, with measures to:

- (i) reconstitute any shortfall in provisions by end-1994;
- (ii) meet a risk weighted capital ratio of at least 2.5% for the year audited or by loan effectiveness;
- (iii) meet a risk-weighted capital ratio of at least 5.0% by end-1994; and
- (iv) improve internal procedures and controls (paras. 4.02-4.04).

(b) PB's failure to meet quantified targets and specific time-bound actions would be cause to suspend further commitments and disbursements under the loan (para. 4.05);

(c) for financial leasing companies, the BCT circular 91-24 would be applied for loan classification and provisioning throughout the life of the project (paras. 4.07 and 4.38);

(d) for other FIs, not receiving direct lines of credit, participation would be conditional on an acceptable audit available to the Bank, showing that it meets the agreed criteria; in addition, Bank staff would carry out an appraisal to ensure that the FI has acceptable management quality, internal policies, medium-term strategy, and credit procedures (para. 4.40);

(e) for BDET, a medium-term strategy would be developed by June 30, 1995 for discussion at the mid-term review (para. 4.29);

(f) retroactive financing would be limited to 10% of each direct line of credit (para. 5.09);

(g) no one FI would borrow more than 35% of the amount in the apex loan (para. 6.01);

(h) the interest rate paid by the FIs on the amount of the Bank's loan will be set at the money market rate plus 50 basis points (para. 6.02);

(i) the PBs would on-lend in accordance with agreed eligibility criteria for beneficiaries and for sub-projects, and on agreed terms and conditions, with appropriate sub-loan processing and administration (paras. 6.03-6.04);

(j) financing of equity by a PB would be associated with capital investments and would in the aggregate be limited to 5% of the loan to each PB and 5% of the apex loan amount (para. 6.06);

(k) pre- and re-payments of the sub-loans and lease financing and proceeds from the sale of equity investments could finance additional eligible sub-projects and would be monitored for the life of the loan (para. 6.08);

(l) with the exception of (m) below, a free-limit of US$1.0 million would apply to all sub-loans and lease financing, above which a full appraisal would be sent to the Bank for prior approval (para. 6.09);

(m) for FIs who are first-time borrowers from the Bank, the first three sub-projects, regardless of their size, will be submitted to the Bank for approval on the basis of satisfactory appraisal reports, prior to commitment by the FIs (para. 6.10);

(n) all FIs would follow the Bank's procurement, disbursement, monitoring, accounting, auditing, and reporting requirements (paras. 6.12-6.18);

(o) PBs will ensure that borrowing enterprises follow ANPE's requirements for an environmental assessment and will finance only those investments that meet the requirements (para. 6.21).

8.02 Agreement was reached with Government that it would develop a strategy for development banks by June 30, 1995, and that such strategy would be discussed during the project's mid-term review (paras 5.10 and 6.19).

8.03 During the mid-term review of the project, the situation in the financial sector will be reviewed to ensure that no key policy reversals have occurred; such reversals would be cause for suspension of new commitments under the loan (paras. 2.09 and 6.19).

8.04 It would be conditions of effectiveness of the direct lines of credit, and conditions for access of FIs to the apex loan, that each FI has:

(a) an acceptable policy statement;

(b) acceptable medium-term business plan, including limits on sector exposure of medium and long-term portfolios (except for BDET, see para. 8.01(e));

(c) a risk-weighted capital ratio of at least 2.5% for those banks below this ratio at end-1992 (para. 4.02).

8.05 Based on the above-mentioned agreements, the project is considered suitable for a Bank loan in an aggregate amount of US$120 million equivalent for seventeen years, including five years of grace for the Republic of Tunisia and three financial institutions and four years of grace for six financial institutions, at the Bank's standard variable interest rate.

Annex 1.0

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

Summary of Loan Amounts
by Category for each Financial Institution
(US$ Million)

Financial Institution	Sub-loans or Lease Financing	Equity Investments	Technical Assistance and Training	Total Loan Amount
ATB	5.1	0.3	0.6	6.0
BIAT	7.5	0.4	0.1	8.0
CFCT	6.55	0.35	0.1	7.0
UBCI	6.55	0.35	0.1	7.0
BDET	11.3	0.6	0.1	12.0
BTEI	9.4	0.5	0.1	10.0
STUSID	9.4	0.5	0.1	10.0
TL	6.0	n/a	n/a	6.0
UTL	4.0	n/a	n/a	4.0
Total	65.8	3.0	1.2	70.0

Annex 1.1

Summary Table of Financial Ratios for Participating Development and Commercial Banks

Presented below is a table of financial ratios for banks participating in this project. Figures are based on 1992 financial statements audited in accordance with international standards.

	ATB	BIAT	CFCT	UBCI	BDET	BTEI	STUSID
	-----------------As % Average Assets-----------------						
Operating Income	3.9	4.5	4.2	5.2	3.2	8.7	6.7
Staff, Administrative and Depreciation Expenses	2.5	2.5	2.4	2.3	.8	2.0	1.2
Other Net Income	.6	0	0	.3	1.0	.8	.8
Provisions 1/ (General & Specific)	.7	1.2	.8	.8	1.8	4.5	3.6
Return on Assets	1.0	.7	1.0	1.2	1.4	1.9	2.7
Leverage (Average)	15.5	27.4	16.9	17.4	9.8	1.3	1.3
Return on Equity	16.1	18.7	17.0	20.5	14.1	2.6	3.5
	---------------------%---------------------						
Specific Provisions/Gross Loan Portfolio	3.7	5.9	5.2	7.9	5.8	14.6	11.6
Capital Reserves/Risk Weighted Assets and OBS 2/	5.4	1.6	1.9	2.9	7.4	58.8	62.8

1/ Includes tax credits for equity investments.

2/ Net of any shortfall in provisioning and based on assets and off-balance sheet items weighted in accordance with Tunisian regulations. For UBCI, BTEI and STUSID, additional reserves which have been constituted from 1992 profits are not included in the calculation.

Annex 1.2

Index of Subsidy Dependence

	FY 1992 BDET	FY 1992 BTEI	FY 1992 STUSID
i. "Market interest rate" to be paid by the DFI = M	11.50%	11.50%	11.50%
ii. Average cost of concessional borrowing (%) = C	8.76%	10.54%	7.69%
iii. Average concessional borrowing = A	428.2	20.12	36.02
iv. Subsidy on concessional borrowing (M-C) x A	11.7	0.2	1.4
v. Average Equity = E	53.11	67.97	160.6
vi. Subsidy on equity (E x M)	6.1	7.8	18.5
vii. Total Subsidy = (iv) + (vi)	17.8	8.0	19.8
viii. Profit = P	8.142	1.78	5.68
ix. Interest income LP * i	41.58	7.77	13.09
x. Subsidy Dependence Index = [(iv)+(vi)-(viii)/(ix)]	23.32%	80.18%	108.18%
xi. Current average on-lending rate	13.00%	13.00%	13.00%
xii. Increase in on-lending rate required to eliminate subsidy dependence	3.03%	10.42%	14.06%
xiii. Required subsidy-free onlending rate = (xi) +(xii)	16.03%	23.42%	27.06%

