

Legislative Frameworks for Addressing Banking Deficits in Banks and Financial Institutions in Algeria

الأطر التشريعية لمعالجة العجز البنكي في البنوك
والمؤسسات المالية في الجزائر

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Abstract

This study addresses the issue of legislative mechanisms for dealing with banking deficits in banks and financial institutions. To clarify these mechanisms, it is essential to shed light on the conceptual foundation of banking deficits, which specifically refers to the financial weakness of a company and its reduced ability to compete in financial markets. Since banks and financial institutions are an integral part of the national economy, it is necessary to conduct a thorough investigation into the various internal and external factors leading to banking deficits, which may affect these institutions. Furthermore, the study explores the frameworks and effective mechanisms for addressing banking deficits during the phases of financial imbalance and cessation of payments. The aim is to develop tools and measures that enhance the bank's performance, improve its productivity and profitability, and, at the same time, manage banking risks and mitigate banking deficits.

Keywords: Legislative mechanisms; banking deficit; deposits; banks and financial institutions; financial balance; cessation of payments.

Introduction:

The banking sector plays a crucial role in the development of the national economy, as the stability of any country's economy and the effectiveness of its monetary policy largely depend on the soundness of its financial system, particularly the banking system. Banks are the backbone of economic life, and their positive activities contribute to the advancement of the national economy. Additionally, they support their clients in their economic ventures.

The significance of the banking system has been reinforced by the essential services it provides, which have become one of the key pillars of economic development. Without these services, no modern economy can function effectively. Since the demand for banking services is derived from the needs of economic development, there has been an increasing necessity for a more advanced, secure, and service-oriented banking system.

However, banks and financial institutions may face risks leading to banking insolvency due to various internal or external factors. This is a major cause of bank failures, as banks are

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commercial joint-stock companies that may cease operations due to an inability to meet financial obligations. The failure to properly account for potential risks often results in payment defaults.

This situation imposes significant financial burdens on the state, which must take measures to restore balance and prevent or mitigate financial and banking crises. Consequently, the relevant authorities in each country adopt mechanisms to support struggling or insolvent banks to safeguard the interests and rights of depositors, ensure the stability and security of the banking system, and ultimately maintain the stability of the financial market.

In light of the above, the central research question of this study is: **What are the key preventive mechanisms introduced by the Algerian legislator to address banking insolvency?**

To answer this research question, an inductive approach was employed, focusing on examining the phenomenon of banking insolvency and identifying its main causes. Additionally, a legal analysis was conducted to review the legislative texts relevant to the study.

The study also adopted a descriptive and analytical methodology by describing and analyzing various legal provisions within national legislation, particularly those outlined in the amended and supplemented Commercial Law. This was done by identifying the general provisions governing bank insolvency as joint-stock companies and exploring the necessary mechanisms for effectively addressing banking insolvency that may arise in financial institutions during their banking operations.

This study is divided into two main chapters, which will be elaborated upon in the following sections:

Section I: The Conceptual Framework of Banking Deficiency in Banks and Financial Institutions

Section II: Mechanisms for Addressing Bank Insolvency in the Phases of Financial Imbalance and Payment Suspension

I- The Conceptual Framework of Banking Deficiency in Banks and Financial Institutions

Banking deficiency is widely prevalent in market economies, necessitating the elimination of less profitable companies. This process allows for the reallocation of resources and profits to more competitive firms. When banks or financial institutions fail to generate sufficient profits, they increasingly rely on borrowing, which weakens their ability to meet short-term obligations. Consequently, their financial capacity deteriorates, reducing their competitiveness in financial markets.

This inevitably leads to a loss of trust among the company's partners. Therefore, as an integral part of the national economy, banks and financial institutions must seek effective solutions to prevent financial difficulties that could result in banking deficiency. Addressing this issue requires a thorough examination of banking deficiency.

Thus, this study will focus on defining banking deficiency, identifying its various economic and financial dimensions, and analyzing the internal and external factors contributing to this phenomenon. Finally, the conceptual foundation of banking deficiency affecting banks and financial institutions will be explored in detail.

A) Definition of Banking Deficiency.

