

Financial Development and Inclusive Growth

Attaining Shared and Sustainable Prosperity in Egypt

MIDDLE EAST AND NORTH AFRICA
FINANCE AND PRIVATE SECTOR DEVELOPMENT

**Financial Development
and Inclusive Growth**
**Attaining Shared and
Sustainable Prosperity in Egypt**

A Study Led By Sahar Nasr



THE WORLD BANK

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CONTENTS

ABBREVIATIONS AND ACRONYMS	IX
FORWARD	XI
ACKNOWLEDGMENTS	XV
EXECUTIVE SUMMARY	XIX
OVERVIEW OF THE FINANCIAL SECTOR	1
FINANCIAL DEVELOPMENT AND INCLUSIVE GROWTH	2
MAIN COMPONENTS OF THE FINANCIAL SECTOR REFORM PROGRAM	8
ACHIEVEMENTS AND MAIN OUTCOMES	14
POST-REVOLUTION RISKS AND CHALLENGES	21
CONCLUDING REMARKS	30
BANKS, ECONOMIC GROWTH AND OPPORTUNITY	33
FINANCE: PRO-GROWTH AND PRO-POOR	33
FINANCIAL SYSTEM—GROWING FROM A LOW LEVEL	39
FINANCING EGYPT POST-REVOLUTION—NEW OPPORTUNITIES AND NEW CHALLENGES	52
CONCLUDING REMARKS	63
THE DEVELOPMENT OF THE CAPITAL MARKETS	67
EQUITY MARKETS	67
FIXED INCOME MARKETS	84
CONCLUDING REMARKS	111
NON-BANK FINANCIAL INSTITUTIONS	115
INSURANCE AND PENSIONS	115
MORTGAGE MARKET	132
FINANCIAL LEASING AND FACTORING	147
CONCLUDING REMARKS	154
FINANCIAL SECTOR INTEGRITY AND ECONOMIC GROWTH	159
BANKING SUPERVISION	160
NON-BANK FINANCIAL SERVICES REGULATION	188
LEGAL AND INSTITUTIONAL FRAMEWORK	201
CONCLUDING REMARKS	207
FINANCIAL SECTOR DEVELOPMENT AGENDA	211
REFERENCES	237

FIGURES

Figure 1.1 Number of Primary Lenders Extending Mortgage Loans	11
Figure 1.2 Capital Adequacy of the Banking System	14
Figure 1.3 NPLs-to-Total Loans	15
Figure 1.4 Credit by Banks to the Government versus Credit to Private Sector	21
Figure 1.5 Islamic Finance Penetration in Selected Countries	27
Figure 2.1 Finance and Growth across Countries (1980–2007)	34
Figure 2.2 Finance and Poverty Alleviation across Countries (1980–2007)	36
Figure 2.3 Actual and Predicted Level of Bank Deposits-to-GDP	42
Figure 2.4 Actual and Predicted Level of Private Credit-to-GDP	42
Figure 2.5 Sectoral Lending Share of Egypt's Banking Sector (2009)	44
Figure 2.6 Maturity Structure of Egyptian Banks (2007–2009)	45
Figure 2.7 Percentage of Firms that have Access to Bank's Credit	47
Figure 2.8 Firms identifying Access to Finance as a "Major" or "Very Severe" Obstacle	48
Figure 2.9 Financial Depth versus Enterprise Use of Bank Credit	48
Figure 2.10 Types in Egypt-Share of Firms with Bank Credit	49
Figure 2.11 Percentage of Firms Having Access to Banks Credit in Egypt	50
Figure 2.12 Reasons for not having a Loan in Egypt across Different Firm Types	50
Figure 3.1 Evolution of the Structure of Domestic Debt	88
Figure 3.2 Egypt's Market Capitalization in GEMX	90
Figure 3.3 T-Bond Issuances in 2011	91
Figure 3.4 T-Bond Annual Maturity Profile	91
Figure 3.5 Government Bonds Trading Volume	100
Figure 3.6 Evolution of Foreign Investor Holdings of Domestic Debt in Percentage	107
Figure 3.7 Central Depositary: Existing model for T-Bills and T-Bonds	108
Figure 3.8 Proposed Model 1: T-Bills and T-Bonds under CBE	109
Figure 3.9 Proposed Model 2: Connectivity between CBE and MCDR	110
Figure 4.1 Private Sector Re-entry to the MTPL Market	119
Figure 4.2 MTPL Premium Penetration Versus Vehicle Density	123
Figure 4.3 Fiscal Balance—Old and New Public Pension Systems	130
Figure 4.4 Mortgage Debt Outstanding	133
Figure 4.5 Mortgage Debt Outstanding to GDP	133
Figure 4.6 Mortgage Debt-to-GDP	133
Figure 4.7 Egypt and Peers Urbanization Rates 1950–2050	139
Figure 4.8 Egypt Housing Demand (Household Formation Rate)	140
Figure 4.9 Housing Supply in Greater Cairo	141
Figure 4.10 Growth of the Leasing Industry	148
Figure 4.11 Leasing Company Market Share for Q4 of 2011- Growth of the Leasing Industry	149
Figure 4.12 Value of Leasing Contracts	150
Figure 5.1 Legal Rights of Creditors in Egypt and Other Countries	203
Figure 5.2 Cost to Create Collateral in Egypt and Other Countries	204
Figure 5.3 Dominance of Collateral-Based Lending in Egypt	206

TABLES

Table 1.1 Egypt—Banking Soundness Indicators	17
Table 1.2 MTPL Claims Ratios by Accounting Year	20
Table 1.3 Islamic Banks Share in Total Banking Sector	29
Table 2.1 Reasons for Not Applying for a Loan or Line of Credit	51
Table 3.1 Stock Market Capitalization as a Percentage of GDP	69
Table 3.2 Number of Listed Companies	69
Table 3.3 Number of Initial Public Offerings	70
Table 3.4 Stock Market Turnover Ratios	71
Table 3.5 Mutual Fund Assets	73
Table 3.6 Monetary Policy Instruments in Egypt	86
Table 3.7 Overview of Corporate Bonds in Egypt as of December 2010	94
Table 3.8 Structure on Securitized Issues as of December 2010	95
Table 3.9 Structure of Banks' Securities Portfolios Expressed as a Percentage	103
Table 3.10 Distribution of T-Bond Holders as of March 31, 2008	103
Table 3.11 Evolution of Mutual Funds	104
Table 3.12 Holdings of Money Market Mutual Funds	104
Table 3.13 Assets under Management	106
Table 4.1 Performance Ratio of the Insurance Sector (2004–2013)	118
Table 4.2 Private Pension Funds (2004–2013)	120
Table 4.3 Misr Insurance Performance Ratios	121
Table 4.4 Misr Life Performance Ratios	121
Table 4.5 State-owned Insurer General and Administrative Expense Ratios	121
Table 4.6 Adjusted Premium per Insurance Employee	122
Table 4.7 Private Pension Funding Levels	125
Table 4.8 MTPL Claims Ratios (2007-2013)	126
Table 4.9 State-owned insurer Claims Ratios by Underwriting	126
Table 4.10 Household Savings Through Financial Institutions in Egypt	128