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA
PRIVATE INVESTMENT CREDIT PROJECT

MATRIX OF CONDITIONALITY
ECONOMIC AND FINANCIAL REFORM SUPPORT LOAN

I. MACROECONOMIC

Objectives	Performance to date	Actions before First Tranche	Actions before Second Tranche	Actions before Third Tranche
- Achieve economic growth with sustained rising per capita consumption and declining unemployment while maintaining long-term macroeconomic stability. Increase the economy's long-term resistance to external shocks. Overcome the effects of the Gulf crisis and regional tensions.	- Comparing 1980-85 with 1986-90, current account deficits were reduced from an average of 7.9% of GDP to 3.3% and budget deficits from 5.6% to 4.0%. Growth of non-oil exports rose from 4.3% p.a. to 13.9% p.a. and GDP growth from 4.2% p.a. to 4.4% p.a.. Inflation fell from an average of 9.6% in 1980-85 to 7.1% in 1986-90. The debt service ratio rose from 13% in 1980 to 28% in 1986 and declined to 23.6% in 1989.	- Adopt a satisfactory medium-term program. The program would in particular be monitored by the use of indicators for: (i) the ratio of total external debt to GDP; (ii) the ratio of total external debt service to GDP; (iii) the net transfer of resources; (iv) the growth of non-oil exports; (v) the growth of manufactured exports; (vi) the shares of the private and public sectors in total borrowing; and (vii) the ratio of budgetary interest payments to government revenue.	* Assessment of macro-economic performance and medium-term outlook, and adoption of satisfactory measures for attaining objective.	* Same as second tranche.
	- The current account deficit is expected to reach 5.3% of GDP in 1991, following a plunge in tourism revenue due to the Gulf Crisis. A supplementary finance law, was adopted in March 1991 and is expected to limit the budget deficit to 3.4% of GDP. Inflation remained around 7%.			

II. TRADE, PRICES AND COMPETITION

A. TRADE LIBERALIZATION

- To continue the policies of opening up of the economy.	- In May 1991, imports subject to quantitative restrictions were 72.2% of goods produced in the domestic industrial and agricultural sectors (1989 production weights).	* At least a 15 points reduction (relative to May 1991) in the weighting of restricted imports, measured in terms of 1989 domestic production.	* Reduction in the weighting of restricted imports, measured in terms of 1989 domestic production to 30% below the level in May 1991.	* Complete elimination of quantitative restrictions with the exception of certain agreed items.

B. PRICE LIBERALIZATION

- Production prices.	- Over 70% of production prices are free, measured in terms of 1989 domestic production.		- Complete liberalization except for certain subsidized goods.	
- Distribution margins.	- 29.8% of distribution margins are free, measured in terms of 1989 domestic production.	* Liberalization of distribution margins on goods representing 10% of 1989 domestic production.	* Achieve liberalization of 40% of distribution margins, in terms of 1989 domestic absorption.	* Liberalization of distribution margins will cover 60% of 1989 domestic absorption.

C. COMPETITION LAW

- Establishment of a system to protect against monopolistic practices.	- A satisfactory Law on Competition was submitted to the National Assembly and the Law on the Organi-zation of Commerce eliminates administrative barriers to entry into distribution.	- Adoption of measures to implement the system.		

III. FINANCIAL MARKETS

- Develop effective primary and secondary markets in financial instruments.				
(a) Increase supply of and demand for financial instruments on primary and secondary markets.	- Since 1987, establishment of money market, including CDs and commercial paper. Introduction of Treasury bills. Establishment of stock exchange authorities and formulation of regulations governing the securities market in 1989.	- Issue Treasury bonds of at least two different maturities of more than one year at market yields.		
		* Replacement of obligation on deposit banks to place up to 20% of their deposits in bons d'équipement by obligation to hold up to 20% of their deposits in any Treasury securities, with the right to purchase these securities from any source.	- Review of experience and, in light of review: (i) issue of Treasury bonds of different maturities, in particular of longer maturities, and (ii) reduction of the 20% obligation.	- Joint review of progress and adoption of measures, on the basis of recommend-ations.
(b) Reduction of stocks of financial instruments issued at non-market terms.		- Cessation of issue of bons d'équipement from January 1, 1992.		
		* A program for redemption before maturity over 4 years (1993-1996), in agreed yearly proportions, of all outstanding bons d'équipement issued after 1988.		* Implementation of program for elimination of outstanding stock of bons d'équipement.

(c) Removal of special tax advantages that are distortionary and hinder the development of secondary markets in financial instruments.	- Reform of direct taxation in 1989-90 standardized and reduced the normal taxation of financial instruments, and reduced some special incentives.	* Inclusion in Loi de Finance for 1992 of satis-factory provisions aimed at removing the distortions due to tax advantages, in particular (i) as between holding financial instruments directly or indirectly (SICAVs); (ii) as between the purchase of financial instru-ments on the primary and secondary markets; (iii) as between special saving accounts & other securities.	* Promulgation of law and implementation.	
- Minimize administrative constraints on interest rates.	- Bank lending and borrow-ing interest rates have been deregulated since 1987, with the exception of the spread on commercial bank loans, whose spread above the money market rate has a cap of three points, and sight deposits and saving accounts.	* The ceiling of three percentage points on the difference between the lending rates of deposit banks and the money market rate to be applied instead to the difference between the average (excluding preferential and special resource credits) of the lending rate of each deposit bank and the money market rate.		* Elimination of the ceiling.

IV. BANKING SUPERVISION AND PRUDENTIAL REGULATION

- Endow the BCT with the required organization, staff, and technical facilities.		* Adopt a satisfactory program: (i) clearly allocating responsibilities between the services of the present inspection and control departments; (ii) adopting programs for inspection of banks in 1992; (iii) recruiting and training examiners; and (iv) setting up a computerized off-site inspection model.	- Satisfactory progress in implementing the program.	- Satisfactory progress in implementing program.
- Bringing prudential regulations and banking legislation into conformity with the best international practices.				
(a) Improving rules on loan classification, provisioning and interest suspension.	- Introduction of loan classification system in 1987.	* Adoption of satisfactory provisioning rules setting minima according to seniority of arrears, performance, and severity of classification, to be applied from 1 January 1992.	- Joint review of the application of the new rules.	- Joint review of the application of the rules introduced and study of the advisability of introducing new rules.
			* Tax exemption of specific provisions and interest suspension to be raised from 20% to 25%, and elimination of requirement that judicial action be started.	
			- Assessment of effects of tax exemption of specific provisions.	- Progress on exempting specific provisions from tax in the light of the assess-ment.

