

The Governance-Performance Link in State-Owned Banks: a Case Study of Algeria

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Abstract: This study aims to examine the relationship between Banking Governance and financial performance of State-Owned Banks in Algeria over the period 2010-2020, to achieve this objective an analytical descriptive approach was employed using data sourced from annual reports of Algerian Central Bank. The Findings of this research reveal that while Banking Governance practices have shown potential in enhancing bank's performance, the current practices adopted have proven insufficient in addressing the public banks' underperforming, and these banks are facing challenges within the economic context and influenced by government policies. Consequently, the study suggested recommending that Algerian monetary authorities should undertake further measures for adopting best practices in Banking Governance through benchmarking successful models.

Keywords: Banking Governance; Financial Indicators; Performance; State Owned Banks.

1. Introduction

The requirement to adopt governance for banks rules did not emerge out of thin air; rather, it is the outcome of the quick advancements of financial worldwide, and the need of specific principals for banking sector is a result of the particularity of banking activity itself, which is distinct from other activities.

The Basel Committee's publications highlight corporate governance as an area of special concern, which demonstrates the need for sound governance in the banking industry. This includes provisions relating to the assessment of credit risk (09/1997), the enhancement of disclosure and internal control by the relevant banking institutions (09/1998), and credit risk management (0/71999) thereby making them important in the context of the banking regulation (these principles were updated in 2010, 2013 and 2015 to reflect developments in corporate governance practices, guidance and regulatory frameworks).

1.1. Research Problematic

In Algeria's case, the importance of the handling of state banks is increasing as they are seen as the instrument for promoting the national economy by ensuring sufficient finance; form the base of Algeria's financial landscape, particularly where there is no developed financial market. Nevertheless, the peculiarities of governance of the banks pose complications, such as deep-rooted conflicts of interests and complexities in ownership, which make a generic model of management less effective. In private companies, the power

of making decisions is rather concentrated; in public banks, power is dispersed among various bodies, including the boards of directors, central bank, ministry (the state) making it challenging to determine specific responsibilities.

The study seeks to answer the following questions:

- How does Banking Governance relate to the performance of State-Owned Banks?
- What are the key aspects of adopting governance within the Algerian banking system?
- What challenges do State-Owned Banks in Algeria face?

1.2. Research Aims

Recent financial and economic studies concur that governance principles positively impact banks' performance. But, effectiveness of these methods in enhancing public banks' performance remains debated. In view of their ownership by the State, Public banks are often focus on the perception of non-profitability as result of the state dominance which typically directs these banks to serve development objectives and provide financing to sectors that are consistent within the authorities' priorities or ensure financing for public institutions and SOEs.

This article seeks to address these issues through a case study of Algerian public banks, and to provide insights into the governance challenges and their implications for this public banks performance; by analyzing public bank performance (quantitative data) and aspects of governance within the Algerian banking system (qualitative data)

In order to answer this Problematic and attending the aims of this research, our approach begins with constructing an analytical framework to grasp the relation between performance and governance. Subsequently, we will introduce the Algerian banking system, highlighting the significance of public banks in comparison to private ones. Following this, we will then focus on presenting how governance is being implemented in Algeria's banking industry. The fourth segment, Using descriptive statistical analysis, we will illustrate the impact of governance policies adopted in Algeria on public banks' performance. Finally, the challenges faced by public banks and results will be covered in the last section.

2.Exploring the relation Banking Governance - Performance

There are differing opinions among academics on how banking governance affects banks' performance. Although some research shows that banking governance principles have a favorable impact on financial performance, other studies contend that Not all of the Committee's suggested governance principles have a substantial impact on bank's performance.