BOXES

Box 1.1 The Role of State-owned Banks and Government Intervention in Credit Allocation	7
Box 1.2 The Principal Bank for Development & Agricultural Credit	16
Box 1.3 Lack of Legal and Regulatory Framework for Microfinance	25
Box 1.4 Evolution of Islamic Finance in Egypt	26
Box 2.1 Three Concepts of Finance	38
Box 2.2 Reform Experience from Transition Economies	53
Box 4.1 The Egyptian Leasing Association	151
Box 5.1 Example of SME Rating Agency: India's SMERA	173
Box 5.2 Special Provisions for SME Funding	186

ABBREVIATIONS AND ACRONYMS

ACH	Automated Clearing House	IPO	Initial Public Offering
AFDB	African Development Bank	LA/TA	Liquid Assets to Total Assets Ratio
AOB	Accounting Oversight Board	LE	Egyptian Pound
AUM	Assets under Management	MCDR	Misr for Central Clearing Depository & Registry
AWB	Al Watany Bank of Egypt	MENA	Middle East and North Africa
BCCI	Bank of Credit and Commerce International	MFA	Mortgage Finance Authority
CAR	Capital Adequacy Ratio	MFC	Mortgage Finance Company
CB	Conventional Banks	MFI	Micro Finance Institutions
CBE	Central Bank of Egypt	MMMF	Money Market Mutual Fund
CCP	Central Counterparty	MOU	Memorandum of Understanding
CD	Certificate of Deposit	MTPL	Motor Third Party Liability
CIB	Commercial International Bank	NAV	Net Asset Value
CIS	Collective Investment Schemes	NBE	National Bank of Egypt
CIS	Commonwealth of Independent States	NBD	National Bank for Development
CMA	Capital Market Authority	NBFI	Non-bank financial institutions
CSD	Central Securities Depository	NHP	National Housing Program
DB	Defined Benefit	NIB	National Investment Bank
DD	Domestic Debt	NPL	Non-Performing Loans
DIFF	Differential	NSB	Nasser Social Bank
DVP	Delivery versus payment	NUCA	New Urban Communities Authority
EALB	Egyptian Arab Land Bank	OOP	Out of pocket (health expenses)
EAS	Egyptian Accounting Standards	OTC	Over the Counter
ECB	European Central Bank	PAYGO	Pay as you go (i.e. no pre-funding)
EDR	Egyptian Depository Receipt	PBDAC	Principal Bank for Development & Agricultural Credit
EFSA	Egyptian Financial Supervisory Authority	PD	Primary Dealer
EISA	Egyptian Insurance Supervisory Authority	PE	Private Equity
EMEs	Emerging Market Economies	PPP	Public-Private Partnership
EMRC	Egypt Mortgage Refinance Company	PTES	Program for Treatment at the Expense of the State
EGX	Egyptian Stock Exchange	REPO	Repurchase Operation/Agreement
ERSAP	Economic Reform & Structural Adjustment Program	REFA	Real Estate Finance Authority
ESA	Egyptian Survey Authority	ROAA	Return on Average Assets Ratio
ETA	Equity to Total Assets Ratio	RTGS	Real Time Gross Settlement
ETF	Exchange Traded Funds	SBL	Stock-Borrowing and Lending Facility
FPM	Financial Projection Model	SDP	Supervisory Development Plan
GCC	Gulf Co-operation Council	SFD	Social Fund for Development
GAFI	General Authority for Free Zones & Investment	SGF	Settlement Guarantee Fund
GDRs	Global Depository Receipts	SIF	Social Insurance Fund
HIO	Health Insurance Organization	SME	Small and Medium Enterprises
HNW	High Net Worth	SOE	State-owned Enterprises
IAS	International Auditing Standards	SRO	Self-Regulatory Organization
IDB	Industrial Development Bank of Egypt	SDP	Supervisory Development Plan
IFIs	International Financial Institutions	TA	Technical Assistance
IFRS	International Financial Reporting Standards	VC	Venture Capital
IHC	Insurance Holding Company	USAID	US Agency for International Development
INFTAX	Inflation Tax		

FORWARD

Better functioning financial systems foster economic growth, poverty alleviation; moreover, a more equitable distribution of economic opportunities enhances overall economic development. It is critical that financial development leads to inclusive growth. This brings us to certain key questions: Who benefits from a better financial system? Does financial development induce an increase in per capita Gross Domestic Product (GDP) only because the very rich are getting even richer? Does finance expand economic opportunities for the bulk of society? Economic theory suggests that finance shapes the distribution of economic opportunities. The financial system affects the degree to which a person's economic opportunities are defined. It influences who can launch a new business venture and who cannot, who can acquire education and who cannot, who can live in a neighborhood that fosters the cognitive and non-cognitive development of their children and who cannot, who can pursue one's economic dreams and who cannot. A more competitive, better functioning financial system exerts a disproportionately positive impact on relatively low-income families.

A large body of evidence finds that the functioning of the financial system influences the rate of long-run economic development, poverty alleviation, and the degree to which families and firms with sound investment projects have access to capital. When financial systems

effectively seek out the best investments, efficiently mobilize resources to fund those investments, and carefully scrutinize the use of those funds by firms and individuals, this tends to accelerate economic development, alleviate poverty, and reduce income inequality. The greater the degree that financial systems collect society's savings with one hand and funnel those resources, this tends to foster growth, promote poverty alleviation, increase inclusivity in the available economic opportunities and expands economic opportunities. Thus, the financial system affects the savings rate and the efficiency of resource allocation, with enduring ramifications on economic activity. Therefore, getting the financial system to operate soundly is vital to fostering sustained economic development.

According to the extent that the financial system performs these functions well, economies tend to grow correspondingly faster. For example, when banks screen borrowers effectively and identify firms with the most promising prospects, this is a first step in boosting productivity growth. When financial markets and institutions mobilize savings from disparate households to invest in these promising projects, this represents a second crucial step in fostering economic growth. When financial institutions monitor the use of investments after financing firms and scrutinize their managerial performance, this is an additional, essential ingredient in boosting the operational efficiency of corporations, reducing waste and fraud, and spurring economic inclusivity.

There is a robust positive relationship between financial development and both poverty alleviation and reduction in income inequality. It is not just that finance accelerates economic growth, which trickles down to the poor; rather, finance exerts a disproportionately positive influence on lower income households. Building on the finance and poverty connection, there is a direct link between finance and human welfare. When policy reforms foster the development of the financial system, financial services improve, accelerating economic growth, which ultimately leads to ending extreme poverty and boosting shared prosperity.

So where is Egypt when benchmarked with other emerging and developing economies? During the post-revolution transition, Egypt has been debating fundamental issues, such as maintaining market-oriented reforms, and promoting private sector-led growth. As uncertainty continues, reforms are debated, and crisis management is in full swing. A pressing challenge towards moving forward is the proceeding with the appropriate policy reforms, and this report puts

forward policy implications, given international best practice while taking into account lessons learnt from previous reforms in Egypt and what is needed to respond to the Egyptian people aspiration post revolution.