(b) Strengthen rules relating risk and loan concentration to capital.	- The maximum lending limit and conditions for its application fixed in 1987.		- Joint review of the application of the rules introduced and study of the advisability of introducting new rules regarding lending to bank subsidiaries.	- Joint review of the application of the new rules.
		* Fixing maximum loan concentration at 40% of own banks funds and adoption of a satisfactory definition of concept of group of related borrowers.	* Reduction of the loan concentration limit to 35%.	* Reduction of the loan concentration limit to 25% and introduction of an increase in the minimum level of capital adequacy for excesses over the 25% level.
	- Risk-weighed capital adequacy ratio established in 1987.	- Modification of weighting of balance sheet and off-balance sheet items.		
(c) Improvement of external control through auditors.		* Definition of the detailed audit opinions to be issued by the "commissaires aux comptes". Elimination of the ceiling on the costs of "long report" audits.	* Adoption of audit rules for banks according to international auditing standards including the obligation to furnish "long reports".	
- Strengthening of banking legislation.	- Since 1967 the Banking Law imposes annual review of financial statements by officially approved accountants.	- Satisfactory proposals for the amendment of banking legislation reflecting the fundamental lines of reform.	* Presentation of draft banking legislation to the Chamber of Deputies, satisfactory to the Bank.	- Adaptation as necessary of BCT regulations to the reforms adopted.

- Strengthening of accounting rules and prudential reporting.		- Initiation of revision and simplification of accounting and statistical documents communicated by banks to the BCT in conformity with international accounting principles. * Issue of BCT circular requiring banks to furnish the BCT quarterly profit and loss accounts.	* Issue of BCT circular on accounting and statistical documents to be communicated by banks to the BCT with application to the accounts of January 1, 1993. - Communication by banks to the BCT of quarterly profit and loss accounts begin-ning 31 March 1992.	- Adoption of rules on information published by banks in their annual reports following international principles.
- Strengthening the solvency and stability of the banking system.	- The Central Bank receives a variety of information returns, including a monthly balance sheet and annual profit and loss account.	- Joint review of the situa-tion of the banking system at the end of 1990. - Definition of the basic principles governing the program for strengthening the solvency and stability of banks, including the types of action to be taken for strengthening weak banks. - Adoption of a program of special audits and institutional diagnose of banks accounting for at least 1/3 of the assets of the banking system.	* Joint review of the situation of each bank which that has been audited or inspected. * On the basis of the review's recommendations, implementation of action plans aimed at streng-thening banks already audited and satisfactory individual plans for strengthening weak banks. - Satisfactory implemen-tation of the program. * Adoption of a program to continue special audits and institutional diagnoses of banks to raise the assets of the system covered to 2/3.	* Joint review of the situation of each bank that has been audited or inspected. * Review of progress in implementing the action plans and of the results of the banks subject to action plans for their strengthening. - Satisfactory implement-ation of program. * Adoption of a program to continue special audits and institutional diagnoses of banks to complete the coverage of the banking system.

V. SPECIAL INCENTIVES

- Restrict special incentives to the areas where they can effectively attain the objectives clearly esta-blished by the Government.	- Adoption in 1990 of new law on the taxation of corporate and personal incomes. - Limitations in the fiscal incentives: (i) all enterprises eligible for tax exemptions, with the exception of exclu-sively exporting companies, financial and banking institu-tions subject to corporate taxes of at least 10%; (ii) deduction on reinvested in-come reduced to 30%, with the exception of deposits in project savings accounts, agricultural invesments, and projects in disadvantaged zones.	- Satisfactory terms of reference for a study to formulate an action program for the establishment of a unified investment Code. The study willexamine: (i) the instruments most appropriate to attain the objectives specified by the Government; (ii) the criteria for eligibility of investments; (iii) the mechanisms for granting incentives and the controls to monitor the approved companies.	* Completion of the study and adoption in the light of its conclusions, of satis-factory measures regarding (i) limiting the duration and selectivity of tax advantages to be included in the Loi de Finances for 1993; (ii) the financial advantages. - A draft unified code will be communicated for discus-sion with the Bank.	* Adoption of a satisfactory unified code and imple-menting regulations.
- Improving the budgetary transparency of the system of special incentives.	- In July 1990: (i) increases of at least one point in the cost of loans rediscounted at preferential rates; (ii) reduction in the outstanding balance of rediscounted preferential credits from some 18% to 13% of total lending; (iii) reduction in the number of loan categories benefiting from preferential rediscounting.	* One point increase in the rates on preferential credits.	* Additional 2 point increase.	* Implementation of the recommendations for the reform of the incentives system.

VI. SOCIAL PROTECTION

A. THE SOCIAL SECURITY SYSTEM

- *Establishment of a system* with wider basic coverage and sound financial viability in the long term.			* *Issue of guidelines for the* investment of fund reserves.	
		- Definition of the objectives of the reform of the social security system.	- Creation of a single identification number system for all beneficiaries of the social security system.	
		- Satisfactory terms of reference of studies to help attain the basic objectives of the reform of the social security system.		* Adoption of a satisfactory reform program for the social security system, and application of the measures envisaged by the program for the most disadvantaged.

B. CONSUMER SUBSIDIES

- Reduce subsidies paid by the Caisse Générale de Compensation (CGC).	- The number of subsidized products has been reduced year by year and their prices increased. From 1984 to 1990, such subsidies declined from 4.2% to 2.9% of GDP.	(i) Raise prices on all subsidized commodities according to action plan submitted for the SAL; (ii) introduce a sterilized milk made with local milk with a subsidy of 80 ml/l; (iii) eliminate the subsidy on super 16 fer-tilizer.	(i) Additional price increases according to action plan; (ii) eliminate the subsidy on imported sugar.	(i) Raise prices again according to action plan; (ii) eliminate subsidy on corn, soybean meal, barley & acid oils.
- Reduce costs of pro-duction of subsidized commodities.		(i) Eliminate the transport equalization scheme on pasta and couscous; (ii) introduce instant milk powder on the market.	(i) Eliminate the transport equalization scheme on grains; (ii) completely liberalize the import of acid oils; and (iii) liberalize the import of corn or soybean meal.	

- Improve targeting of subsidies.	- On the basis of a 1989-90 study the Government prepared in September 1990 an action plan consisting of a series of medium-term measures centered on (i) better targeting of the population; (ii) reduction in distribution costs and simplification of the CGC intervention procedures; and (iii) price increases.	- Introduce targeting by quality differentiation by: (a) announcing a pilot opera-tion for a bread made from PS+2 flour; (b) shifting the subsidy on all milk pack-aging to cheaper packaging with the introduction of <u>coussin</u> for 9 million liters of pasteurized milk; (c) introduce non-subsidized, bottled sunflower and corn oils onto the market on a pilot-basis.	(i) Continue to improve quality differentiation by (a) increasing the quantity of milk sold in <u>coussin</u> and (b) carrying out a study on how to help millers regarding PS+2 flour and the execution of a pilot operation for this flour; (ii) direct sales of subsidized bulk oil toward rural areas and poorer neighborhoods; (iii) increasing quantities to meet demand for grain oil sold at cost; (iv) execution of a study based on the note already prepared, regarding the alternatives to direct subsidy programs for disadvantaged families, with assessment of existing programs and identification of new ones.	(i) Implementation of the recommendations of the study for the millers; (ii) continue to enhance quality differentiation for other products; (iii) continue reinforcement of direct distribution systems and introduction of new systems identified by the study.