Banking deficiency is defined as the financial instability or insolvency of a bank. It refers to the bank's inability to meet its long-term obligations. A bank is considered deficient when the market value of its assets is lower than the value of its liabilities, often due to significant financial losses resulting from a decline in the securities portfolio or failure to recover loans.¹

It is worth noting that banks often fall into such financial distress under the temptation of profit-seeking. To better understand this phenomenon, it is essential to establish a direct link

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between cause and effect—between the motives behind financial decisions and the extent of accumulated debts that borrowers are unable to repay.

Banking deficiency has multiple dimensions, both economic and financial. From an economic perspective, it is defined as the inability of a financial institution or company to generate sufficient revenue to cover its various expenses or a decline in the net present value of investments². This concept is primarily based on observable facts, the consequences of banking failures, and their broader impacts. The issue of banking deficiency did not emerge suddenly; rather, it is the result of a series of underlying causes and accumulated factors that have ultimately led to banks facing financial distress.³

According to the Economic Concept of Banking Deficiency, Some legal scholars consider banking deficiency to be equivalent to corporate bankruptcy. From this perspective, businesses that have not yet reached the bankruptcy stage are not considered deficient⁴. They argue that financial deficiency should not be attributed to an institution as long as the causes of financial distress can be addressed before bankruptcy occurs. Another group of scholars holds a broader view, equating banking deficiency with corporate insolvency. They argue that a financially deficient institution is one that is in a state of financial insolvency and is unable to meet its financial obligations because its resources are insufficient to cover its needs and commitments.⁵

Meanwhile, another perspective defines banking deficiency as financial failure, which serves as a fundamental precursor to corporate insolvency. This view characterizes banking deficiency as a temporary liquidity shortfall, where a business is unable to meet its current obligations on time⁶. From a legal standpoint, it refers to the decline in the real value of a company's assets below its liabilities, which threatens the business's continuity and survival.

According to the Financial Concept of Banking Deficiency, Economists and financial analysts differ in defining a universal concept of financial deficiency. Therefore, we will explore the most important perspectives in this field.

Some scholars argue that a financially deficient institution is one that has been officially declared bankrupt. According to this view, companies that have not yet reached bankruptcy should not be classified as deficient. Consequently, proponents of this perspective focus their corrective efforts on institutions that are on the path to financial distress, addressing underlying causes before they escalate into bankruptcy.⁷

Another group of scholars defines a deficient institution as one facing financial insolvency—meaning it cannot meet its current or imminent financial obligations because its short-term resources and revenues are insufficient to cover its financial commitments⁸.

A third perspective sees financial deficiency as a financial imbalance resulting from an institution's inability to meet its short-term obligations due to limited resources and capabilities. This deficiency arises from a mismatch between internal resources and external liabilities. Depending on the severity of the imbalance, financial deficiency can range from a temporary disruption to a structural financial crisis. The closer the imbalance is to being structural, the more difficult it becomes for the institution to recover from the financial distress it causes⁹.

In this context, and from our perspective, we believe that a more precise definition of financial deficiency is to consider it both a "**process**" and a "**state**."

As a **process**, financial deficiency is not an immediate outcome but rather the result of various factors that have interacted and continue to evolve over different timeframes, either short or long. These factors collectively lead to the **state** in which an institution finds itself unable to meet its financial obligations or secure new commitments.

The severity of financial deficiency or imbalance varies based on two key criteria¹⁰:

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1- The Institution's Vitality and Management Efficiency: This includes the effectiveness of its administrative systems, the competence of its leadership, the availability of reserves for crisis management, and the level of interconnectivity with its surrounding economic environment.

2-The Strength and Scale of the Deficiency-Causing Obstacle: This refers to the magnitude of the financial hindrance relative to the institution's capacity, the abruptness of its emergence,¹¹ and the external environment's response to the institution's financial distress.

B) Causes Leading to Banking Insolvency.

Diagnosing the causes of insolvency is the key to preventing it. A sound, accurate, impartial, and objective understanding of the issue is an essential part of formulating a solid and effective solution. Although it is difficult to outline all the factors that lead to banking insolvency, we have attempted to highlight the most significant reasons that drive banks into this state. These causes can be classified into internal and external factors.