By examining existing literature, this section will show how governance principles can enhance bank performance in the following aspects:

2.1. Effect of Independent Board members on performance

According to theory of agency, the presence of an independent board of directors improves the ability to control management, epitomizes the agency costs and grabs conflicts of interest and in the final analysis, performance improves. With respect to Banking Governance, conflict of interest is in check with the presence of independent board members whose responsibilities include enhancing the monitoring functions. This aids in the prevention of self-interest actions by managers, hence protecting the stakeholders' interests. this deductive statement has been tested through econometric model and experimental studies (Berrani & Hacini,2021),according to this study the independent board members significantly impacted financial performance. In other words, high proportion of independent directors enhances board transparency and autonomy, which increases the return on equity

for shareholders and impacts financial performance.

2.2. Effect of the Audit Committee on performance

Guidelines of Governance require the Audit Committee fulfill the responsibilities effectively and function autonomously, ensuring adherence to governance principles. By overseeing processes that improve communication among managers and owners, the Audit Committee plays a crucial role in increasing the bank's value, reducing agency issues, and enhancing corporate performance. Findings of the studies conducted by (Chou & Buchdadi, 2017) and (Danoshana & Ravivathani, 2019') demonstrate that bank's performance positively is influenced by the Committee of Auditors. This is supported by the research by (Berrani & Hacini, 2021) revealed that both the independence of the Audit Committee and the regularity of its meetings play a crucial role in influencing financial performance. Increasing the number of meetings helps strengthen members' oversight and enhances their ability to fulfill their responsibilities, ultimately boosting the performance.

2.3. Effect of disclosure and transparency on performance

Disclosure and transparency principles are necessary for enhancing performance in all financial organizations and in particular banks. Regular information disclosure in reports shows that management is able to manage funds in an economical and logical way, as well as that it can carry out its duties. Transparently disclosing all of this information will greatly enhance performance and support the growth of the bank.

This analysis is supported by a number studies, including one by (Oino, 2019). Higher levels of transparency and disclosure in administrative activities increase financial institution performance, according to the study's key findings. It also demonstrated that improved risk management, auditing, and compliance all have a positive impact on financial institutions' financial performance.

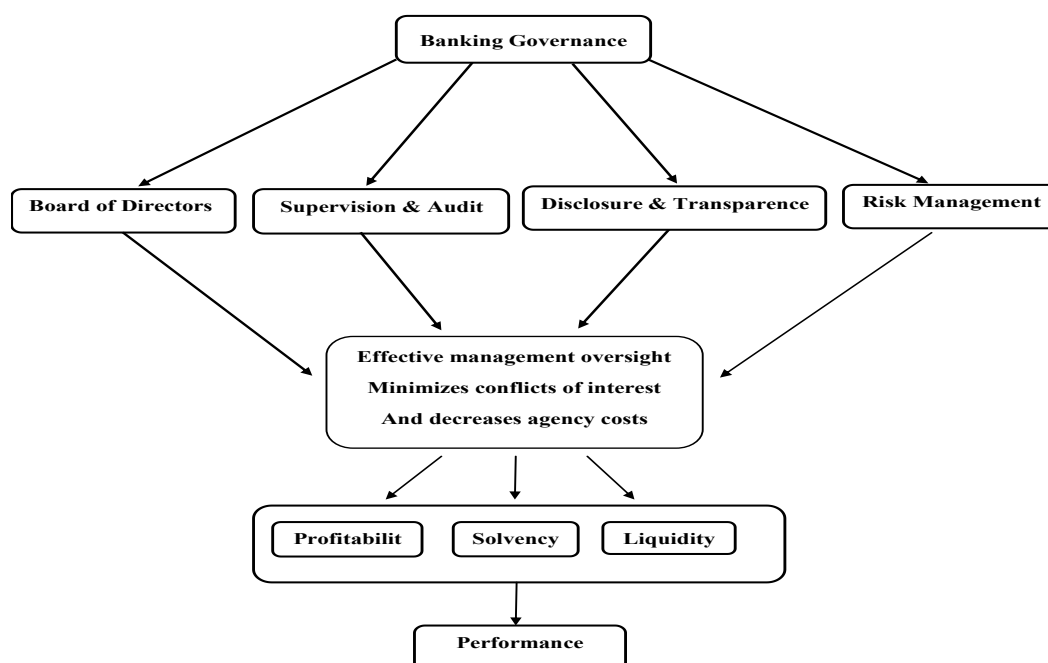
Moreover, information disclosed and the credibly, objectively, and reliably data that reflects the Bank's activities contributes in promoting self-censorship on the one side, build trust among collaborators on the other side, and simultaneously serve stakeholders in improving the effectiveness of decision-making.