VII. DEBT MANAGEMENT

- **Strengthening of technical and institutional capacity** to manage the external debt & diversify borrowing instruments at a time when Tunisia is increasingly turning toward the financial markets, in particular to make proper preparations in a context of growing access to those markets on the part of domestic banks & private enterprises.	- Tunisia has never rescheduled external debt. - An asset and liabilities management unit (ALM)was established in the Central Bank in 1990 and is now operational.	(i) *Establishment of a high-level committee to coordinate matters involving the country's external indebtedness and formulate re-lated policies and strategies.*	
		(ii) Submission of satisfactory proposals by the high-level committee with regard to the design of a unified database, needs in computer hardware & software and training, based on a report prepared by an ad hoc commission that would be set up to study these issues. The commission would be composed of representatives from the ALM unit; the debt offices of the Central Bank, Ministry of Planning, Ministry of Finance and other such experts as the authorities deem necessary.	- Establishment of a unified database with computer hardware, software, access procedures and satisfactory coverage; acquisition of appropriate know-how.

* *Key conditionality of the loan*

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

The Manufacturing Sector[10/]

1. Growth of the manufacturing sector. The manufacturing sector has grown in importance from the early 1980s, when it represented about 12% of GDP to the early 1990s when its share of GDP had grown to 15% (Table 1 below); much of this growth has been export-driven. Manufactured exports grew from 26% of total exports and 38% of merchandise exports in 1980 to over 50% of total exports and 77% of total merchandise exports by 1992 (Table 2). While some of the increase in relative importance of manufacturing goods in both total merchandise exports and in total exports is due to the decrease in the importance of oil exports from 38% of total exports in 1980 to about 10% in 1992, the growth of exports of manufactured goods was strong in the latter half of the 1980s, registering 14% to 19% per year (Table 2).

Table 1: Selected Data on Manufacturing Value Added
(in percent)

	1980	1985	1987	1989	1990	1991	1992	1993 proj.
Manufacturing Value Added as % of GDP	11.8	11.8	13.1	14.4	14.9	15.1	15.0	15.5
Growth Rates of Manufacturing (constant terms)	15.2	5.0	4.4	6.0	11.1	4.1	8.0	5.5
Subsectors' share in Manufacturing VA:								
Agroindustry	24.3	23.5	22.0	19.1	19.6	19.9	21.3	18.8
Construction Materials	14.9	17.7	15.8	15.8	15.1	14.8	14.2	14.6
Machinery	13.0	15.2	14.0	13.7	13.5	13.6	12.8	12.9
Chemicals	11.9	4.9	5.4	7.2	6.2	6.0	5.7	5.8
Textiles & Leather	23.7	23.8	27.8	29.7	31.5	31.4	31.8	33.2
Others	12.2	14.9	14.9	14.6	14.1	14.2	14.3	14.6

2. Manufactured exports were the beneficiaries during these years of a policy that granted tax exemptions, simplified customs procedures, and automatic access to use of foreign exchange for importing inputs to encourage enterprises that exported all of their output, the "off-shore" sector. At the same time, however, export growth was vulnerable to the condition of the economies of the principal importing countries. As seen in Table 2.2., growth rates of manufactured exports have declined in recent years to about 11% in 1990, and 3.4% for 1991 and 1992. About three quarters of all exports are destined to Europe (particularly France, Germany and Italy), so that the growth in exports is closely tied to developments in Europe. The recent slowdown in manufactured exports is attributed to the weaknesses in the European economy. The private sector in Tunisia has also expressed concerns that the former

10/ Most of the investments under the proposed Project are expected to be in the manufacturing sector; the focus of the sectoral analysis in the report is thus on this sector.

communist countries of Europe will be given market preference in Western Europe, jeopardizing the special status of Tunisia with the EEC.

3. Structure of the sector. Within the manufacturing sector, textiles and leather have played an increasingly dominant role, both in terms of the proportion of value added in the sector, and in their contribution to exports. In 1980, textiles and leather production represented about 24% of total value added in manufacturing, and by 1992, this proportion had grown to about 33%, the role of agro-industries and chemicals production having decreased (Table 1). In addition, exports of textiles and leather dominate export earnings from manufactured goods, accounting in 1992 for over half of total manufactured exports; machinery exports have also grown, accounting for another 15% of export earnings from manufactured exports (Table 2). In 1992 textile and leather exports accounted for the single greatest export earnings of any category of goods and non-factor services: they were about 160% those of tourism exports and almost three times greater than fuel exports.

Table 2: Selected Data on Manufactured Exports

	1980	1985	1987	1989	1990	1991	1992	1993 proj.
	(in DT millions)							
Total Manufactured Exports	366.5	731.7	1186.2	2009.6	2302.4	2580.9	2760.8	3237.2
Total Merchandise Exports	970.0	1443.0	1770.6	2782.0	3088.6	3429.9	3566.5	4052.1
Total Exports	1424.6	2253.1	2798.4	4253.7	4591.9	4710.9	5291.4	6085.2
	(in %)							
Man. Exports/Merchandise Exports	37.8	50.7	67.0	72.2	74.5	75.2	77.4	79.9
Man. Exports/Total Exports	25.7	32.5	42.4	47.2	50.1	54.8	52.2	53.2
Growth Rates of Man. Exports		1.7	13.9	19.1	10.5	3.4	3.4	9.8
Man. Exports by Sub-Sector Share (%):								
Agro-Industry	9.0	8.6	7.6	5.6	6.0	8.0	5.3	5.5
Chemicals	32.7	32.9	25.4	24.8	17.9	17.4	16.2	15.7
Textile and Leather	46.5	42.4	46.5	43.5	51.3	51.4	56.1	56.2
Machinery	8.4	10.2	11.9	11.6	15.5	15.7	15.4	15.4
Others	3.4	5.9	8.6	14.6	9.2	7.5	7.0	7.1

4. Tables 1 and 2 also show that while the role of textiles grew, the relative importance of chemical products declined. This is due to the problems experienced by Groupe Chimique, a group of public enterprises that extracts phosphates and produces and exports fertilizers and other phosphate-based chemical products. During the mid-1980s, its value added turned sharply negative. Because of the role it plays in employment, production, exports and financial indebtedness (accounting for some 10% of the banking system's assets), it is an important aspect of the Tunisian industrial and financial landscape. The

Government is committed to restructuring Groupe Chimique and has been supported in this by Bank work carried out to define the potential and strategy for such restructuring.

