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Algeria's private banks look to retail market as liquidity dries up

Richard Nield | 1/07/2016 9:00 am

Private banks in Algeria have until now been highly profitable, as the energy-rich country was awash with liquidity. But a government that failed to hedge its hydrocarbon wealth against a price drop is now cutting public spending and tightening trade finance rules, driving private banks to rethink their business strategy. Richard Nield reports.

As is the case with many countries across the globe whose economic health is intrinsically linked to the international oil price, Algeria is suffering. The largest country in Africa by land mass, Algeria is also the continent's biggest gas producer and its third highest oil producer. Its gas reserves are second only to Nigeria and it has the fourth largest oil reserves. But it did not sufficiently use the boom years of high oil prices to insure against the collapse of the market, and is now suffering the consequences.

What Algeria has done well is save money. By the end of 2013 it had accumulated foreign currency reserves of $192.4bn and in excess of $50bn in its oil stabilisation fund, the Fonds de Regulation des Recettes (FRR). Gross external debt was just $3.4bn. On the other hand, the government completely failed to diversify the economy away from its over-reliance on hydrocarbons. Oil and gas account for 97% of Algeria's exports, more than 60% of government revenues, and about one-third of gross domestic product (GDP). Non-oil industries make up just 5% of GDP.

The crash in the global oil price is hurting Algeria. The International Monetary Fund's (IMF's) most recent Article IV consultation, completed on May 16, concluded that the country is facing a "severe and likely long-lasting external shock" and "the collapse in oil prices has exposed long-standing vulnerabilities in a state-led economy that is overly dependent on hydrocarbons".

From feast to famine

Economic indicators that for years were so healthy have gone into reverse. A current account surplus of $800m at the end of 2013 had by the end of 2015 become a deficit of $27bn. The trade balance went from a surplus of $9.4bn to a deficit of $18.1bn over the same period, as hydrocarbons earnings collapsed from $63.3bn to $33.1bn. A budget deficit of 0.4% in 2013 ballooned to 15.8% in 2015.

Reserves are also dwindling fast. Between 2013 and 2015 more than one-quarter of Algeria’s foreign exchange reserves were exhausted, and the IMF expects reserves to decline by a further 36% by the end of 2017 to $91.3bn. The FRR, used to fund the budget deficit when oil earnings fail to do so, is rapidly being depleted. By the end of 2016, FRR funds are expected to have dropped to AD750bn ($6.8bn), the lowest permissible level, according to the head of one foreign bank in Algeria.

None of this is good news for the country's banking sector. The government, which is the principle driver of investment, is trying to bring down spending (it went up in 2015, but is likely to fall this year). It is determined to reduce the country’s imports bill, which will limit opportunities for trade finance. The challenging economic environment will increase the risk profile of investments in the country. In the absence of a forwards market, banks are exposed to the volatility of the Algerian dinar. Liquidity is becoming increasingly tight.

“A couple of years ago, the Algerian banking market was characterised by very significant over-liquidity,” says the head of Algerian operations of one international bank. “The banking system placed around $20bn in excess liquidity with the central bank. Collectively, banks are still net placers with the central bank, but some institutions are now net borrowers, especially the large state banks that are involved in funding investment for state companies such as [the heavily indebted power company] Sonelgaz. The trend is clear, and if it continues more and more banks will have to find alternative sources of revenue.” The government has recently opened a six-month window for banks to refinance at an interest rate of 4%.

Tightening regulations

All of this is compounded by an increasingly challenging regulatory environment. For much of Algeria’s recent history, it has been a highly attractive market for foreign banks. There are 14 private banks in Algeria, all overseas owned. The sector is dominated by the six public banks, which own more than three-quarters of bank branches in the country and employ about 85% of workers in the sector. They manage 87% of deposits, totalling about $100bn, and 88% of the $66bn credit market.

But when it comes to revenues, private banks have done disproportionately well. Of total revenues of $3.3bn in 2013, private banks accounted for $1bn, or 30% of the sector total. “Private banks put an emphasis on corporate finance and trade finance, which were very profitable – they were making huge money,” says Rachid Sekak, CEO of HSBC Algeria from 2007 to 2013.

In 2014, private banks managed 50% of trade flows into the country, and were deriving half of their revenues from trade flows, compared to just 11% for public banks. “Private banks earned a lot of money in Algeria, and certain commissions were exaggerated, such as those on foreign exchange,” says another former head of a foreign bank operating in the country.

Changing landscape

From 2009, the regulatory landscape started to change. Concerned about rising imports, the government introduced a ban on consumer credit. But it also introduced rules stipulating that imports must be covered by letters of credit, opening up another lucrative revenue stream for foreign banks.

The government then began to tighten regulations for banks operating in the country from 2013. First it capped trade finance commissions, roughly halving them, and then it began to tighten the prudential rules governing trade finance. Banks had been allowed to open letters of credit amounting to four times their net worth, but by early 2014 this had been reduced to two times, and by early 2015 to one.

“They were pretty significant changes, and they have had an impact on the volume and profitability of the intermediation of trade,” says the current head of Algeria operations of another international bank. “For most international banks it was a significant part of their business and it has come down dramatically.”

The idea was to encourage private banks to shift their strategy and encourage the development of the retail market. “If you do not develop the retail market then you rely on the corporate market, which is more volatile,” says Mr Sekak. “Resources from households are by their nature more sticky.” But despite these regulatory changes, in 2015 banks were still insulated by the huge amount of liquidity flooding the market. “There was such an excess of liquidity that there was no need to fight for deposits in the retail market,” adds Mr Sekak.

Now that much of that liquidity has been absorbed, the economic downturn looks set to bite. “In 2015, the government used the fiscal buffer of the FRR to create liquidity,” says Mr Sekak. “But now it’s empty this will no longer be the case, and it will impact the liquidity of the sector.”

The government’s determination to reduce its imports bill will also affect trade finance opportunities. “If the oil price stays low we can anticipate a huge drop in trade finance,” says Mr Sekak. “In 2015 the government didn’t cut imports, but it will have to in 2016.”

Government constrained

However, the government has few options to reverse its economic fortunes. It cannot influence the global price for its oil sales, and prices are likely to remain well below the roughly $100 a barrel it needs to balance its budget for the foreseeable future. It has limited scope to reduce imports, as the bulk of the goods brought in are essential foodstuffs and consumer products for which demand is relatively inelastic.

There is some scope to further reduce the value of the Algerian dinar against the US dollar. The real effective exchange rate remains “significantly overvalued”, according to the IMF. But the value of the dinar eased by 25% in 2015, and the downside is already evident in the scarcity of certain products in shops and rise in inflation from 2.9% in 2014 to 4.8% in 2015.

Given these challenges, Algeria’s most likely recourse is to the debt market. The government has launched a domestic treasury bond and, says the local banking chief, “will probably have to re-engage with international money markets. I don’t think the domestic market will be enough.” In the 2016 budget, the government re-authorised the leveraging of external debt, albeit under strict conditions.

For most international private banks, the Algerian market is likely to remain profitable. The sector itself is well capitalised, the capital adequacy ratio for the sector is 16% overall and 21% for private banks. Return on assets is about 2% and return on equity just under 24% – but the changes in the operating environment will necessitate a change in strategy.

“Private banks will need to develop the right business model,” says Mr Sekak. “They cannot rely any more on corporate banking and trade finance. They need to put more emphasis on the retail sector to secure the resources they need to finance their balance sheet.”

There is “scope for growth in banking penetration”, says the Algerian banking chief, adding: “Cards and electronic payment methods are still relatively basic and the authorities intend to grow that market.”

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