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Governance as a Supervisory Mechanism in the Banking System: The Algerian Banking System as a Case Study

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Abstract
This study defines banking governance and identifies the principles on which it is founded. It examines the role of governance in safeguarding the banking system against banking risks and improving banking performance. It further highlights the importance of banking supervision in establishing an effective governance framework by examining the supervisory bodies operating within the Algerian banking system and specifying the functions and responsibilities assigned to each.

Keywords: governance; banking supervision; banking system.

Introduction

The need for governance has become increasingly apparent in many developed and emerging economies over recent decades, particularly in the aftermath of the economic collapses and financial crises that affected the world during the final decade of the twentieth century, especially those involving banking systems. The importance of governance has also grown as many countries have moved towards capitalist economic systems that rely heavily on private enterprise. Algeria followed this trend, particularly after the legal and economic reforms introduced under the 1989 Constitution.

Against this background, the following research question arises: To what extent does governance, as a supervisory mechanism, contribute to improving banking performance?

This question is addressed in two sections:

1. **The Concept of Banking Governance**
2. **Governance in the Algerian Banking System**

1. The Concept of Banking Governance

The concept of banking governance varies according to the nature of the banking system in each country and the circumstances and factors that affect its proper implementation. This section therefore examines selected definitions of banking governance and its distinguishing characteristics, followed by its determinants and underlying principles.

1.1 Definition and Characteristics of Banking Governance

1.1.1 Definition of Banking Governance

Banking governance has been defined in various ways. Because its determinants differ among countries for legal, political, and cultural reasons, no single universally accepted definition has been established.[1] The following discussion presents several definitions of banking governance, particularly those issued or adopted by international bodies.

The Bank for International Settlements (BIS) defines banking governance in terms of the methods by which banks are directed through their boards of directors and senior management. These methods determine how a bank's objectives are established and its operations conducted, protect the interests of shareholders and other stakeholders, ensure compliance with applicable laws and regulations, and safeguard depositors' interests.[2]

Banking governance has also been defined as the framework within which companies operate. It concerns the relationships among employees, members of the board of directors, shareholders, other stakeholders, and government regulators, as well as the manner in which these parties interact in supervising the company's operations.[3]

The 1992 Cadbury Report defined corporate governance as the system through which shareholders direct, manage, and monitor their company by appointing members of the board of directors and selecting the external auditor. Governance also encompasses the allocation of rights and responsibilities among the parties associated with the company. It provides a mechanism for balancing the company's economic and social objectives, on the one hand, with individual and collective objectives, on the other. A bank or corporate governance framework encourages the efficient use of resources. It promotes accounting and accountability for their management, to align, as far as possible, the interests of individuals, banks or companies, and society.[4]

The Organisation for Economic Co-operation and Development (OECD)[5] defines corporate governance as the system by which business organisations are directed and controlled. It specifies the distribution of rights and responsibilities among the principal participants in an organisation, including the board of directors, shareholders, and other stakeholders; establishes rules and procedures for decision-making; and provides the structure through which objectives are set, the means of attaining them are determined, and performance is monitored.[6]

The foregoing definitions focus principally on supervisory systems and controls designed to protect the interests of all parties associated with a banking institution, restrain improper conduct by executive managers, and strengthen the role of boards of directors. This focus reflects numerous instances in which management, sometimes in collusion with others, manipulated corporate funds, including those of banks organised in corporate form, thereby causing bankruptcy or, at a minimum, serious financial and legal difficulties.[7]

Among the definitions considered above, the OECD formulation most closely captures the essential elements of governance. It combines the allocation of rights and responsibilities with the monitoring of performance. Both elements are fundamental to effective governance and demonstrate the integrated nature of the process through which governance objectives are realised.