5. The role of off-shore enterprises. The encouragement of off-shore enterprises has enabled Tunisia to maintain a strong record of growth even as it carried out an adjustment and stabilization program that involved compressing public investment rates and liberalizing the trade regime.[11] At the same time, however, the policy of encouraging off-shore enterprise development has not served to create the ripple effect of benefits usually associated with a robust export sector. Because the off-shore enterprises were typically subsidiaries of large (mainly European) multinational firms, both input supply and marketing of output were the responsibility of the parent company. As a result of this structure, the greater economic efficiency, quality and marketing skills typically realized by exporters have not permeated the Tunisian domestic industry. The manufacturing sector in Tunisia has developed a dual nature, with little commerce between the off-shore companies and domestic suppliers, and with domestic firms producing primarily for the domestic market. Government is well aware of this as a challenge for industrial sector policy; it is being addressed partly through a revised investment code and partly through additional sector work to identify any additional measures that may be required.

6. A second challenge for the Tunisian authorities will be to reduce the role of public enterprises in the production of manufacturing. Public enterprises continue to dominate in certain sub-sectors of the economy.[12] Privatization, which began in Tunisia in 1987, has been slow. So far only 39 cases have taken place, mostly of small, loss-making firms. There still remain about 190 firms with State majority holdings and many more with the State as a minority shareholder. In December 1992, the Government streamlined the privatization process and reactivated the program. Some thirty large and profitable enterprises have been slated for early divestiture in this new phase.

7. Investment demand and investment climate. Investments in the manufacturing sector have been uneven over the past seven years; in the two-three years following the 1985 balance of payments crisis and the start of the adjustment program, investments in manufacturing dropped, as did total investments (Table 2.3). They recovered in subsequent years, as the economy continued to grow and exports remained strong. They slowed down again recently in 1992, due to a combination of a downturn in earnings from exports and to the uncertainties caused by the liberalization program underway.

8. The program of trade liberalization that has been underway since 1986 should be largely completed by end 1994. The detailed measures to be implemented and the timetable for their implementation, however, have not been announced by the authorities. In addition, entrepreneurs still do not know the exact content of the new investment code. These uncertainties may be contributing to the recent slowdown in investment.

11/ As of 1989, off-shore enterprises accounted for about 13% of total value added in the manufacturing sector.

12/ In 1989, public enterprises accounted for almost half of value added in the manufacturing sector, and over 80% of value added in the non-manufacturing industrial sector.

Table 3: Investment in Manufacturing

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
	(in DT millions current prices)									projected		
Investments in Manuf.	274	290	274	265	370	434	469	492	544 [1]	588 [2]	635 [2]	686 [2]
Total Fixed Investments	1850	1685	1620	1680	2000	2515	2727	3290	3655 [1]	4202 [3]	4740 [3]	4996 [3]
	(in %)											
Investments in Manuf./ Total Investments	14.8	17.2	16.9	15.8	18.5	17.3	17.2	15.0	14.8	14.0	13.4	13.7
Growth Rates of Invest. in Manuf. (current prices)		5.8	-5.6	-3.3	39.6	17.3	8.1	4.9	10.6	8.0 [2]	8.0 [2]	8.0 [2]
Investments in Manuf. by Sub-Sector Share (%):												
Agro-Industry	12.9	8.2	11.3	14.2	14.1	16.5	15.6	16.1				
Construction Materials	24.6	26.0	26.9	15.1	14.5	15.1	16.3	16.2				
Machinery	25.4	20.7	16.6	29.4	19.2	17.0	15.8	16.9				
Chemicals	20.6	29.3	20.3	6.8	6.3	7.6	6.4	8.9				
Textiles	8.6	8.8	19.2	23.8	35.7	33.4	34.1	28.5				
Others	7.7	6.9	5.6	10.8	10.2	10.4	11.7	13.4				

1/ Tunisian Government, Ministry of Plan estimates
2/ Mission estimates based on 8% nominal increase
3/ Based on WB projections of GDP and GFCF/GDP

9. The Bank has recommended that the Government remove the uncertainty by announcing, as soon as possible, the exact measures, tariff and non-tariff related, to be taken on specific products, with a timetable announcing the schedule for their enactment. The Bank has also recommended the rapid promulgation of the new unified investment code (a condition for third tranche release of the EFRSL (Annex 2)). At present there are several investment codes, one for each sector, including industry. Each code has numerous objectives and most activities are eligible for some advantages. The investment code covering industry is administratively cumbersome and in some respects vague on eligibility. As a result, many entrepreneurs have been frustrated in their attempts to understand and to benefit from the advantages that may have been available to them. A unified code that is clear and simple to administer will improve the effectiveness of the system of advantages. The new investment code will eliminate subsidized investment credits from domestic resources that have hindered the development of the financial markets for long-term financial instruments.

Annex 4

STAFF APPRAISAL REPORT

TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

Estimated Disbursement Schedule of Bank Loan [1/]

Calendar Year and Month-ending Semester	Fiscal Year	Estimated Schedule: Amount (US$ million)	Cumulative Amount (US$ million)	Percentage of Total
06-30-94	94	5	5	4
12-31-94	95	8	13	11
06-30-95	95	9	22	18
12-31-95	96	13	35	29
06-30-96	96	14	49	41
12-31-96	97	14	63	53
06-30-97	97	14	77	64
12-31-97	98	14	91	76
06-30-98	98	14	105	88
12-31-98	99	8	113	94
06-30-99	99	7	120	100

[1/] In general conformity with the standard disbursement profile.

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

Outline for Appraisals of Sub-Projects for Sub-Loans above the Free Limit

1. Each application for financing will be the subject of a detailed appraisal, prepared by the participating bank (PB), consisting of a technical, commercial, and financial feasibility study. These appraisal reports would cover:

(a) description of the proposed or existing enterprise (type of products, branch of industry, key characteristics of input and output markets, particularly in light of the changing levels of protection on imported goods, equipment and technology proposed for use, organizational structure and management quality, technical level and experience of personnel, ownership and capital structure, financial statements of the past three years);

(b) description of the investment program (technical specifications, local and foreign cost of equipment with potential suppliers, source and cost of related working capital, expected capacity increase and utilization); estimated cost of land acquisition and of all taxes; information on procurement procedures used and prices quoted by suppliers of goods and services;

(c) commercial feasibility (for local marketed products: local demand for additional production, current domestic production, imports and import protection through quotas and tariffs, with particular attention to the changing levels of this protection, and price/quality competitiveness with domestically produced and imported products competing in the same market, export potential, marketing arrangements; for exported products: justification of price/quality competitiveness, steps taken by sponsors to secure export markets, marketing channels abroad and purchase orders received or long-term contracts, past export performance, if any);

(d) financial feasibility (analysis of the past three years' financial performance, projected sales revenues and estimated production costs from the proposed project and for the overall firm (if they are separable), a projected financial rate of return of 12%; financial projections concerning balance sheets and profit/loss statements for the next five years, calculation of financial indicators for sub-project eligibility, cash-flow analysis and financing plan of investment program, comments on why participating bank decided to take equity participation, if such is the case); current and projected debt-equity ratio equal or greater to 70:30; current debt service coverage must be at least 1.1 with a projected ratio rising to 1.3 by the first year of full development of the sub-project; and the borrower must have no loans or payments of lease financing in arrears in any Tunisian bank, or have a plan for repaying them.