1-Internal Causes :The internal factors contributing to banking insolvency can be summarized as follows:

- **Absence or inadequacy of lending policies:** Poor credit management is one of the most challenging issues banks face. It essentially means the bank's inability to recover the loans it has granted. This problem arises due to several reasons, reflecting an inefficient system for identifying and managing doubtful loans.
- **Inefficient governance:** This is evident in weak bank management, the absence of effective internal operational and supervisory systems, and an inadequate strategy for managing the bank's assets and liabilities. Furthermore, it includes a lack of skilled human resources and inefficient information transfer systems.¹²
- **Excessive centralization of decision-making power:** When investment and lending decisions are overly concentrated in a few hands without adequate oversight or control, it leads to significant risks that can contribute to a bank's financial distress.
- **Uncontrolled expansion of credit granting:** This occurs when banks extend credit beyond the actual needs of some clients or when they deliberately or implicitly bypass central bank regulations. Such practices prioritize competitive advantage over financial security and sustainability considerations.¹³
- **Liquidity Shortage:** Banks may experience liquidity shortages despite holding significant deposits and a reasonable amount of quality loans. A bank's liquidity depends on its ability to liquidate its asset portfolio quickly and without losses. Consequently, a bank's liquidity increases when its assets have shorter maturities and its liabilities have longer maturities. Conversely, if deposit maturities are short—particularly demand deposits, which are a major liability—it leads to reduced liquidity due to the rising proportion of demand deposits relative to total deposits.¹⁴
- **Absence or Inadequacy of Credit Guarantees:** This occurs when credit guarantees are either absent or insufficient relative to the nature and size of the credit granted. Contributing factors include neglecting the collateral's lending value, allowing clients to use credit before securing the necessary guarantees, failing to consider the inherent characteristics of the collateral, or disregarding collateral monitoring.
- **Lack of Essential Skills and Expertise in Credit Personnel:** Some banking staff may lack the necessary personal attributes, technical expertise, and practical ability required for credit management. Additionally, external auditors may fail to thoroughly assess client credit approvals in their reports accompanying bank financial statements. This oversight prevents corrective measures and the formation of necessary provisions.¹⁵
- **Challenges in Central Bank Oversight:** The rapid expansion of the banking sector within a short period has made it difficult for central banks to maintain effective and continuous

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supervision. Additionally, some banks fail to implement the prudential oversight measures imposed by the central bank. Furthermore, some senior management levels in banks do not provide sufficient room for democratic dialogue with lower management levels on critical credit-related matters, leading to rigid decision-making.

- **Inadequate Capital:** A bank's capital serves as the first line of defense to protect depositors against potential losses. It acts as a cushion to absorb unexpected losses at any time. Therefore, a bank's capital must be sufficient to fulfill its essential functions, particularly safeguarding depositors and maintaining the confidence of regulatory authorities. To assess capital adequacy, several benchmarks can be used, such as the ratio of capital to risk-weighted assets, which helps determine the bank's risk exposure¹⁶.
- **External and Uncontrollable Factors:** Some causes of banking insolvency stem from external circumstances beyond the control of banks or their clients. Key examples include force majeure or unforeseen events such as fires, earthquakes, or sudden financial and economic crises in the markets. These crises introduce risks that affect both banks and clients alike. Additionally, legislative changes—such as modifications in import/export regulations, customs tariffs, and exchange rate fluctuations—can create instability, further contributing to banking insolvency.¹⁷

2- External Causes of Bank Insolvency : External factors contributing to bank insolvency include macroeconomic factors, market structure, and regulatory and institutional factors. The key macroeconomic elements, particularly in emerging markets, include inflation, interest rate fluctuations, changes in foreign capital flows, exchange rate systems, and uncontrolled public budgets. These factors often serve as the sources of banking crises, especially in developing countries.

In emerging or transitioning countries, structural and organizational changes often exacerbate these macroeconomic factors. In this context, banks are unable to properly manage credit risk in an environment of continuous economic changes. Regarding market structure, intense competition pushes banks to take on high, inappropriate risks¹⁸, particularly through poor pricing relative to the risks involved. It can be said that there is a direct relationship between risk-taking and competition levels. Professor "Heilman" highlighted that the likelihood of taking high risks is greater in highly competitive markets, especially in a market where banks compete on unsound bases to attract the same customers.