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EXECUTIVE SUMMARY

Prior to the revolution, Egypt had been hit by the global financial crisis along with higher international food and fuel prices, which induced capital outflows, a moderate slowdown in economic activity, stagnation in employment growth, and high inflation due to rising food prices. As the country was recovering from such external shock and capital inflows started to flow back, the 2011 revolution sent the economy into a tailspin. The Egyptian economy continues to be adversely affected by the ongoing political unrest and violence. Economic activity started to pick up in the second half of FY14, as the government accelerated its stimulus spending, but growth is still feeble at 2.2 percent in 2014 (well below potential), similar to growth rates realized in the previous two years. The sluggish growth reflects mainly contraction in the petroleum and tourism sectors. On the demand side, real investment continued to shrink in real terms due to high uncertainty and net exports remain a drag on growth. However, the remainder of 2014 may witness an improvement in economic activities, thanks to the accommodative government

Prior to the revolution, Egypt had been hit by the global crisis, namely food, fuel and financial crisis, which induced a capital outflow, a moderate growth slowdown, stagnation in employment growth, and high inflation due to rising food prices. As the country was recovering from that shock and capital had started flowing back, the January 25, 2011 revolution sent the economy into a tailspin.

policies pursued, including a notable stimulus backed partially by the Gulf aid packages. Gulf States Saudi Arabia, United Arab Emirates and Kuwait, pledged around US\$24 billion in financial aid to Egypt since July 2013, of which around US\$17-18 (Cash and in kind) billion has been received in 2014.

The overall instability has adversely affected investments and the private sector. Domestic investment fell to 13.1 percent of Gross Domestic Product (GDP) in 2014. Foreign direct investments (FDI) have fallen to 1.1 percent of GDP in 2013. The sluggish growth and domestic demand, high government borrowing needs, risk averse practices by the banking sector, and the drop in national investments and savings had a negative effect on the creation and growth of micro and small enterprises (MSEs). These factors have contributed to an increase in unemployment and poverty rates. Unemployment increased from 8.9 percent in December 2010 to 13.3 percent in June 2014. It is particularly high among women at 25 percent and youth at 42 percent. The poverty rate also increased to 26.3 percent in 2013, up from 25 percent in 2011 and 21.6 percent in 2009.

Egypt's fiscal situation has been deteriorating sharply since 2010 due to weak real growth, adoption of populist measures, and the lack of corrective actions. The overall budget deficit reached 12.5 percent of GDP in 2014, down from 13.7 percent a year earlier on the backdrop of exceptional Gulf receipts and the one-off transfer of government deposit worth Egyptian Pounds (LE) 30 billion from the Central Bank of Egypt (CBE) to the Treasury. However, fiscal aggregates are likely to temporarily improve in 2015, mainly due to structural reforms implemented in July 2014 (increasing and/or enacting taxes and streamlining energy subsidies. th.

The high deficit and government borrowing needs has also led to the crowding out of private sector credit. Banks opted for purchasing less risky, high-yield Government bonds and

Starting 2014, with the exceptional financing from the Gulf trickling in, reserves increased to around US\$17 billion at the end of September 2014 (equivalent to about 3 months of 2014 projected merchandise imports).

Treasury bills that represent 41 percent of the banking system assets, accounting for 40.0 percent of GDP, leaving little loanable funds available. Claims on the government to-total domestic credit have increased to 60 percent, while claims on the private sector credit dropped to 37 percent in June 2013, as opposed to 54.

Starting 2014, with the exceptional financing from the Gulf trickling in, reserves increased to around US\$17 billion at the end of September 2014 (equivalent to about 3 months of 2014 projected merchandise imports). In tandem, the exchange rate appreciated during first half of 2014 before it started to slightly depreciate to reach LE 7.15 per US dollar by end May 2014 and stabilized since then. However, a parallel market premium that had emerged by end-2012 due to foreign exchange rationing—is still persistent. The relative improvement in Egypt's external conditions prompted rating agencies to upgrade Egypt's sovereign rating and outlook. In November 2013, Standard and Poor's raised Egypt's long- and short term foreign and local currency sovereign credit rating to 'B /B', with a 'stable' outlook. Fitch also upgraded Egypt's outlook to 'stable' in January 2014.

However, with the election of El-Sissi as the president in June 2014, the economy is expected to stabilize, and economic recovery is likely as the government moves forward with implementing the reform program, including making the financial system more inclusive, a key contribution and reform to restoring economic growth and making it more inclusive.

Egypt has been undergoing major political and social transformations, following the January 2011 revolution. Egypt has embarked on a dramatic political transition with the stepping down of former President Hosny Mubarak, the appointment of an interim caretaker government, and the dissolution of Parliament. The Egyptian people demands were summarized in "bread, freedom and social justice". The Supreme Council of Armed Forces (SCAF) assumed executive and legislative powers until the Parliamentary and

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The sluggish growth reflects poor performance by manufacturing and construction sectors, in addition to contraction in the petroleum and tourism sectors.

Presidential elections were concluded, and a new constitution was put in place. The prolonged political transition and frequent changes in prime ministers, and cabinet ministers contributed to the delay and uncertainty about policies and directions, including those related to or affecting the financial sector. In June 2012, the Muslim Brotherhood candidate Dr. Mohamed Morsi won the presidential election.

After a year of very little progress made to respond to the Egyptian people's aspirations and failure to introduce a more inclusive political process, including the leftists, liberals, and youth that had helped bring him to power, president Morsi was removed in the wake of massive demonstrations protesting the dire economic and political situation in Egypt. The protestors demanded early presidential elections after Morsi one year in office. The Egyptian military forces, headed by Marshal Abdel Fatah El Sissi, then the Minister of Defense and Military Production, issued a 48 hours ultimatum to the president to respond to the demands of the protestors. On July 3, 2013, the Egyptian Military force convened with various political parties including Salifist party, representatives of Al-Azhar and the Coptic Church, and announced suspension of the constitution, appointment of the head of the constitutional court, councilor Adly Mansour, as an interim president, and conduction of early presidential elections. A roadmap was announced and has been in progress. Two and a half years after the revolution of January 25, 2011, Egypt is undergoing major political, economic and social transformation with the amendments to the 2012 Constitution approved in a referendum held on January 14–15, 2014, which saw a 38.6 percent turnout and a 98.1 percent approval rate. The presidential election took place in May 2014, with Marshal Sissi elected as a new president for Egypt. Parliamentary elections are expected after the Summer of 2014.

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the lack of corrective actions. The overall budget deficit reached 13.7 percent of GDP in 2013, up from 11 percent a year earlier. However, fiscal aggregates are likely to temporarily improve in 2014, mainly due to the exceptional Gulf aid packages, and the one-off transfer of government deposit worth Egyptian Pounds (LE) 30 billion from the Central Bank of Egypt (CBE) to the Treasury. Actual figures for the first nine months of 2014 indicate a lower overall deficit of 7 percent of the year's projected GDP compared to a deficit worth 10 percent a year earlier.