(e) economic competitiveness, showing an economic rate of return of at least 10%, again paying particular attention to the changing import (border) prices for inputs and output;

(f) environmental impact assessment, following applicable local standards, which have been examined and are acceptable to the Bank.

Enterprise Diagnoses

2. For enterprises in need of revising their corporate strategy, either because they are currently facing problems or because they will soon be exposed to increasing competition from imports, a complete diagnosis should be carried out by external experts in the respective field. Because most enterprises are indebted in a number of banks and most sub-projects have benefitted from consortium financing, the PB that takes the initiative in addressing the problems of a given enterprise will establish itself as the leader of the effort. This PB and the enterprise will then agree on the scope of the diagnosis, with the lead PB working with the enterprise to define the detailed terms of reference. The diagnosis should cover, inter alia, price competitiveness of current and/or prospective markets, level of technology, quality of the products and packaging, marketing strategy and prospects, level of training and expertise of the staff, organization and management, environmental, health and safety aspects of production, and environmental standards of current or prospective markets. The diagnosis should pay particular attention to the changing level of protection on imports of both inputs and the expected production, and should assess competitivity of the firm in the light of expected changes in these protection levels.

3. Appropriate expertise will be identified from a short list of consulting firms in Tunisia who have the experience and/or have professional ties to foreign firms to carry out the diagnosis. The enterprise will bear the cost of the diagnosis, the scope of which would be defined in a contract signed between the enterprise and the consulting firm. Grant funds have been identified to defray up to 40% of the cost of the first several enterprise diagnoses in the context of developing new corporate strategies. The portion of the cost of the diagnosis to be borne by the enterprise would be eligible for financing under the loans; the sub-loan for the enterprise diagnosis would either be rescheduled by the investment loan or recovered within a period of three years from the date of the advance, if no investment loan were made pursuant to the diagnosis.

4. The appraisal of the PB of any proposed investments recommended by the diagnosis should be based on an assessment of the financial and economic viability as projected by the diagnosis, taking into account recommended changes in corporate strategy, organization and management, training of personnel, and technical assistance required for the enterprise. Sub-loan conditionality should be specified by the PB to the borrowing enterprise based on the recommendations of the diagnosis.

Annex 6

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

Format for Sub-Project Appraisal for
Sub-loans Below Free Limit

Sample Format

1. Bank/Consortium: Name of banks, proposed loan and/or equity shares for each bank.

2. Beneficiary: Enterprise name, branch of industry, ownership structure.

3. Financial Data: Eligibility indicators, that is: current ratio (> 1.3), debt/equity ratio (≤ 70/30), debt service coverage (> 1.1) at beginning of sub-project, increasing to at least 1.3 by the first year of full development of sub-project. If indicators not met, indication within how many years indicators are projected to be met. Borrower should have no loans or payments of lease financing in arrears in any Tunisian banks, or a plan to pay the arrears.

4. Investment Project: Brief description of goods to be purchased, total investment cost, including identification of cost of land acquisition and taxes, financing plan (at least 30% equity contribution), financial rate of return (> 12%), economic rate of return (>10%).

5. Environment: Brief description of expected environmental impact, of environmental standards applied, and of measures taken to limit environmental impact.

6. Sub-loan Conditions: Interest rate, maturity, grace period, collateral.

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA
PRIVATE INVESTMENT CREDIT PROJECT

Terms of Reference for the Audits of Financial Intermediaries (FIs)

The annual audit of each FI as required by the legal agreement with the FI would be carried out according to the BCT's note 93/23 of July 30, 1993. International accounting standards are to be applied to the financial statements of the FIs. The audit should give a brief description of the audit procedures used, including a description of any deviation from the above-mentioned norms used by the auditors for auditing or for accounting.

The scope of the audit is an examination of the FI and an opinion of the auditor on:

(a) income statement;

(b) balance sheet;

(c) supplementary financial information, which would include analysis of the use of the World Bank proceeds: a statement of approved sub-loans for the fiscal year, including current and due portion, by sector of the economy.

(d) auditors' opinion on the use of the Special Account and statements of expenditure (SOEs).

Pro forma financial statements, including balance sheets, income statement, and off-balance sheet items, should be presented in accordance with the international accounting standards, with an explanation of any changes in methodology and accounting compared with the previous year and explanations of the adjustments proposed by the auditors to each item in the financial statements.

The annual audit would also present the auditors' estimate of the percentage of the gross loan portfolio in loan categories 2, 3, and 4, as defined by the BCT circular 91-24, the percentage of the gross loan portfolio requiring provisions, according to the circular, and the amount of specific provisions required for loan loss for the year as a percent of the loans in categories, 2, 3, and 4. The audit would also present the percent of the gross equity portfolio requiring provisions, and the amount of specific provisions required for loss in investment value as a percent of gross equity portfolio.

The annual audit would give a special opinion as to the FI's compliance with the BCT circular 91-24 with respect to loan classification and loan loss provisioning, taking into account BCT's acceptance of the validity of information available after the close of the fiscal year and BCT's acceptance of the validity as guarantees of mortgages registered with official agencies. The auditors would express an opinion as to the level of shortfall in provisions for potential loan losses, if any, compared to those required by the application of the BCT circular 91-24.

The annual audit would give a special opinion on the FI's compliance with the BCT circular 91-24 with respect to single borrower limits as presented in Articles 1 and 3, and Article 2 as amended by the Central Bank to a limit for a single borrower of 25% of the bank's capital.The auditors would include a special opinion on the level of capital adequacy, using the weightings for risk assets, including off-balance sheet items, in the BCT circular 91-24.

The audit would also include a management letter, giving auditors' comments as to the quality of the management systems in place, including written procedures, management of the risk portfolio, accounting procedures, and internal control. The auditors should review the implementation of the action plan resulting from the previous years' audit, if any, and comment on the matrix of actions agreed between the FI and the World Bank. The audit should make recommendations, where appropriate, for correcting weaknesses.

The auditors would give separate opinions with respect to both the special account and SOEs used for withdrawals of the Bank Loan. For the special account, the audit would: (i) cover the movement and availability of the funds in the Special Account as recorded in the accounts of the depository bank; and (ii) give an opinion on the statement of transactions and availability of funds at the beginning, during and at the end of the fiscal year, and on the accounting, administrative, and control procedures as well as the system of authorizations made by the depository bank regarding the mobilization and use of the special account subject to examination.

With respect to the SOEs, the auditors' opinion should be issued regarding: (i) the eligibility of the expenditures shown in the SOEs and the adequate utilization of the Loan funds withdrawn on the basis of SOEs; (ii) the adequacy of internal controls and procedures involved in their preparation; and (iii) the reliability of the SOEs to support the application for disbursements.