2.4. Effect of Risk Management on performance

The principle of risk management helps the bank to enhance its financial performance by identifying risks in its various activities, tracking their evolution, evaluating potential impacts, and implementing hedging strategies to sustain profitability, liquidity, and solvency at reasonable levels.

Risk Management principles and practices permit the design of appropriate risk management tools to intervene prior to the bank encountering a risk crisis that could destabilize the banking system; therefore, it can be said that risk management related corporate governance mechanisms is a vigilant system to prevent possible risk can banks facing and which permit also to make adjustment to improve its performance. this analyses was tested and approved by many empirical studies, taken the result of the study by (Taiwo et al., 2017) showed that Sound credit management practices can strengthen savers' and investors' trust in banks, increase the capital accessible for lends and credit, and improvement the profit of banks, Additionally the study conduct by (Saiful & Ayu, 2019) demonstrates that the effective credit risk management and liquidity control impact positively the performance of banks in Indonesia as shown in their ROE and ROA.

Figure.01. Understanding banking Governance- financial performance influence



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Source: Author's analysis of how Governance is related to performance.

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3. Applying Governance Measures within banking industry in Algeria

Analysis of the implementation of the Governance practices to the Algerian banks will be carried out through the key points relating to the mainly areas of the Basel Committee's governance principles referred to above, as following areas:

3.1. Board of Directors

The Bank of Algeria has implemented governance requirements for the Board of directors by establishing laws and guidelines that define its overall responsibilities, required qualifications, composition, structure, and practices; details as follows:

- The composition of Board: as outlined in Article 11 of Law No 04-88 (issued on January 12, 1988), defines the structure of the Board of Directors for state-owned enterprises operating as commercial joint-stock companies. According to Art-611 of the Algerian Commercial Code, the Board functions as a collective body responsible for managing all aspects of the institution's operations, it consists of at least three members and twelve members at most, also as stated explicitly in the mentioned Code (Art-610), and the procedure of election or selection takes place within the aforementioned limits in the Constituent Assembly or the General Assembly as a maximum and as a minimum, and this proves the collective capacity within the board , so it is Not possible to take an individual decision;
- The Banking & Money Act of 2003 is the key legal frame regulating Algeria's banking sector, it defines how banks are structured and operate, outlining the board's roles and composition.
- Structure and practices: State owned banks are administered by a board of directors, which is in charge of supervising operations and ensuring compliance with necessary rules, and defines the Bank's goals and establishes its strategic direction. Those with appropriate skills and experience, such as bankers, economists, and legal experts, often

make up the board, according to an IMF assessment, board procedures at Algerian public banks have improved in recent years, with a greater emphasis risk management, accountability and on openness.

- The Bank managers are selected and nominated based on their expertise, with performance contracts established between them and the supervisory authority to enhance efficiency and ensure strong results.
- As the state fully owns the capital of public banks, it was given broader prerogative to the boards and clear guidelines were established for their members.

3.2. Supervision and internal audit

From the 2015s, the Algerian monetary authorities (the BA and the Banking Commission) have consistently worked to enhance banking supervision, to ensure conformity with global standards and principles in this area, in parallel; the Bank of Algeria has reviewed the monitoring, vetting and alert systems, especially in monitoring banks' conditions using stability indicators of the banking system. In this regard, banking supervision, control, and audit procedures have been revised and updated.

As required by the Banking and Money Act of 2003, Algerian public banks are required to establish and conserve a robust internal control system with clear policies and procedures. These measures must be regularly revised to keep up with changes in the banking environment

The internal control legal frame in Algerian's banks aligns with the principles issued by Basel committee about requiring banks to establish and maintain strong risk management, strong internal control and corporate governance.