The high deficit and government borrowing needs has also led to the crowding out of private sector credit. Banks opted for purchasing less risky, high-yield Government bonds and Treasury bills that represent 41 percent of the banking system assets, accounting for 40.0 percent of GDP, leaving little loanable funds available. Claims on the government to-total domestic credit have increased to 60 percent, while claims on the private sector credit dropped to 37 percent in June 2013, as opposed to 54.

Starting 2014, with the exceptional financing from the Gulf trickling in, reserves increased to above US\$17.5 billion at the end of April 2014 (equivalent to about 3 months of 2014 projected merchandise imports). In tandem, the exchange rate appreciated during first half of 2014 before it started to slightly depreciate to reach LE 7.15 per US dollar by end May 2014. However, a parallel market premium that had emerged by end-2012 due to foreign exchange rationing—is still persistent. The relative improvement in Egypt's external conditions prompted rating agencies to upgrade Egypt's sovereign rating and outlook. In November 2013, Standard and Poor's raised Egypt's long- and short term foreign and local currency sovereign credit rating to 'B /B', with a 'stable' outlook. Fitch also upgraded Egypt's outlook to 'stable' in January 2014.

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The financial sector, prior to 2004, was dominated by state-ownership and an absence of competition.

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THE FINANCIAL SECTOR REFORM PROGRAM

The financial sector, prior to 2004, was dominated by state-ownership and an absence of competition. The banking sector, the major financial intermediary, constituting over 95 percent of the financial system's assets, suffered from heavy government intervention, weak creditor rights, and a compliance-based regulatory and supervisory framework. This resulted in relatively low and unproductive credit, negligible innovation and a large stock of non-performing loans (NPLs). A relatively small insurance, mutual fund and contractual savings sector, underdeveloped bond, and almost non-existent mortgage markets, thin trading in equities, weak corporate governance, and poor financial infrastructure, characterized the non-bank sector in Egypt. The limited size of these non-bank intermediaries contributed to the absence of long-term savings and the overall limited access to finance. Ancillary financial firms, such as stock brokerages, specialized non-depository lenders (including leasing companies and microfinance lenders) and rating agencies were present, but remained relatively underdeveloped. The financial institutional infrastructure and the legal and regulatory framework were woefully deficient.

The Egyptian authorities launched in 2004, a two-phase financial sector reform program aiming at enhancing the stability and soundness of the system, which would be increasingly private sector-led, able to contribute more effectively to Egypt's growth performance. Phase I (2004–2008) focused mainly on reforming the banking sector, restructuring the insurance and pension systems; strengthening the capital markets, developing the almost non-

existent mortgage finance market, as well as, strengthening the regulatory and supervisory frameworks governing the financial sector. Phase II (2009–2012) focused more on enhancing access to finance, and building a more inclusive and competitive system. It aimed at improving financial intermediation after achieving stability under the previous phase. The ambitious reform program of the financial sector launched in 2004 witnessed smooth implementation driven by the benign international economic conditions in addition to commitment from the Egyptian authorities, and the relative political stability witnessed during those years as opposed to Phase II of the reform program, which was interrupted significantly at its early stages with the January 25th, 2011 revolution.

Overall, the reform program produced positive results. For the first time in recent history, the banking sector became majority-owned by the private sector and open to competition. The banking sector was consolidated, and the number of banks was reduced from 57 to 39 banks. State-owned banks were subject to financial, operational, and institutional restructuring leaving a stronger and more competitive sector. The Central Bank of Egypt (CBE) also worked on strengthening the corporate governance of the banking system and designing a Basel II framework customized to the Egyptian banking system. On the non-bank front, reforms entailed the restructuring of the insurance sector, including reducing public ownership; overhauling the legal and regulatory framework; establishing a new mortgage finance system; and deepening and strengthening the capital markets. At the same time, the financial institutional infrastructure was improved significantly, evident in the creation of the first private credit bureau and the establishment of a safe, secure payments system, among others.

All this improved the financial sector's resiliency to the global crisis and the lengthy transformation of the political regime since the revolution, and helped it weather the crisis.

The ambitious reform program of the financial sector launched in 2004 witnessed smooth implementation driven by the benign international economic conditions in addition to commitment from the Egyptian authorities, and the relative political stability.

On the non-bank front, reforms entailed the restructuring of the insurance sector, including reducing public ownership; overhauling the legal and regulatory framework, establishing a new mortgage finance system; deepening and strengthening the capital markets.

The reforms did not lead to improvements in financial intermediation, and was accused of catering to large, well-established firms. Small and medium enterprise (SMEs) did not fully reap the benefits of these reforms, the country had no legislative body for almost three years, which negatively affected legal reforms and the passage of laws that were crucial for improving financial intermediation and enhancing access to the marginalized groups and underserved areas. To a large extent, this issue was compounded by macroeconomic instability—increased government deficit and huge borrowing from the banking system since 2008 as a result of the global crisis, and the lengthy uncertainties of the transition to a new political regime after January 2011.

Financial intermediation has been low, as evident in the loans-to-deposit ratio that declined from 50 percent in 2011 to reach 46 percent in January 2014. Moreover, there is lack of term funding, which especially hampers sectors that are the main creators of jobs, such as manufacturing.

Although sectoral analysis shows that there is no liquidity crisis in the banking sector, MSEs have limited access to finance. Financial intermediation has been low, as evident in the loans-to-deposit ratio that declined from 50 percent in 2011 to reach 46 percent in January 2014. Moreover, there is lack of term funding, which especially hampers sectors that are the main creators of jobs, such as manufacturing. This is compounded by the increase in the banking sector's risk aversion, as evidenced in the decline of private sector credit-to-GDP from 36.1 percent in June 2009 to 27.5 percent in January 2014. MSEs suffer disproportionately from low financial intermediation, and are offered limited financial products. A recent Investment Climate Rapid Assessment Survey (2012) reveals that only 11 percent of micro enterprises and 17.4 percent of small enterprises have bank loans, as opposed to 38.2 percent of large enterprises (Figure 3), of these surveyed firms, more than 70 percent raise concerns regarding the surge in the cost of finance post revolution. As a result, they often resort to alternative sources of finance, relying on personal savings (79 percent) or inheritance (15 percent) to raise capital, while only four percent access the formal market.

DEVELOPMENTS AND CHALLENGES IN THE BANKING SECTOR

An additional macro-financial issue of concern is the potential “crowding-out” of credit to the private sector by government borrowing. The crowding-out, accompanied with weak appetite for borrowing given the overall uncertain economic environment and the security situation, led to a decline in the credit to the private sector to 37 percent in June 2013, from 50.7 percent in January 2011.

The CBE closely monitored and supervised all banks to ensure that any financial weaknesses are addressed in a timely manner, and undertook regular stress testing. The loan quality and profitability indicators was expected to be affected by the slowdown in economic growth, capital outflows, and a rise in interest rates associated with the political uncertainty. An increase in NPLs in the banking system is a likely result of the contraction in economic activities and the turmoil following the revolution. A key sector that has been significantly affected is tourism, while construction, mining, and manufacturing have also suffered. Yet actual indicators prove the exact opposite as a clear decline in NPLs ratio from approximately 10% in 2012 to 9.1 in 2013 due to write offs conducted by banks under their normal course of action. Consequently, the recent bank performance indicators that show little change in the loan portfolio quality or profitability indicators, almost three years after the shock.