Annex 8

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

Supervision Plan
Supervision Input into Key Activities

Approximate Dates	Activity	Expected Skill Requirements	Staff Input (SW)
FY 94	-Supervision mission -Project launching	-Task Manager	4
02/94			
06/94	-Supervision mission -follow-up on action plans -appraisal of new potentially eligible FI	-Task Manager -Financial Analyst -Bank supervisors	12
FY 95			
11/94	-Supervision mission -use of funds -follow-up on action plans	-Task Manager -Financial analyst	3
06/95	-Mid-term Review - financial sector review - review of Government strategy for development banks - review BDET's business plan - follow-up on action plans - use of funds	-Task Manager -Bank staff -Bank supervisors	12
FY96			
11/95	-Supervision mission -use of funds follow-up on action plans	-Task Manager -Financial analyst	4
05/96	-Supervision mission -use of funds -follow-up on action plans	-Task Manager -Bank supervisors	6
FY97			
11/96	-Supervision mission -use of funds -preparation of PCR	-Task Manager -Financial analyst	4
		Total	45

STAFF APPRAISAL REPORT

REPUBLIC OF TUNISIA
PRIVATE INVESTMENT CREDIT PROJECT

Bank Experience in the Financial and Industrial Sectors

A. Past Bank Involvement

1.01 The Bank's support to Tunisia's industrial development has evolved over time. Through its first loans to industry in the late 1970s, the Bank aimed at providing general support to industrial development; later, it aimed at promoting industrial decentralization and labor-intensive industries, and financing high priority industries, such as electro-mechanical industries (EMIs) and small scale industries (SSIs). This support consisted mostly of lines of credit channelled to the ultimate beneficiaries through the intermediation of financial institutions. A number of credit lines was successfully channelled, in the late 1970s and early 1980s, through BDET, one of the main borrowers proposed under this loan. The last of these, Loan 1505 (FY78), was for a pilot small-scale industry (SSI) project to prepare the ground for a US$30 million loan to SSIs in 1981, SSI I (Loan 1969-TUN). Two loans were then targeted at the EMI sector: EMI I (Loan 2113-TUN, FY82) for US$30.5 million and EMI II (Loan 2554-TUN, FY86) for US$54 million. To support further Government strategy, a US$50 million loan was made (Loan 2522-TUN, FY85) to promote the efficient development of export-oriented industries. The latest line of credit to Tunisia was for small and medium industrial development (SMI II, Loan 2911-TUN, FY88) for US$28 million.

1.02 Performance results of the two EMI projects were mixed, partly because of a difficult economic climate and partly because they proved to be too optimistic in trying to transform, in a short period of time, a relatively backward, non-integrated sector into a technically advanced one. In addition, these two lines of credit were targeted to a narrowly defined sector, and therefore were more sensitive to changes in the demand for credit. Part of the funds earmarked for their financing had to be cancelled: under EMI I, US$9.6 million out of the original loan amount of US$30 million, and under EMI II, US$31.27 million out of the original loan amount of US$54 million. Although these two projects were not considered successful in terms of performance, they initiated a dialogue between the Bank and the Government which eventually led to a significant liberalization of the economy and of the industry, including the EMI sector.[13/]

1.03 The scope of both SSI I and the Export Industries Projects was more broadly defined, but the projects suffered from preferential credit policies which made the Bank loan uncompetitive, and from slow demand because of the depressed overall economic climate; US$26 million was cancelled of the original US$50 million loan amount for the Export Industries Project, and US$2.6 million cancelled out of US$30 million for the SSI I Project. Lessons learned under SSI I were taken into account in the design of SMI II; improvements in the financial sector under an adjustment loan, ITPAL (para 1.06), also helped. A larger number of banks took part in the distribution of credit under SMI II, and therefore a broader range of end users was reached. The loan is fully committed, is expected to close in June 1995, and disbursement is at a faster pace than projected.

13/ For a full discussion of Loan 2113-TUN, EMI I, see PPAR No. 10501. A Project Completion Report is available for Loan 1969-TUN, SSI I.

1.04 In FY87 the Bank introduced the first two adjustment loans in Tunisia to support the Government's macro-economic adjustment program: one in agriculture and one addressing reforms in trade and industry (Industrial Trade and Policy Adjustment Loan, ITPAL, Loan 2781-TUN), each a loan of US$150 million. Since then, a series of adjustment loans have been concerned mainly with trade and price liberalization and public enterprise reform: the Structural Adjustment Loan, SAL (Loan 2962-TUN, FY88), for US$150 million; Agricultural Structural Adjustment Loan II (Loan 3078-TUN, FY89), for US$84 million, the Public Enterprise Reform Loan, PERL (Loan 3109-TUN, FY89), for US$130 million, and most recently the Economic and Financial Reforms Support Loan, EFRSL (Loan 3424-TUN, FY92), for US$250 million, the last adjustment operation in Tunisia.

1.05 The purpose of the adjustment loans, as time slices of a larger process, was to support the first phase of the Government's program of industrial and trade policy reforms, within the framework of a general macro-economic restructuring program. To complement these efforts, the Government adopted a Medium-Term Industrial and Trade Adjustment Program (MITAP), which had four main objectives: (i) export-driven growth; (ii) increase in efficiency of resource allocation through decontrol of prices; (iii) reduction in government spending; and (iv) promotion of labor-intensive sectors by restraining wage increases. Measures were adopted under the ITPAL and the SAL to decontrol prices, reduce and simplify import duties, remove prior authorization for investments and for bank lending, simplify and rationalize the tax system and introduce a value added tax, and liberalize and ensure positive real interest rates.

1.06 Overall, the industrial and trade policy adjustment program under ITPAL (closed on December 31, 1989) and macroeconomic adjustment program under the SAL (closed on June 30, 1991) generated satisfactory results. Most policy measures supported by the loans were implemented, with the notable exception of removing protection for domestic producers (intended under the SAL). Over the 1987-91 period exports grew rapidly, as did investment, particularly private investment. The reforms allowed greater scope to price signals, notably through the decontrol of domestic prices and the lowering of tariffs, although quantitative restrictions remained a major obstacle. The banking sector was liberalized, although fiscal distortions and Treasury borrowing practices constrained investors' access to term-financing and equity markets, and prudential regulations did not meet international standards. Other constraints to sustainable growth included an inefficient and costly system of special incentives and a costly social security system that reached only a small proportion of the population. To address these remaining obstacles to long-term growth, the Bank made a last adjustment loan, the EFRSL, in FY92 (para 1.09)

1.07 In 1989, a PERL was put in place aimed at public enterprises (PEs), with two main objectives: (a) to reduce Government ownership in the productive sectors of the economy, by divesting, restructuring or liquidating enterprises in difficulty; and (b) to diminish Government intervention in the management of the enterprises that would remain under their control. A number of troubled PEs have been privatized and the number of PEs subject to state controls has been reduced. Performance contracts have been used on a pilot basis to improve the management of six PEs by reducing direct Government intervention in the management of PEs, while establishing agreed performance objectives and targets, including an explicit compensation mechanism for social functions carried out by the PEs. The use of performance contracts is scheduled to be generalized to all remaining PEs during the 1992-96 Development Plan. The first tranche of the loan was disbursed by mid-1991, and the second tranche was released, with some delay, on January 15, 1993.