1.1.2 Characteristics of Banking Governance

The following features characterise bank governance:[8]

- **Discipline:** adherence to appropriate ethical conduct and to the standards governing professional performance.
- **Transparency:** accurate, credible, clear, and timely disclosure of the institution's operations and practices, together with appropriate participation by relevant parties.
- **Independence:** freedom from inappropriate external influence or pressure. This requires, among other safeguards, a chair of the board who is independent of senior management and an effective separation between supervisory and executive functions.
- **Responsibility:** respect for the rights of the bank's various stakeholders, recognition of the rights established by legislation and regulation, and encouragement of co-operation between the bank and other parties.
- **Fairness:** protection of shareholders' interests and equitable, impartial treatment of all shareholders without unjustified preference.
- **Clarity:** preparation of financial statements and reports in a clear, transparent, and fair manner so that they are comprehensible to their intended users.

1.2 Determinants and Principles of Banking Governance

1.2.1 Determinants of Bank Governance

The proper and effective implementation of governance in banking institutions depends on a range of determinants, which may be divided into internal and external determinants.

A. Internal Determinants

These comprise the rules and principles that govern decision-making and the distribution of authority within a bank or banking institution among the general assembly, the board of directors, and executive management. Their existence and effective application help to reduce conflicts among the interests of these three parties.[9] They also include the institution's internal-control procedures and policies, which should ensure balanced consideration of all related parties without favouring any one of them.[10]

B. External Determinants

External determinants relate to the general investment climate within the state and to the environment in which banks and financial institutions operate. This environment may vary from one jurisdiction to another. The principal external determinants include the following:

- Laws and regulations governing the operation of financial markets.
- A sound financial system capable of providing the financing required for projects, thereby supporting banks' continuity and international competitiveness.
- Efficient supervisory and regulatory authorities, whether sector-specific or general, including capital-market authorities and central banks. Their responsibilities include

rigorous supervision of companies and banks, verification of the accuracy and integrity of published information, and the imposition and effective enforcement of appropriate sanctions for non-compliance.

- The role of non-governmental professional bodies, including associations of accountants and auditors, in ensuring that their members comply with professional, ethical, and behavioural standards that support efficient market operation.
- The role of Sharia supervisory bodies in Islamic financial institutions in ensuring that operational procedures comply with Sharia requirements in matters requiring precise religious conformity.
- The role of informal supervisory actors, including the media, and the extent of their freedom to expose financial corruption to the public.
- The awareness of bank customers concerning their rights and obligations and the procedures available for reporting financial corruption.[11]

1.2.2 Principles of Banking Governance

Any discussion of the principles governing banking institutions must begin with the principles issued by the Basel Committee on Banking Supervision (BCBS).[12] The Committee established influential prudential rules and principles of banking supervision and serves as an international point of reference for national banking systems. The principal elements may be summarised as follows:[13]

- **Principle 1: Protection of Shareholders' Rights**

Mechanisms should safeguard shareholders' rights in relation to the transfer and registration of share ownership, participation and voting at general meetings, receipt of dividends, and review of financial statements. These protections help ensure the proper use of banks' funds and maximise returns and share value over the long term.

- **Principle 2: Equitable Treatment of Shareholders**

All shareholders should be treated fairly and transparently and should be able to defend their legal rights. The board of directors must oversee and approve the bank's strategic objectives, values, and standards of conduct, while taking account of the interests of shareholders and depositors. The bank must comply with applicable law and prohibit activities, relationships, and circumstances that may undermine effective governance, including conflicts of interest such as preferential lending to employees, managers, or controlling shareholders.

- **Principle 3: Disclosure and Transparency**

Transparency in bank management is fundamental to sound and effective governance. Shareholders and other market stakeholders cannot properly monitor management performance when adequate information is unavailable. They should therefore receive sufficient information concerning the bank's structure, ownership, objectives, and performance. Public disclosure is especially important for listed banks because it supports market discipline. Information should be accurate, timely, and disclosed through the bank's website and its periodic and annual reports.