However, this light, it is crucial to ensure that an adequate macro-prudential regulatory framework is in place. In particular, bank regulators may need to account for bank ownership structure in developing an early warning system that would alert them about potential problems in the banking industry. Most important is to adopt a financial inclusion strategy, which would promote access to finance, especially to previously marginalized segments of the society. Central Bank of Egypt understands the positive effect of financial inclusion and its importance

The CBE closely monitored and supervised all banks to ensure that any financial weaknesses are addressed in a timely manner, and undertook regular stress testing.

More generally, the lack of certainty regarding future government policy, combined with ambiguity about government commitment, can adversely affect the situation.

on financial and economic stability, and banking sector soundness. Efforts are exerted to understand the major concerns and problems that hinder financial inclusion. Accordingly financial inclusion takes a high priority on the CBE's top management's agenda in order to take all the necessary actions to increase financial inclusion levels specially related to SMEs finance.

DEVELOPMENT OF THE NON-BANK FINANCIAL SECTOR

Non-bank financial sector reforms have been slow to be implemented due to a variety of reasons. The move to a full-risk based supervisory approach at Egyptian Financial Supervisory Authority (EFSA) has been disrupted. The management that followed has been overwhelmed by the volume of complaints and accusations related to the insider trading, minority shareholders' rights, and lax enforcement of regulations. This has contributed at that time to the delays in non-bank financial institutions (NBFI) reforms. However, in August 2013 a new Chairman has been appointed, the third since EFSA inception, together with a newly appointed board an aggressive regulatory reform program has been adopted, culminating in significant changes to numerous laws, executive regulations and decrees, at an unprecedented pace.

Equity Market. On the non-bank front, and in specific for the capital markets, the authorities established two funds (i) Investor Protection Fund, which insures investors against any illegal activity by brokerage companies such as fraud, trading without investors consent; however, it does not cover any losses arising from normal trading activities; and (ii) the Settlement Guarantee Fund that ensures the timely settlement for any transaction conducted through the Egyptian Exchange (EGX) in case any party defaulted on the transaction. This ensured less defaults for any stock market transaction and timely settlement of all transactions however, neither greater financial system credit to

investment in the private sector nor greater access to finance occurred.

Major challenges confronting Egypt in further developing its equity market include the absence of a sufficient supply of tradable securities as well as the marginal role played by institutional investors. Although mutual funds in Egypt have grown considerably in the past decade, from 22 funds with LE 3.9 billion under management in 2001 to 91 funds with LE 66 billion under management in February 2014, these funds are not significant investors in equities. Over 90 percent of all mutual fund assets are invested in short-term debt or finance instruments. Growth has been concentrated in money market mutual funds (MMMF), as opposed to equity that did not grow in terms of assets under management relative to MMMF.

In that regard, it is critical to expand the supply of shares listed on the EGX. This could be accomplished through the government listing a portion of its asset holdings, increasing the number of shares of government entities already listed and increasing the free float threshold for existing and prospective listed companies. In order to increase the role played by institutional investors; the respective oversight authorities should review their asset allocation guidelines to enable entities such as insurance companies and pension funds to invest a portion of their assets in equities; and finally, perform a comprehensive analysis of the adverse impact on market liquidity and efficiency that has resulted from certain regulatory requirements that are intended to mitigate market volatility. A few of these requirements include, limitations on intra-day and margin trading, a prohibition on short selling, a statutory prohibition on brokers engaging in proprietary trading, and price limits and trading halts. It is worth noting that it was announced that effective end of July 2014, such precautionary measures will be removed.

The few months leading the mid 2014 witnessed EFSA's issuance of new listing rules, and overhauled executive regulation of the

Major challenges confronting Egypt in further developing its equity market include the absence of a sufficient supply of tradable securities as well as the marginal role played by institutional investors.

Significant achievements were achieved in government debt markets while the non-government segment remained relatively nascent.

Capital Markets law, introduction of exchange traded funds (ETFs) in addition to a new real estate investment funds regime.

Fixed Income Market. Despite progress made in the government debt markets, the non-government segment remained relatively nascent. By December 2010, the government yield curve had been lengthened to 7-years, rollover risk had been significantly reduced and secondary market trading in the government bond market was gradually developing. This was additionally supported by plans to upgrade and harmonize the existing segmentation of the clearing and settlement platforms between T-bills at the CBE and T-bonds at Misr for Central Clearing, Depository and Registry (MCDR).

Although certain regulatory hurdles could be improved, limited market development has been caused by two structural bottlenecks: the dominance of banks as the main funding source at relatively low rates because of excess liquidity, and the need to consolidate government bond markets as a price reference in the long end of the yield curve. To address these challenges, a prioritized set of key recommendations, include: (i) increasing the efficiency and liquidity of the money markets; (ii) resuming the pre-revolution program to consolidate the government bond's yield curve, which will involve efforts in the primary market and the secondary market (eliminate de facto primary dealer (PD) monopoly, introduce an electronic trading platform, create a securities lending facility and impose and enforce quoting obligations on PDs); and (iii) establishing corporate bond market development as a priority.

In this regard, a steering committee comprising relevant government agencies in close consultation with market stakeholders should be established. The focus of this committee should include, upgrading primary market rules along with developing a hybrid market model aimed at non-bank institutions, moving from a merit to disclosure based primary market regime, and explore available options to facilitate access by

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small companies; fourth, create a rationalized CSD mechanism for both government and non-government fixed income securities.

Insurance and Pensions. Although the Egyptian insurance sector was opened to foreign competition in 1998, it did not include the necessary supervisory capacity building; development of the necessary supporting infrastructure; and the installation of management in the state owned insurers capable of operating in a competitive market place. The main emphasis in the first generation reforms adopted in 2004. Hence, carried out between 2004 and 2008, was mainly to restructure the state owned insurance sector and build supervisory capacity. This period witnessed the mandatory split of life and non life insurance, additionally in early 2014 EFSA allowed insurance companies to contract asset managers to manage their funds. This move aimed at allowing insurance companies to benefit from professional money management capabilities. Additionally, EFSA authorized marketing of insurance policies via post office branches along the same line as bankassurance. New rules for insurance brokers have also been adopted by EFSA.

The private supplementary pension sector continues to experience unprofessional management and a number of plans that are heavily underfunded. Actions taken to date have been largely of a diagnostic nature, although a draft law has been produced to enable the supervisory entity to effectively do its job and to require the appointment of professional fund managers. To address these challenges, a prioritized set of key recommendations include: setting up of a central database to collect Motor Third Party Liability (MPTL) exposure and claims, passage of the Private Pension Law to strengthen EFSA's ability to supervise private pension funds, ensure properness of the fund management, upgrade EFSA's enforcement capacity to risk rate insurers and private pension funds to take appropriate enforcement action.