The Bank of Algeria's instruction n°06-01 outlines how banks and financial institutions should establish and operate their internal control bodies; it specifically addresses the requirement for effective internal control in banks, and the need for independent internal audit functions.

The Algerian Banking Law N°. 15-01 of 2015 contains provisions related to corporate governance and internal control in banks.

3.3. Transparency and Disclosure

The use of accounting criteria is crucial for promoting transparency and disclosure, which are fundamental to ensuring effective bank governance. To this end, the Algerian government has enacted a set of laws and regulations, such as Law N° 07-11, which replaced Order N°. 75-35 when it came into effect on January 1, 2010. This law's primary aim is to establish a financial accounting system, along with specific requirements for its implementation. This system comprises a conceptual framework for financial accounting, accounting criteria, and a chart of accounts that enable the preparation of financial statements based on generally accepted accounting principles. These principles include "commitment accounting, continuity of use, understandability, relevance, reliability, comparability, historical cost, and economic substance over legal form" (Article 06 of Law N° 07-11).

By implementing this new financial accounting system, companies and banks can reinforce their governance principles and foundations by achieving objectives such as ensuring regularity, reliability, and transparency in collecting, auditing, presenting, and communicating information (Article 10 of Law N°.07-11). Additionally, the system aims to present an accurate financial position of the entity, its efficiency, any changes in its financial status, and the overall operations and events resulting from its transactions and related activities (Article 26 of Law N°. 07-11).

4. Contribution of Governance to the public banks' financial performance

This section examines how the financial performance of Algerian public banks evolved from 2011 to 2020. During this period, the Bank of Algeria established and regulated the

committee responsible for Governance in early time (Banking Control Law 11-08), and its efforts to adopt the principle of banking Governance over this period were clear, through strength the systems of control and information, internal auditing systems, financial accounting system conforming to international standards, instructions regarding disclosure and transparency and other procedures as required by the Basel Committee , FMI and World Bank.

4.1. Liquidity indicators

The Algerian authorities have made significant efforts in addressing the liquidity crisis that has characterized public banks and have urged banks to pursue a new liquidity management strategy. Many academic papers have addressed this issue because liquidity is critical for performance of public banks. The table below highlights how liquidity indicators changed over this period.

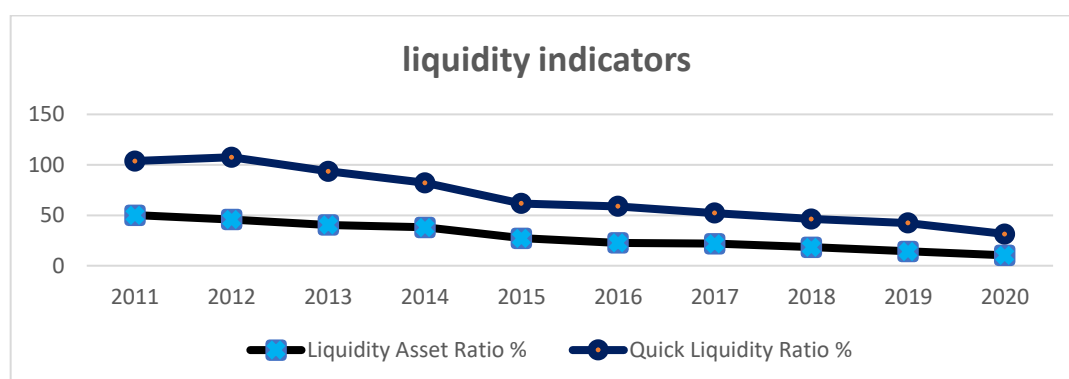
Table.01.Liquidity ratios of Algerian SOBs for the period 2011-2020

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Liquid %	50.16	45.87	40.46	37.96	27.17	22.66	21.88	18.42	14.21	10.3
Quick Liquid %	103.73	107.51	93.52	82.06	61.64	58.84	52.17	46.3	42.24	31.44