1.08 From a broad perspective, the PERL was successful in achieving its objectives. Relationships between the state and PEs have been clarified and state intervention has been reduced. The performance of some of the PEs has improved significantly, benefitting from greater autonomy. Privatization is expanding with larger enterprises being put up for sale. Progress in the implementation of performance contracts has taken longer than expected, however, because such contracts are new in Tunisia and represent, in some cases, significant social costs for Government.

1.09 In 1988 the Bank phased out quick-disbursing adjustment lending, although one final adjustment loan, the EFRSL, was exceptionally approved in December 1991 because of the severe shock to the balance of payments as a result of the Gulf crisis. Its objective is to address remaining obstacles to achieving long-term sustainable growth by focusing on: (a) removing quantitative restrictions and achieving virtually complete liberalization of trade and prices; (b) strengthening the financial markets through reducing Treasury intervention in the bond markets, introducing prudential regulations of international standards, strengthening supervision and regulation by the Central Bank, and fully liberalizing all interest rates; (c) reforming the incentives programs by adopting a unified code of investments; and (d) reforming the social security system. The first tranche was released upon loan effectiveness, in December 1991, and progress has been steady, although somewhat slower than expected, on the reform measures; the second tranche was released in August 1993 and the third tranche is expected to be released in early 1994. Annex 2 contains the detailed matrix of conditionality for this loan.

TUNISIA

PRIVATE INVESTMENT CREDIT PROJECT

Selected Documents and Data available in Project File

Banque Centrale de Tunisie (BCT) documents:

1. Circular 91-24, of December 17, 1991, of the BCT (prudential regulations)
2. Note aux banques et établissements financiers no. 93/23 (terms of reference for the audit of the accounts, dated July 30, 1993).
3. Letter dated February 17, 1993 from the BCT to banks, concerning the "consolidation des assises financières et application des normes de la circulaire de la BCT no. 91-24 du 17 décembre 1991" (application of the BCT 91-24 circulaire)

Documentation on participating financial institutions, including:

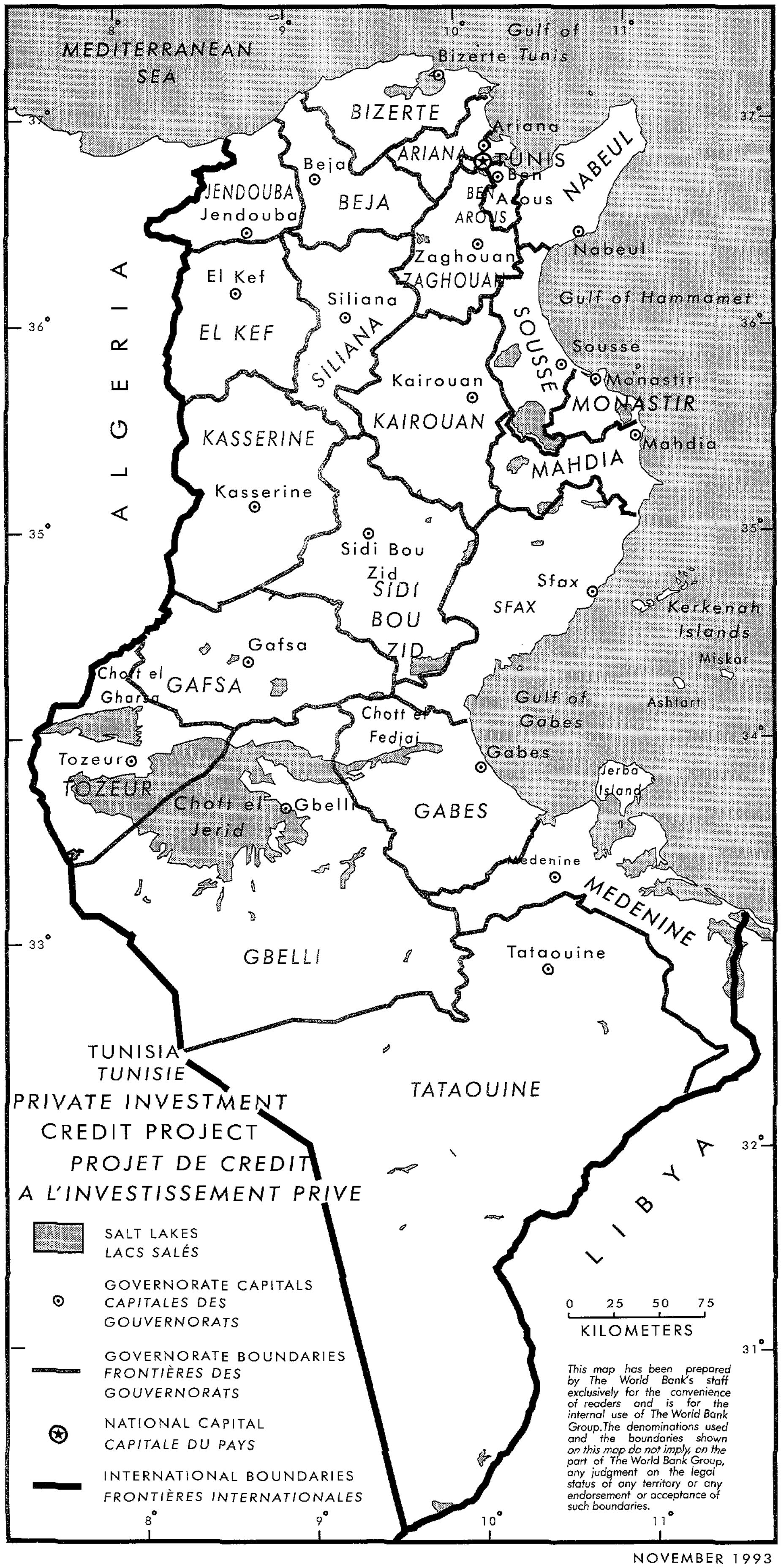
- statutes
- policy statement
- annual reports
- medium term plans
- miscellaneous background information
- international audits for 1991 and/or 1992
- working papers containing Bank staff analysis

For the following financial institutions:

* Arab Tunisian Bank
* Banque Internationale Arabe de Tunisie
* Crédit Foncier et Commercial de Tunisie
* Union Bancaire pour le Commerce et l'Industrie
* Banqe de Développement Economique de Tunisie (includes projections)
* Banque de Tunisie et des Emirats d'Investissements (includes projections)
* Société Tuniso-Saoudienne d'Investissement et de Développement (includes projections)
* Tunisie Leasing
* Union Tunisienne de Leasing

Guidelines on enviromental assessments:

1. List of projects requiring enviromental assessments
2. Flow chart on steps required for approval of enviromental protection agency (Agence Nationale pour la Protection de l'Environnement, ANPE)
3. Outline of contents required for an environmental assessement
4. Technical guides for selected industries:
    * soap factories
    * textile factories
    * tanneries
    * metal, plastic, glass, ceramic factories
    * mining



NOVEMBER 1993