• **Principle 4: Consideration of Other Stakeholders**

The rights and interests of other parties dealing with the bank should be respected, and appropriate redress should be available when those rights are infringed. Effective co-operation between the bank and its stakeholders supports the bank's long-term success and continuity and may create new investment opportunities that strengthen its financial position.

• **Principle 5: Responsibilities of the Board of Directors**

The board of directors must define clearly the responsibilities assigned to the bank's managers and employees and establish an organisational structure that promotes accountability. It must ensure that executive management acts consistently with board policy and that responsible officials possess the skills required to manage the bank's activities. The board must also verify that the financial statements fairly present the bank's financial position in all material respects by ensuring that external auditors work in accordance with applicable standards and engage appropriately with internal controls relating to financial-statement disclosure.

2. Governance in the Algerian Banking System

The Algerian banking system has experienced several financial shocks, particularly following the enactment of Law No. 90-10 on Money and Credit, which formed part of the legal and economic reforms associated with the 1989 Constitution. That Law opened the Algerian market to private and foreign banks. Prominent institutions established during this period included Khalifa Bank and the Algerian Commercial and Industrial Bank. A defining weakness of the period was inadequate central-bank supervision during both the establishment and operation of these banks. The resulting crises affected the Algerian banking system. They diminished public confidence in private banks, with significant consequences for domestic and foreign private banks that entered the Algerian market after the liquidation of those two institutions.[14]

Banking supervision may therefore be regarded as a mechanism for implementing sound governance. It contributes to the proper management of banks and protects them against corruption, thereby safeguarding the rights of employees, customers, and other stakeholders. The following discussion first examines the importance of banking supervision and then considers the supervisory mechanisms operating within the Algerian banking system.

2.1 The Importance of Banking Supervision in Implementing Governance

The application of governance principles by banks may produce several positive outcomes. It can expand financing opportunities, reduce investment costs, stabilise capital markets, limit corruption, and reduce risk. Banks' compliance with governance standards may also encourage the companies they finance to adopt comparable standards, particularly those relating to disclosure, transparency, and sound management.[15]

2.1.1 The Concept of Banking Supervision

This subsection defines banking supervision and then examines its principal instruments.

A. Definition of Banking Supervision

Banking supervision may be defined as the set of rules, procedures, and methods adopted by monetary authorities and central banks to preserve the sound financial position of banking institutions and to establish a robust banking system that contributes to economic development and protects the rights of depositors and investors.[16] It may also be understood as an administrative process intended to ensure that banks comply with applicable legislative and regulatory provisions and with accounting and prudential rules; to verify that banking operations conform to prescribed standards; and to identify and correct errors and negligence.[17]

Banking supervision also seeks to ensure the proper implementation of the laws, regulations, and instructions addressed to banks. The Bank of Algeria, as the central bank, is responsible for issuing relevant regulations and instructions, monitoring banks' compliance, and assessing the effectiveness of the supervisory framework. This requires identifying strengths and weaknesses in the banking system and adopting legislation suited to the realities of that system.[18]

Banking supervision should not be understood merely as a fault-finding exercise undertaken for punitive purposes. In its positive sense, it forms part of administrative management and is intended to verify, evaluate, and, where necessary, correct performance.[19]

B. Instruments of Banking Supervision

Several instruments may be used in banking supervision. The most important are set out below.

- **Budgetary Control:** the budget forms part of the planning process and plays a vital role in a bank's management. Actual results are compared periodically with budgeted estimates so that errors and deficiencies can be identified and addressed promptly. A budget presents expected results in financial terms.[20]
- **Reports:** Reports contain the information and data required by supervisory authorities and officials to identify, prevent, and remedy violations.[21] They may be operational, explaining how work and tasks are performed, or advisory, providing assistance and information to the person responsible for implementing a decision.[22]
- **Managerial Supervision:** Managerial supervision is both educational and directive. It guides employees towards proper performance, helps identify errors and deviations, and anticipates the measures required to address them. It therefore assists employees in mastering their work, assessing their abilities, and improving their competence and performance.[23]
- **Personal Observation:** Personal observation is based on direct contact between the observer and those performing the work, whether through direct viewing or listening or through the use of recording devices.[24]
- **Quantitative Indicators:** financial ratios may be used to evaluate the activities of banks and financial institutions in relation to capital, liquidity, and solvency.[25]
- **Internal Audit:** internal audit is an important instrument of banking supervision. It entails the systematic and independent evaluation by internal auditors of the various