Source: Reports of Algeria Central Bank

Liquidity ratios for the banking sector in general and for public banks registered a significant decline in the 10 years, registering for Liquidity Asset Ratio 27.17% in 2015 compared to 50.16% in 2011 and up to 10.3% in 2020. In same direction Quick Liquidity Ratio also declined significantly at a gradual rate, register of 31.44% compared to 103.37% in 2011. This decree is positive evolution because the public banks have suffered for years of the high liquidity which affect negatively the bank profitability (crisis of Excess liquidity 2010-2015).The figure below illustrates the trend of liquidity indicators for public banks over the study period.

Figure.2. Evolution of liquidity indicators of Algerian public banks



Source: Generated by Excel from BA reports

Between 2010 and 2015, the Bank of Algeria made significant adjustments to liquidity absorption thresholds and announced in 2015 that it had brought the situation under control. And under the independent factors influenced bank liquidity, the bank gradually reduced these thresholds; the inflationary effect of the liquidity surplus began to gradually disappear as it fell in the monetary market.

Enhanced Risk Management Framework led to implementing of better risk management frameworks in public banks, this framework includes effective liquidity risk management policies and procedures. The most significant was Circular No. 07/2012 issued by the

Central Bank of Algeria in 2012, which offers recommendations for managing liquidity risk in banks. It describes the fundamental the principles, methodologies, and tools for evaluating and controlling liquidity risk, such as stress testing and contingency planning.

According to the same Circular No. 07/2012, Public banks are required to set up internal committees for managing liquidity risk and monitoring liquidity positions, these committees are in charge of implementing the directives from the Central Bank, adopting best practices in risk management for ensuring that strategies for managing liquidity risk are properly supervised, coordinated, and applied.

Improved governance systems have established clear lines of responsibility and accountability for liquidity management and focused attention on managing and monitoring liquidity positions. Therefore, public banks are better able to react quickly to shifting liquidity conditions due to effective governance arrangements.

4.2. Solvency indicators

All Banks have been following new rules since 2014 to meet Basel 3 requirements of determining and defining own funds, funds covering Operational and Market risks, financial reporting, and statement's structure. To ease the impact of the Covid-19 crisis on the banking sector, the Bank of Algeria decided in May 2020 (through the instruction 05-2020 of April 2020 on exceptional measures to relax certain precautionary provisions applicable to banks and financial institutions) to grant banks and financial institutions an exemption from the safety buffer requirements outlined in Art-4 of Regulation No14-01 on solvency ratios issued in 16/02/2014.

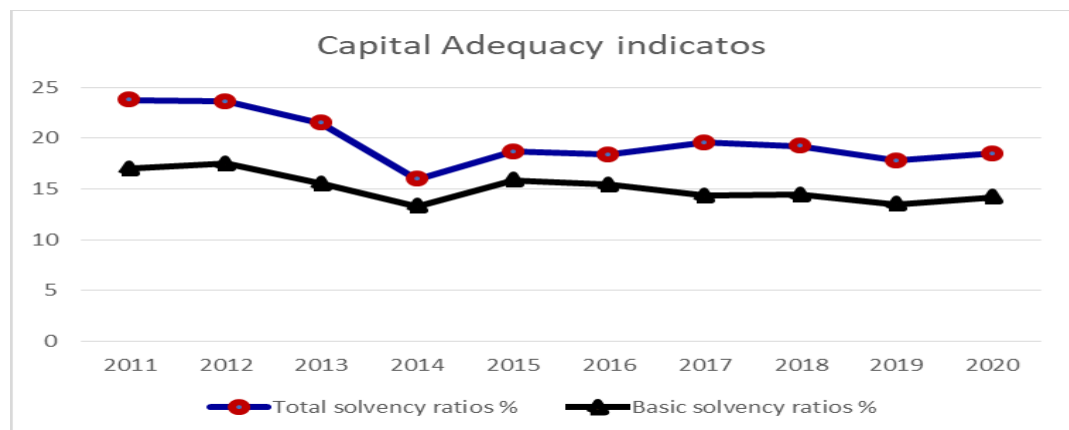
Table.2. Solvency ratios of Algerian SOBs for the period 2011-2020