Risk-taking can also arise from the characteristics of banking regulation, such as the absence of effective banking supervision, the presence of a deposit insurance system with fixed premiums, and the behavior of regulators¹⁹. A deposit insurance fund can reduce depositors' incentive to discipline banks through market forces. Additionally, fixing the insurance premium can encourage banks to use deposits for funding risky loans, leading to multiple risks.²⁰

Institutional and legal factors can also be sources of risk. Professor "Rafael La Porta's" work emphasizes the significant impact that the quality of the legal and institutional environment has on bank performance, financial market functioning, and overall financial system effectiveness. The legal and institutional environment of a country is a critical determinant of the effectiveness of governance mechanisms²¹.

Thus, the relationship between the legal environment and governance mechanisms can be positive if effective mechanisms exist in a favorable environment, negative if poor mechanisms are present in a good environment, or contradictory if there is a mismatch between a good/bad environment and good/bad mechanisms. Therefore, the legal environment can either encourage excessive risk-taking or undermine the effectiveness of oversight by authorized regulatory bodies²².

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II- Mechanisms for Addressing Bank Insolvency in the Phases of Financial Imbalance and Payment Suspension

The expansion of banks and financial institutions, along with the diversification of their activities, has necessitated the development of tools and mechanisms to assess bank performance, enhance productivity and profitability, and manage banking risks, including addressing bank insolvency. Consequently, the Algerian legislator had to follow the example of other countries in implementing the Basel Committee's regulations, which require national regulatory authorities to ensure that banks and financial institutions can perform functions appropriate to the nature and scale of their operations. This contributes to minimizing cases of bank insolvency and mitigating associated risks.

Thus, understanding the mechanisms for addressing bank insolvency requires an examination of the remedial measures in the phase of financial imbalance, followed by an analysis of the key mechanisms used after a bank suspends its payments.

A) Mechanisms for Addressing Bank Insolvency in the Phase of Financial Imbalance.

When a bank experiences financial imbalance, the auditor intervenes to rectify its financial situation²³, as stipulated in the provisions of the Monetary and Banking Law. In this regard, Article 99 of the Monetary and Credit Law states: "The Governor of the Bank of Algeria may summon the principal shareholders of the concerned bank or financial institution if it is determined that the institution's situation warrants such action, requesting them to provide the necessary financial support. Additionally, the governor may organize the participation of all banks and financial institutions to take the necessary measures to protect depositors' and third parties' interests, ensure the proper functioning of the banking system, and maintain the financial sector's reputation."²⁴

Based on this provision, the central bank governor can request the main shareholders to provide the required financial support to help the bank overcome its difficulties. If the request is accepted, shareholders may agree to bear the bank's losses either through refinancing or by settling creditors' dues as part of an amicable agreement.²⁵

However, this measure may prove ineffective if shareholders fail to respond to the governor's request. Notably, the aforementioned article does not explicitly outline the penalties for shareholders who do not comply with the governor's request. Moreover, even if shareholders accept the request, they may either refuse or be unable to cover the bank's losses²⁶.

It is also worth noting that the Governor of the Bank of Algeria may request banks operating within the financial sector to refinance the struggling bank in the financial market to prevent the total collapse of the banking sector²⁷. This measure clearly represents a form of solidarity among banks to avert the sector's downfall. However, it assumes that the failing bank plays a systemic role, as the legislator has indicated the possibility of a total sectoral collapse due to the liquidation of the concerned bank. In other words, the financial sector's solidarity measure is directly linked to the risks posed by the liquidation of the affected bank on the overall banking system²⁸.

Additionally, the Banking Committee plays a crucial role in addressing bank insolvency. In this regard, Article 112 of the Monetary and Credit Law states: "The Banking Committee may summon any bank or financial institution, if its situation justifies it, to take within a specified period all necessary measures to restore or strengthen its financial balance or correct its management."²⁹

Beyond its external supervisory role, the Banking Committee has a vital function in assisting banks and financial institutions in overcoming financial difficulties by obliging them to take corrective measures within a specified timeframe concerning financial and administrative management. Furthermore, the committee has the authority to appoint a temporary administrator, granting them full powers to manage the bank, financial institution, or its branches in Algeria.³⁰

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This appointment may be initiated by the institution's management if they declare their inability to continue their duties under normal conditions. Alternatively, it may be initiated by the committee itself if it determines that the bank can no longer be managed under regular circumstances. The appointment may also occur as a result of one of the sanctions stipulated in Article 114, specifically in its fourth and fifth paragraphs of the aforementioned law.