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To help improve access to formal home ownership by low and middle income households, the government has in the past provided a range of subsidies, through a plethora of special programs.

There are a number of reasons underlying the Egyptian mortgage market's relative underdevelopment. The cumbersome property registration process remains the fundamental obstacle.

Mortgage Market. Creating a vibrant mortgage lending market was one of the authorities' key priorities over the past decade. The government introduced a number of reforms, including setting the legal and regulatory framework, the establishment of a mortgage liquidity facility, the setting up of a fund to support low and middle-income housing, and streamlining property registration through a nationwide mapping and titling program. These building blocks have helped in gradually developing the mortgage sector in Egypt. Despite the increase in the number of mortgage finance companies, they still account for a small share of lending due to inadequate availability of long-term funds and delays in registering property titles in the new urban communities.

To help improve access to formal home ownership by low and middle income households, the government has in the past provided a range of subsidies, through a plethora of special programs. Many of these public housing schemes continue to involve large government subsidies. The Affordable Housing Program was launched in 2010, which aimed at expanding the residential mortgage market and increasing access to mortgage loans for low and middle-income households in order to improve housing affordability. This program that aimed at improving the targeting and efficiency of subsidies by linking subsidies to affordable mortgage loans.

In February 2014 the Central Bank of Egypt announced a mortgage loan initiative for low and middle income earners by allocating 10 billion Egyptian pounds to banks over a period of 20 years at low price to be lent to low income earners at 7% and to middle income earners at 8%. The initiative should play an important role in boosting the construction and real estate sectors as well as availing housing units at affordable prices .CBE has announced this initiative under its corporate social responsibility role.

The mortgage market remains relatively underdevelopment, mainly due to the

cumbersome property registration process delaying of the execution of a secured lending system based on property. The installment loan system provided by real estate developers also poses many problems for lenders as well as for the mortgage market acting as an incentive to delay the subdivision of their plots into individual titles thereby making mortgages impossible to secure until the whole development is complete. Moreover, funding mortgages is constrained by EMRC's inability to create a bridge between the capital markets and the housing market. The cost of funds for mortgage finance companies and banks is a serious flaw that exists in the Egyptian deposit market with deposits being largely price inelastic, making it difficult for EMRC or indeed other capital market funding mechanisms to compete with much less expensive deposit based funding.

Strategic interventions to support an efficient, robust and better equipped mortgage market entail the authorities to review developers financing and regulation of developer installment loans with the aim of creating a safer and more sustainable system; develop regulatory measures to better monitor maturity mismatch risks to curb the strong reliance on the deposit base for long term lending, and reduce systemic risks in the market. A key reform is to improve property registration, and a move towards 'general boundary' principles, which would yield efficiency improvements and a much more rapid roll-out of the systematic registration program. Most importantly is to expand and progress the Affordable Housing Program that would yield major social benefits, as well as economic benefits through job creation.

Financial Leasing. Despite the financial leasing industry's relative cumulative growth and the favorable developments in the market since the issuance of Law 95 of 1995, leasing remains relatively small and underutilized in Egypt. There are several constraints facing the leasing industry that have inhibited its growth and ability to achieve its full potential.

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In order for Islamic finance to further grow in Egypt, special laws for the introduction and practice of Islamic banking must be put in place.

The most important inhibiting factors include: (i) the scarcity of long-term funding; (ii) the difficulty of repossessing assets associated with the inadequate enforcement of ownership rights and the delays in the collection of overdue payments; (iii) legal obstacles that create unfair disadvantages to leasing and create unnecessary barriers to the expansion of the sector; (iv) the need for a sounder institutional environment to operate within, particularly through the establishment and development of more effective registry procedures; and (v) the lack of understanding of the sector and the limited information and data available on it.

In order for the leasing industry to reach its potential and develop further, a number of short-term measures need to be considered. First, the definition of leasing in Law 95 of 1995 must be modified to contain a clearer, more precise definition that differentiates this transaction from others including property hire or rent to prevent abuses of tax benefits and double taxation. It would also be of great benefit to amend the law to allow for leasing for non-commercial purposes. Furthermore, it is vitally important for the industry that the private credit bureau moves forward with the establishment of its moveable assets registry. In the long-term, there is a need to secure long term funding needed to grow exponentially. The bond and asset-backed securities markets need to be further developed in order to extend the average maturity of leasing contracts and better serve potential and existing clients. Furthermore, a stronger judicial system, which is able to enforce foreclosures and ensure the efficient and effective repossession of assets in case of default, is also key to developing a more supportive regulatory environment for leasing.

Islamic Finance. Egypt has, marginally, due to the minor size of Islamic banks and its operations compared to the whole sector, been involved in the recent expansion of Islamic finance.. Egypt is ranked the fourteenth in terms of countries with Shar'ia compliant financial

assets, for an equivalent to US\$7.9 billion, accounting for less than one percent (0.7 percent) of total global Islamic finance assets, which is very small. Banks are the main source of Islamic finance in Egypt.

In order for Islamic finance to further grow in Egypt, special laws for the introduction and practice of Islamic banking (Islamic Banking) must be put in place. Such laws would facilitate the operation of Islamic Banking side by side with conventional banks. There needs to be an adequate supply of qualified staff for the continuing expansion of the Islamic banking industry and for proper risk management. Improving risk management is very important as Islamic products are becoming more complex and sophisticated with financial innovation. Given the specific nature of risk, Islamic banks need a specific risk management approach. Reserve requirements in this case should be relatively higher to cater to the potential significant default risk as well as to prevent depositors' losses in case of poor performance and rapid capital outflows.

FINANCIAL SECTOR INTEGRITY AND ECONOMIC GROWTH

Banking Supervision. A thorough reform of the regulatory and supervisory framework was an integral part of the reform program, as a result of which the banking sector has emerged as more efficient and transparent, financially sounder, and better equipped to manage the risks inherent to its activities. Enhanced access to finance necessitates that banks be able and willing to "move up the ladder" in terms of individual risk-taking, and risk-based supervision is accompanying this development of financial intermediation. With regard to the issue of diversification in bank lending, limits to bank exposures to a single client and its related parties, and to the parties related to the bank itself already encourage competition and diversification in bank lending. There is also a need to establish a stronger linkage

Enhanced access to finance necessitates that banks be able and willing to "move up the ladder" in terms of individual risk-taking, and risk-based supervision must accompany this development of financial intermediation.

In regards to facilitating SME financing, there is strong evidence that the development of SME financing has been hampered by the existence of a large informal sector where companies operate without proper documentation for tax evasion purposes and thus are not bankable.

between management of these exposures and progress with access to finance. For instance, approval of new branches could, in part, depend on the bank's performance regarding large exposures. CBE is already giving the priority to the approvals on opening branches in remote areas outside greater Cairo and Alexandria, accordingly to CBE existing regulations on opening branches. Furthermore, the system of loan classification, collateral, and provisioning must be reviewed from the perspective of access to finance given that it affects banks' credit decisions. Specifically, greater flexibility in the collateral regime is needed to facilitate access to finance. This would apply to SMEs, in particular. In regards to facilitating SME financing, there is strong evidence that the development of SME financing has been hampered by the existence of a large informal sector where companies operate without proper documentation for tax evasion purposes and thus are not bankable. Moreover, Banks are from a corporate mindset and need to shift to the SMEs financer requirements relating to credit origination, follow up, and monitoring of a such sector.