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Solvency %	23.77	23.62	21.5	15.98	18.69	18.37	19.58	19.24	17.81	18.47
Basic Solvency %	17	17.48	15.51	13.27	15.86	15.42	14.33	14.43	13.47	14.2

Source: Reports of Algeria central bank

Solvency ratios dropped from 23.77% in 2011 to 15.98% in 2014. By 2015, they had rebounded to a stable level of 15.98%, exceeding the Basel Committee's minimum requirements (capital adequacy 2010). Public banks maintained relative stability, with solvency ratios rising to 18.47% in 2020 from 17.81% in 2019, in line with regulatory standards. This improvement resulted from a 0.3% reduction in risk-weighted assets and an increase in regulatory capital.

Figure.3. Evolution of solvency indicators of Algerian public banks



Source: Generated by Excel based on BA reports

Under the frame regulatory by end of 2009 that set the minimum capital requirements for financial institutions, banks have considerably strengthened their private capital; even, the capital level of public banks was above the regulatory minimum before the new regulation came into force. At the same time, public banks continued to allocate part of their results to the reserve, allowing them to respond largely to precautionary instructions for covering the three risks (operational, loan risk, and market risk).

It is important to highlight that although the decrease of the solvency indicator between 2013 and 2014 is still acceptable and higher than it is required by Basel committee, this diminution is due regulatory framework of the banking sector passed significant reforms during 2012- 2014, these reforms aimed to enhance supervision, and were implemented after adopting a new prudential framework that aligns its provisions with the Basel Committee's standards, specifically Basel III. The reforms included additional requirements for private funds known as "safety cushions," as recommended by Basel III to be included in the capital requirements, and there was a review of the rules and constraints imposed on risk concentration and bank contributions. This review involved the introduction of new thresholds for these concentrations and clarification of the concepts related to risk division.

4.3. Profitability indicators

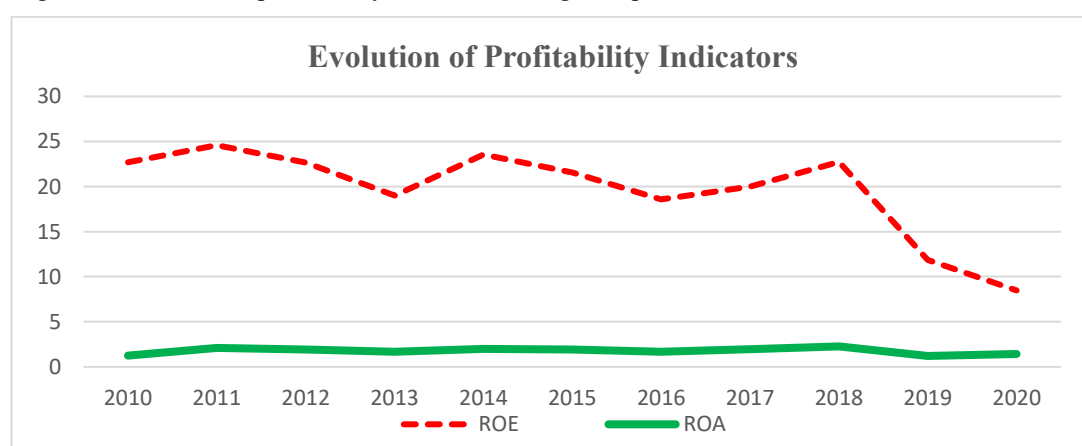
The profitability's indicators of Algerian public banks are crucial to the authorities for the procedures of surveillance and supervision; these indicators are calculated by the central bank as follow:

Table.3. Solvency ratios of Algerian SOBS for the period 2011-2020

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ROE	22.7	24.58	22.67	19.00	23.55	21.55	18.56	20.00	22.72	11.85	8.48
ROA	1.25	2.10	1.93	1.67	1.98	1.93	1.68	1.97	2.27	1.21	1.42

Source: Reports of Algeria Central Bank

Figure.4. Evolution of profitability indicators of Algerian public banks



Source: Generated by Excel based on BA reports

During the 10 years Return On Equity (ROE) noted a fluctuation and didn't record generally high adjustment, with lowest level in 2019 and 2020 by 11.85% and 8.48% Respectively, with decline of 13.7% in 2019 compared to 9% in 2020, this explains that over the last five, the accumulation of more own in public banks (62.6 %), because control functions and capital regulatory have become more stringent.

In contrast, the public banks' ROA has been relatively stable with a slight improvement in

the last 47.1% in 2019 to 54.1% in 2020, this improvement resulting from the evolution of result net (+6.7%). However, these banks' profitability remained weak and volatile and this situation raises risks to financial stability.

Profitability indicators (ROE&ROA) are increased by effective capital allocation to profitable business or industries, and the way capital and resources are allocated inside banks is influenced by governance practices, in which public banks with strong governance processes frequently follow well defined strategic goals for allocating money, guaranteeing the best use of assets for greater returns.

In spite of adopting governance practices (risk management, supervision, and internal audit) profitability has not shown an upward trend. This means that governance efforts have not delivered the expected improvements in raising the profitability of these banks.

5. The challenges faced Algerian SOBS

Even though the efforts made to improve the performance of public banks, particularly through the adoption of banking governance, it appears that the latter has not contributed to increasing profitability, which remains the essential criterion for evaluating bank performance. However, it has significantly contributed to liquidity management and achieving good solvency ratios.

Referring to analysis of factors influencing the performance of public banks, it is evident that governance, although being a key internal factor, it is insufficient on its own to solve the inefficiency of public banks, because these banks in fact face numerous challenges that negatively impact their performance. The following points provide an overview and analysis of these challenges and how they affect performance.

5.1. State interposition in the market

Despite numerous restructurings of state -owned banks and the implementation of market-based reforms in the early 1990s, the absence of a strong institutional framework and adequate expertise hindered their effectiveness in fostering financial intermediation. Additionally, these banks have suffered of continued financial support to unprofitable public enterprises under government directives, which further weakened their financial stability, as well as from a legacy of directed lending to SOEs and sectorial credit specialization, both of which have significantly lowered the quality of their portfolios.

As the Government has long provided major state-owned banks with an implicit guarantee, the culture of banking regulation has not yet fully formed which result in delays for the full implementation of new enacted regulations and guidelines. Also, the limited operational capacity of state-owned banks, combined with the state's dominance over major financial institutions, hinders the establishment of an effective financial oversight system.

5.2. Political intervention

Political intervention frequently affects state-owned banks in Algeria which affect the autonomy and independence of these banks, the Algerian government remains responsible for public banks and retains certain supervisory and regulatory powers and the critical decision-making processes, as result the decision of lending may be made based more on political objectives rather than on sound financial principles. Moreover, political involvement may lead to the appointment of unqualified managers, which may result in bad management and mismanagement, which will ultimately negatively affect the bank's overall performance.

5.3. Ineffective Poor management

The hierarchical and bureaucratic framework of most of state institutions causes a lack of flexibility and agility in decision-making, which results in missed business opportunities, low productivity, and high operating expenses for state-owned banks. Additionally, as is the