operations carried out by a banking institution, including accounting, financial, and other activities. The modern conception of internal audit is not limited to reviewing accounts; it also encompasses evaluating operational performance and measuring the extent to which established objectives have been achieved.[26]

2.1.2 Forms of Banking Supervision

Banking supervision takes two principal forms: internal supervision, conducted within the bank or financial institution, and external supervision, entrusted to bodies that are independent of the institution supervised.

A. Internal Supervision

Internal supervision is an independent evaluative function established within a bank or financial institution and performed by persons within the institution who are entrusted with supervisory duties.[27] It involves the examination and evaluation of the institution's activities and operations.

Its scope encompasses accounting and financial supervision, administrative supervision, and internal control. Accounting supervision seeks to ensure that accounting instructions are implemented within authorised delegations of power, transactions are recorded in a manner that supports the preparation and use of financial statements, and discrepancies identified through the reconciliation of balances are appropriately addressed.[28]

Administrative supervision seeks to improve employees' professional efficiency, implement administrative policies, and provide training. Internal control consists of routine procedures applied to the institution's operations to prevent or detect fraud and errors and to correct them promptly. This form of control is entrusted to technical bodies reporting to the bank's or financial institution's senior management. Their findings are submitted in written reports to the chair of the board of directors or the general manager, in accordance with the institution's hierarchy, so that the reports may be followed up and corrective intervention undertaken where necessary.[29]

B. External Supervision

External supervision complements internal supervision. However effective internal supervision may be, it cannot identify every deficiency, weakness, or improper practice within a bank, and such limitations may adversely affect overall performance. External supervision is therefore necessary to remedy deficiencies and improve performance.[30] It is comprehensive and is exercised in accordance with the law by independent and specialised bodies outside the bank or financial institution under supervision.[31] It is also characterised by impartiality and transparency in presenting financial facts. Banks and financial institutions may seek external expertise to assess their financial activities generally, examine a specific issue, or evaluate procedures relating to overall management or the management of different categories of risk.

Within the legal framework examined in this study, Ordinance No. 03-11 on Money and Credit regulated both internal and external supervision of banks and financial institutions. Internal supervision was entrusted to the Bank of Algeria through the regulations and instructions it issued for implementation by institutions under its authority. In contrast, external supervision was entrusted principally to the Banking Commission and statutory auditors, together with the Central Credit Risk Register and the Central Register of Unpaid Claims.

2.2 Banking Supervisory Bodies in the Algerian Banking System

Banking supervision is intended to protect the banking system against financial risks and crises, particularly because of the system's direct connection with the wider economy. The Algerian legislature therefore attached considerable importance to banking supervision through legislative and regulatory measures, especially Ordinance No. 03-11 on Money and Credit[32] and Ordinance No. 10-04, which amended and supplemented it.[33]

Given the importance of banking supervision to bank governance, the legislature entrusted its exercise to independent and specialised bodies, which are examined below.

2.2.1 The Banking Commission and Statutory Auditors

The Banking Commission and statutory auditors both play an important role in the Algerian banking system through their supervision of banks and financial institutions. Both operate as external supervisory bodies, and their powers under the historical framework were defined by Ordinance No. 03-11.