Although, CBE requires banks to create SMEs unit in each bank, and SME's portfolio has increased since the exemption reserve requirements on SMEs portfolio. Three overarching factors must be examined: first, the broad regulatory infrastructure must be conducive to SME lending. This calls for minimum accounting standards manageable for SMEs, credit bureaus specializing in SME assessment, efficient legal enforcement of creditor and borrower rights in the case of transactions with SMEs, and specialized SME credit rating agencies; second, prudential regulations cannot, even unintentionally, be biased against the smaller enterprises. This calls for the banks to be allowed to take on exposures to SMEs based on a much broader choice of possible collaterals. As already mentioned, this would require a new legal framework for movable collateral, supported by a centralized registry for all types

of collateral; and third, the banks must be provided an appropriate incentive structure that encourages them to move into higher reward/risk lending opportunities. This can only be achieved through greater competition, based on market-oriented corporate governance.

FINANCIAL INSTITUTIONAL INFRASTRUCTURE

Financial Market Infrastructure.

With regard to well designed and enforceable secured transaction rules, there are many weaknesses in the legal framework and its enforcement, such as the lack of real estate title registration. These weaknesses are entrenched and long standing, and call for greater flexibility and novel approaches, such as a "register-able" property mortgage finance based on an "interim" real estate title registration, which could form the base for mortgage collateral and its registry. Another significant gap with secured transactions, which need to be addressed, is the lack of a legal and regulatory framework for the use and registration of a broad range of movable property collateral. Furthermore, the existing bankruptcy procedures continue to focus exclusively on liquidation, and need amending.

Egypt has made significant advances in the availability of reliable credit information, a key requirement for soundness and facilitating greater access to finance, but more can be done. The obligation to obtain an I-Score report before a bank can extend credit should be applied in other financial institutions as well. Furthermore, one priority should be to ensure that the fees of the credit bureau do not discourage microfinance institutions from becoming members of I-Score and using its credit information, and some form of fee subsidy could be considered. Two priorities would be the creation of a central registry for both immovable and movable collateral along with the creation of a SME rating agency, with possible government support to mitigate the deterrent effect of rating fees.

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Understanding the shortcomings of the status quo including pre January 2011 reforms in Egypt is key to approaching reform.

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Greater conformity between CBE and EGX governance and disclosure requirements, through further strengthening of CBE requirements, should encourage banks to list.

Entry and exit rules that promote greater competition should incentivize the banks to broaden their lending activities. In this regard, the conditions for approval of new branches gives greater weight to the prospects for increasing access to finance in the location being considered, by making the local density of SMEs an important variable in the decision, and giving priority of branches approval to remote location outside the greater Cairo and Alexandria. Going forward, ending the moratorium on new banks and promoting the market-oriented behavior of state-owned banks, are priorities, as is the introduction of a full-fledged banking resolution regime. A uniform, limited, and funded deposit insurance scheme would not work due to negative religious connotation.

Legal Framework. Understanding the shortcomings of the status quo including pre January 2011 reforms in Egypt is key to approaching reform. The prevailing legal framework constrains the cost and terms of finance. Some laws are poorly written, especially those regarding secured transactions, bankruptcy, and settlement of disputes. Moreover, the court system, though well reputed for its impartiality and independence, suffers from several drawbacks that keep it from helping expedite debt collection and resolve other financial disputes. The introduction of Specialized Economic Courts in 2008 did not result in having specialized courts for financial institutions or specialized judges with adequate knowledge of financial market risks. There is difficulty in discussing specific reform concepts in the absence of well-articulated and comprehensive policy objectives to be made by the new government. Yet it is important for policy makers to appreciate that fundamental changes are needed. This is far from straightforward and is not risk free. These changes relate to reforming the law on secured transactions, bankruptcy law and the functioning of the court system. Such changes should aim at reforming the laws, regulations and procedures governing each matter and not an element thereof. International

experience offers several models and policy choices for consideration by Egyptian policy makers.

Collateral legislation is poorly enforced. Property rights registration and titling issues make it difficult for firms, especially SMEs, to use land assets as collateral. Even when collateral is registered, there is no information on its value. This inadequate legal and judicial system has resulted in uncertainty and high cost, making banks reluctant to lend or instead opt to over collateralize their lending. Shortcomings in rules for secured transactions have hindered access to finance. Egyptian law recognizes three major forms of security, mortgage, pledge, and business charge, all of which are governed by rules that have shown various shortcomings in actual practice.

Governance and Transparency. With respect to reliable financial reporting and auditing, there is a need to include in the banks' quarterly reporting requirements information on the structure and concentration of the banks' shareholders, and on the loan concentrations reflecting the largest borrowers, given the relevance of this information to the incentives for enhancing access to finance. Furthermore, with the increased significance of brokerage, mortgage finance, and financial leasing subsidiaries and affiliates, banks are required to quarterly reporting of their consolidated operations as well.

There is a requirement to have separate risk management and audit committees. Greater conformity between CBE and EGX governance disclosure requirements should encourage banks to list. In addition, the Central Bank of Egypt should develop incentives that encourage banks to seek an international credit rating, for instance by making it a condition for banks to undertake certain types of borrowing.

MACROECONOMIC AND FINANCIAL STABILITY

The main challenge for policymakers in Egypt is to design a framework that ensures the continued independence of the CBE. This implies

The Central Bank of Egypt should develop incentives that encourage banks to seek an international credit rating, for instance by making it a condition for banks to undertake certain types of borrowing.

Policy actions for further reform should begin with improving macroeconomic stability—a necessary but not sufficient action for financial deepening, increased credit to the private sector, and increased access to finance.

the importance of better coordination between fiscal and monetary policy to anchor expectations. This independence is needed to ensure the ability to influence inflation expectations and maintain them within the inflation target range.

Policy actions for further reform should begin with improving macroeconomic stability—a necessary but not sufficient action for financial deepening, increased credit to the private sector, and increased access to finance. Other possible actions include further reductions in the risks of a systemic financial crisis and increased market discipline, by continuing to improve financial supervision and the early warning of financial indicators, and by establishing a legal framework for intervention if need be.

This will lead to, greater intermediation of funds to the private sector, more inclusion, and more financial services to the public at lower cost. Other possible actions would increase competition in the financial sector and improve access to credit—these include providing a legal basis through a new law for micro-credit financial institutions and extending the coverage of I-Score to small borrowers. This will also entail having a more transparent policy for entry of “fit and proper” banks, easing restrictions on bank branching, increasing the use of the networks of the Post Office, and encouraging greater use of the existing licenses for mobile banking.