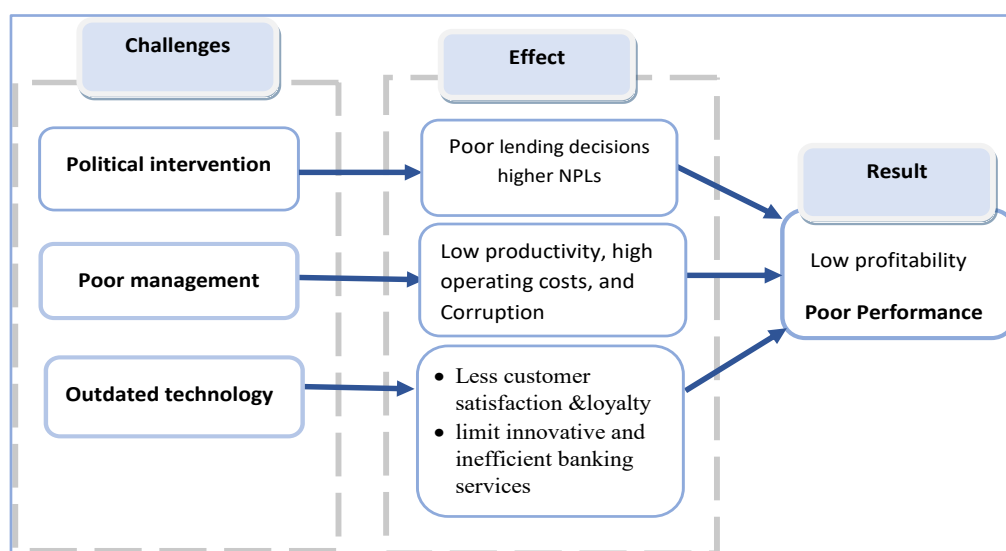
case in Algeria, corruption and nepotism are widespread in public banks worldwide, and the lack of accountability and transparency results in a lack of trust from both clients and investors.

5.4. Outdated technology

Using out-of-date technology, Algeria's public banks have been unable to compete with private banks due to their delayed adoption of banking industry technical advancements. Until today, they are dealing with an issue with obsolete technology systems, which may limit their ability to provide innovative and efficient banking services, which result in a reduction in customer satisfaction and loyalty. Customers can decide to switch to more technologically advanced banks (private or foreigner) as a result.

The figure below explain and resume how these challenges affect negatively the bank's profitability and how it led to poor performance.

Figure.5.
Challenges
affecting the
SOBs' performance in
Algeria



Source: Author's analysis

6. Conclusion

Through this study we tried to explore the relationship between banking governance and the performance of public banks, by demonstrating of fundamental analytical frame and a deductive approach of Governance-performance relation and how adoption the baking Governance principles published by the Basel Committee can enhance performance, contributing to the stability and security of the banking sector as a whole.

Existing studies have paid little attention to focus on public banks and the specific factors affecting its performance, that's why the findings of my study can contribute to fill the gaps of research, especially for the challenges facing public banks in Algeria that can also led to poor performance, this important state owned structure haven't been discussed in previous

literature on banks performance , where profitability of Algerian public banks is still seriously questioned, since its returns on assets and equity are low this is due to many reasons and challenges facing these public banks which have been discus

This study generated the following results:

- implementing Governance principles plays a key determinant in enhancing performance of public banks in Algeria, the Board of directors (members' independence and its composition), Audit Committee, Transparency and Risk Management directly influenced public banks' performance,
- The principles for Board, Risk Management, Control and Audit in Algeria are Not updated and it did Not reflect all requirements mentioned in Basel committee guideline of 2015;
- Due to limited competition, most Algerian public banks do Not promote good practices in the implementation of banking governance principles.
- Algerian public banks still have low performance even the capital adequacy indicator is high and express good solvency.
- Challenges faced public banks in Algeria have prevented Banking Governance practices from achieving its positive results in raising performance.

In final conclusion, Banking Governance is Not the miracle solution to address the poor-performing of Algerian public banks, because it appears that it depends to other factors; Given the dynamic nature of the banking industry, policymakers should prioritize governance reforms to address the challenges facing public banks and promote innovation, technology, transparency, accountability in order to promote their competitiveness and support to the overall stability and resilience.

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Abbreviation

SOBs :	State Owned Banks (public banks)
BA :	Bank of Algeria (central bank)
ROA :	Return On Assets
ROE :	Return On Equity