A. Functions of the Banking Commission

Article 105 of Ordinance No. 03-11, as amended and supplemented, defined the Banking Commission's supervisory functions as follows:[34]

- Monitoring compliance by banks and financial institutions with the legislative and regulatory provisions applicable to them.
- Imposing penalties for established breaches.
- Examining the operating conditions of banks and financial institutions and monitoring the soundness of their financial positions.
- Ensuring compliance with standards of proper professional conduct.
- Where appropriate, identifying violations committed by persons carrying out banking or financial-institution activities without authorisation and imposing the disciplinary sanctions prescribed by applicable law, without prejudice to criminal or civil proceedings.

These powers demonstrate that the Banking Commission's supervision covers several areas. It monitors compliance with applicable legislation and regulations; penalises the officials responsible for established breaches; examines the operating conditions of banks and financial institutions; monitors their financial positions; and ensures compliance with proper professional standards. Where appropriate, it also identifies unauthorised banking or financial activities and imposes disciplinary sanctions without prejudice to judicial proceedings.

B. Functions of Statutory Auditors

The Algerian legislature required every bank or financial institution, and every branch of a foreign bank operating in Algeria, to appoint at least two statutory auditors under Article 100 of

Ordinance No. 03-11. Failure to make the required appointments could expose an institution to legal sanctions, including withdrawal of its authorisation.

In their supervisory capacity, statutory auditors perform a range of duties and exercise several powers. They certify the accuracy and regularity of annual accounts and their conformity with the results of transactions conducted during the preceding financial year. The same requirement applies to the financial position and assets of private companies and banking entities, including domestic and foreign banks and financial institutions.[35]

Statutory auditors also examine the accuracy of annual accounts and their conformity with the information contained in the management report submitted by managers to shareholders, partners, or holders of equity interests. They express an opinion, in a report, on the internal-control procedures approved by the board of directors, management board, or manager of the bank or banking institution.[36]

A statutory auditor may, at any time and on the institution's premises, inspect accounting records, balance sheets, correspondence, minutes, and all other documents and written records belonging to the banking entity. The auditor may request explanations and information from the entity's managers and employees, conduct any inspection considered necessary, and request from the competent bodies at the entity's registered office information concerning affiliated institutions or other institutions in which it holds an equity interest.[37]

Under Article 101 of Ordinance No. 03-11, statutory auditors of banks and financial institutions were also required, in addition to their general legal obligations, to perform the following duties:[38]

- Immediately inform the Governor of the Bank of Algeria of any violation committed by the institution under their supervision under the Ordinance or the regulations adopted pursuant to it.
- Submit to the Governor of the Bank of Algeria a special report on the supervision performed. The report had to be delivered within four months after the close of each financial year.
- Submit to the general assembly a special report concerning any facility granted by the institution to a natural or legal person. For branches of foreign banks and financial institutions, the report had to be submitted to their representatives in Algeria.
- Send the Governor of the Bank of Algeria a copy of the reports addressed to the institution's general assembly.

The statutory auditors of banks and financial institutions were subject to the supervision of the Banking Commission, which could impose the sanctions prescribed by law, without prejudice to disciplinary or criminal proceedings,[39] where they failed to fulfil their statutory supervisory obligations.

2.2.2 Central Registers of the Bank of Algeria

To reinforce the protection of the banking system, the legislature established additional supervisory services within the Bank of Algeria alongside the Banking Commission and statutory auditors. These services, referred to as central registers, included the Central Credit Risk Register and the Central Register of Unpaid Claims, as provided for by Article 98 of Ordinance No. 03-11.

A. The Central Credit Risk Register

The Central Credit Risk Register was first established under the now-repealed Law No. 90-10 on Money and Credit and was retained under Ordinance No. 03-11.[40] It was an administrative service managed by the Bank of Algeria and responsible for collecting the names of loan beneficiaries, the nature and ceilings of loans granted, the amounts drawn from banks and financial institutions, and the guarantees provided for each loan. It therefore constituted a database covering the loans granted by banks and financial institutions and their performance, to provide sufficient information to mitigate financial risks that might disturb the financial equilibrium of individual institutions or the banking system as a whole.