B) Mechanisms for Addressing Banking Insolvency After the Cessation of Payments.

The general provisions of commercial law have stipulated the case of cessation of payments, as has the Monetary and Credit Law, which established specific regulations for banks regarding the definition and proof of this state. Cessation of payments refers to a debtor's failure to meet their obligations on time, regardless of the reason for the default, even if the debtor possesses assets exceeding their liabilities. This concept is closely linked to bankruptcy law because it facilitates the proof of a debtor's insolvency, as it is sufficient to establish the debtor's inability to pay a due debt, regardless of their overall financial capacity or available assets.

According to the provisions of commercial law, cessation of payments is considered an objective condition for being subject to bankruptcy or judicial settlement. Since banks operate as commercial companies in the form of joint-stock companies, they are subject to the same bankruptcy and judicial settlement rules as other commercial entities. In accordance with Article 215 of the same law: "A merchant must declare the cessation of payments within 15 days in order to initiate judicial settlement or bankruptcy proceedings."³¹

While the banking system requires the Banking Committee to declare that deposits are unavailable at a bank due to its failure to pay due deposits for reasons related to its financial situation or because repayment is doubtful, based on its assessment proving the unavailability of deposits, the failure of a bank to pay deposits is considered a specific application of the state of cessation of payments³².

Regarding the subsequent procedures for establishing cessation of payments, in commercial law, bankruptcy or judicial settlement procedures are initiated by the court. However, in banking law, a special compensation system is established for deposit holders, known as the Bank Deposit Guarantee System, after the Banking Committee confirms the cessation of payments³³.

In accordance with Article 118 of the Monetary and Credit Law, Regulation No. 18/01 was issued concerning the Bank Deposit Guarantee System³⁴. This system ensures compensation for bank deposits through the Bank Deposit Guarantee Fund, which is managed by the Bank Deposit Guarantee Company, established for this purpose, in coordination with the central bank.

Once the Banking Committee verifies the unavailability of deposits at a bank due to its financial condition, it notifies the Bank Deposit Guarantee Company of its findings, confirming the lack of available deposits. The company then reviews the entitlements of depositors classified under unavailable deposits and disburses compensation within a maximum period of six months from the date the Banking Committee declares the deposits unavailable or from the date of the ruling by the competent regional court ordering judicial settlement or bankruptcy³⁵.

Conclusion:

In conclusion, this study addressed the legislative mechanisms for addressing banking deficits in banks and financial institutions. We explored the conceptual foundation of banking deficits, which refers to the financial weakness of a company and its reduced ability to compete in financial markets. Additionally, we examined the various internal and external factors leading to the occurrence of banking deficits, which may affect banks and financial institutions.

On the other hand, we highlighted the legislative frameworks for addressing banking deficits during the phases of financial imbalance and cessation of payments. These frameworks contribute to reducing banking deficits and mitigating the associated risks. In this regard, we have reached several key findings, outlined as follows:

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- Monetary and exchange laws aim to establish a special system for addressing the financial difficulties of banks, considering the critical importance of the banking sector, its unique characteristics, and the specific nature of its creditors—primarily depositors.
- The concept of cessation of payments in monetary and credit law is limited to the unavailability of deposits. Thus, the procedures outlined in this law do not necessarily imply the initiation of bankruptcy or judicial settlement proceedings as stipulated in commercial law.
- The deposit guarantee system is not intended to protect banks from bankruptcy risks, as banks are subject to commercial law provisions, particularly those governing joint-stock companies. Instead, its primary objective is to safeguard depositors, given the significance and specificity of deposits within the banking system.

Finally, the Algerian legislator has given considerable attention to the issue of banking deficits by introducing effective mechanisms aimed at maintaining financial market stability and recognizing the crucial role of banks in fostering national economic development.

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