The legislature required all banks and financial institutions to participate in the Central Credit Risk Register and to provide information concerning loans, their beneficiaries, their nature, and the guarantees provided.[41] The Register's competence therefore related specifically to the status and performance of loans granted by banks and financial institutions to their customers.

The functions of the Central Credit Risk Register may be grouped into three categories. First, its statistical function involved collecting the identities of loan beneficiaries and information concerning the nature, ceilings, and guarantees of loans granted by banks and financial institutions. Secondly, its information function involved making centralised information about the status and performance of loans available to participating institutions. Thirdly, its advisory function involved providing a bank or financial institution, upon request, with information concerning its customers.

B. The Central Register of Unpaid Claims

Article 98(5) of Ordinance No. 03-11 provided for the Central Register of Unpaid Claims. Like the Central Credit Risk Register, it was an administrative service operating under the authority and management of the Bank of Algeria. Its functions concerned payment incidents arising from loans or other means of payment. Its organisation and operation were governed by Regulation No. 92-02 on the Organisation and Operation of the Central Register of Unpaid Claims and Regulation No. 08-01 on Measures for Preventing and Combating the Issuance of Cheques without Sufficient Funds.

Under Articles 2 and 3 of Regulation No. 92-02, the Central Register of Unpaid Claims performed the following functions:

- Maintaining a central index of payment incidents and any proceedings arising from them, based on information received from financial intermediaries concerning payment incidents relating to loans or means of payment. For the Regulation, financial intermediaries include banks, financial institutions, the Public Treasury, the financial services of Algeria Post, and any other institution that made means of payment available to customers and managed them.

- Periodically communicating to financial intermediaries and any other competent authority a list of payment incidents and the proceedings arising from them.
- These functions show that the Central Register of Unpaid Claims was intended to inform financial intermediaries about existing payment incidents, enabling them to adopt preventive measures against insolvency and impairment of their financial position, particularly when dealing with persons registered in the central database.

Conclusion

Banking governance is a modern mechanism that can contribute significantly to protecting a state's banking system and, consequently, to strengthening its economy and investment environment. The first section of this study examined the concept, characteristics, determinants, and principles of banking governance. The second section considered governance in the Algerian banking system, focusing on the importance of banking supervision, its concept and forms, and the bodies responsible for exercising it. The analysis demonstrates that banking supervision is essential to the implementation of governance. Without effective supervision, the banking governance required by modern financial systems cannot be achieved, particularly in the aftermath of the financial and economic crises experienced internationally in recent decades.

The study reaches the following conclusions:

1. Banking governance comprises procedures, rules, and technical methods applied in the banking sector. It may also be understood as the body of laws, regulations, and decisions issued by competent banking authorities to reform and strengthen the banking system.
2. Banking governance pursues two principal objectives: protecting the rights of shareholders, depositors, and other stakeholders; and supervising banking performance and improving its quality. Both objectives require banks and financial institutions to comply with sound governance principles.
3. Banking supervision plays a central role in implementing governance, maintaining banking-system stability, and protecting the system against financial risks. This role is exercised through the various supervisory bodies operating in the banking sector.
4. Bank governance can contribute to attracting domestic and foreign investment, combating corruption, and limiting capital flight.
5. The application of sound governance principles within the banking system can support broader economic reform and promote economic development.

Principal Recommendations

1. The banking system should be reformed, or at least improved, through the adoption and effective application of sound governance principles across all banks and financial institutions.

2. Banks and financial institutions should be encouraged and incentivised to apply banking-governance principles and to participate in improving banking performance in ways that strengthen their financial stability and competitiveness.
3. Banking supervision should be strengthened by amending the legislative and regulatory framework applicable to the banking sector so that it is consistent with international governance principles established by the Basel Committee on Banking Supervision.[42]
4. Because governance is essential to banking-system reform, the management of financial risks and crises, and the attraction of investment and capital, those responsible for financial and economic policy should provide an appropriate legal and political environment for improving Algeria's business climate.

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