In conclusion, the Egyptian revolution has resulted in many positive outcomes, one of which is the desire and power to change and reform institutions. There is a momentum for reform and an appetite for change; it is crucial to tap on this opportunity at such a critical transition time. Enhancing the policy dialogue and consultations with all stakeholders, including civil society, government officials, Parliamentarians, political forces, academia, private sector, donors, and development partners will ensure the continuity of reforms.

There is a momentum for reform and an appetite for change; it is crucial to tap on this opportunity at such a critical transition time.

1. OVERVIEW OF THE FINANCIAL SECTOR

The Egyptian economy continues to be adversely affected by the ongoing political unrest. Economic activity started to pick up in the second half of FY14, as the government accelerated its stimulus spending, but growth is still feeble at 2.2 percent in 2014 (well below potential), similar to growth rates realized in the previous two years. The sluggish growth reflects mainly contraction in the petroleum and tourism sectors. On the demand side, net exports remain a drag on growth whereas real investment started to recover meagerly towards the end of the year with accelerated disbursement of the stimulus package and adopted accommodative policies backed partially by the Gulf aid packages. In addition, the Gulf States –Saudi Arabia, United Arab Emirates and Kuwait– pledged around US\$24 billion in financial aid to Egypt since July 2013, of which around US\$17-18 billion has already been received in 2014.

The revolution, and its associated risks, had various negative implications on the financial sector. The widening fiscal deficit has led to the crowding out of private sector credit. Banks have opted for purchasing less risky, high-yield Government bonds and Treasury bills that represent 41 percent of the banking system assets, accounting for 58 percent of GDP, leaving very little loanable funds available. All this has contributed to an increase in unemployment and poverty rates. Unemployment is on the rise, reaching 13.3 percent in Q2 2014, up from 8.9 percent in Q4 2010. The poverty rate also increased to 26.3 percent in June 2013 up from 25 percent in June 2011 and 21.6 percent in June 2009. Not only has economic growth been well below its potential, it has failed to create sufficient job opportunities. Moreover, growth

benefits have not been inclusive, creating grievances and unrest among many segments of society. Given such environment, governance and transparency remain pressing issues. According to the World Bank Worldwide Governance Indicators, weak governance, privileged lending, lack of a level playing field, weak regulatory framework and unequal access to markets have contributed to limited economic opportunities, an underdeveloped private sector, and have ultimately hindered job creation.

Moreover, Phase II of the Financial Sector Reform Program (2009–2012) that aimed at improving the soundness and stability of the financial sector was interrupted. In addition to the urgency of cash availability at banks throughout the governorates and villages following the closure, the CBE had to respond to critical matters, such as capital outflows, international reserves, foreign exchange, the inflation rate, and overall macroeconomic policies. Given the prolonged political transition, and certain policy inflexibility on both the fiscal and monetary sides, uncertainty prevailed and capital outflows persisted. By February 2013, international reserves had fallen to US\$ 13.5 billion, covering less than 3 months of imports before picking up again to reach around US\$ 17 billion as of end September 2014 thanks to the exceptional capital flows with a magnitude of more than US\$ 18 billion from the United Arab Emirates (UAE) Saudi Arabia and Kuwait so far.

On the non-bank front, EGX ceased trading since the end of January 2011 to the end of March 2011. Egyptian Financial Supervisory Authority (EFSA) and EGX resorted to unprecedented measures to curb stock price volatility. They implemented measures such as narrowing circuit breakers that halt stock trading for a period of 30 minutes from ±10 percent to ±5 percent. Furthermore, price limits were narrowed from ±20 percent to ±10 percent. Trading hours were reduced to three hours during the curfew before resuming the normal trading hours (four hours). Additionally, arbitrage opportunities for stocks traded via GDRs on international stock markets and on EGX were limited down significantly to control any suspicious capital outflows. Additionally, EFSA allowed mutual funds to amend their redemption policies and timing as deemed needed by them. These were among the many measures the authorities had taken to address the risk associated with the January 25th revolution.

FINANCIAL DEVELOPMENT AND INCLUSIVE GROWTH

The Financial Sector Landscape Immediately Preceding Phase I (2004–2008) of Reforms

The elements of the financial sector landscape immediately preceding the reform program in 2004 were as follows: a banking system that is lacking competition and not adequately capitalized, a sizable stock exchange, and a relatively small insurance, mutual fund and contractual savings sector. Ancillary financial firms such as stock brokerages, specialized non-depository lenders (including leasing companies and microfinance lenders) and rating

agencies were present, but remained rather undeveloped. The banking sector dominated the overall financial system in 2003, as banks accounted for 130 percent of GDP and 95 percent of financial sector assets.

The banking sector has historically dominated Egypt's financial system. In its present form, the Egyptian banking system represents a product of multiple transformations that occurred over roughly the past two decades. This is reflected in the transition from a banking system, largely dominated by foreign banks, to a system that is predominantly Egyptian and dominated by state-owned banks. The 1970s witnessed the beginning of a new era of liberalization where banking sector activities were opened to private capital, both foreign and domestic. This move towards greater financial system liberalization and enhancement of its overall competitiveness was accelerated in large part by the launch of the Economic Reform and Structural Adjustment Program (ERSAP) in 1991, of which one very important component was financial liberalization. This was followed by a period of very limited reforms until 2004 when a comprehensive financial sector reform program was launched, aimed at enhancing the soundness and stability of the financial sector.

At the start of the reform program in 2004, the banking system had 57 banks, of which seven were state-owned, namely, the four largest commercial banks—National Bank of Egypt (NBE), Banque Misr, Banque du Caire, and Bank of Alexandria; and three specialized banks—Egyptian Arab Land Bank (EALB), Industrial Development Bank of Egypt (IDB), and Principal Bank for Development & Agricultural Credit (PBDAC). In addition, the state also owned substantial shares in 23 joint-venture banks that accounted for around 20 percent of the system's deposits and assets.

Although the banking sector assets and deposits were large, large public sector deficits and debt, pervasive state ownership of financial institutions, heavy intervention in money markets, weak creditor rights, and a compliance-based regulatory and supervisory framework resulted in relatively low and unproductive credit, negligible competition and innovation, and the emergence of a large stock of NPLs, mainly in the state-owned banks.

Prior to the 2004 reforms, specialized banks operated in an ambiguous policy framework—financial institutions versus development agencies. Three specialized banks accounted for about six percent of Egypt's bank deposits and about 45 percent of Egypt's branch network (with PBDAC accounting for almost all of these). These specialized banks were used to channel subsidies to agriculture, housing (to both developers and households), and small and medium enterprises (SMEs), through both ceilings on interest rates and non-recovery of principal.¹ All three specialized banks were significantly overstaffed, even when taking into account the small size of its individual deposits and loans. In addition to its banking activities, PBDAC was an implementing agency for the import, distribution and marketing of products, and crop purchases for the Ministry of Agriculture. However, the issuance of 'Central Bank, Banking System and Money Law 88 of 2003' set the foundation

for the ambitious reforms. The law introduced several critical improvements, including complete independence of the CBE, stronger prudential regulations and enforcement powers, higher minimum capital requirements, and principles for loan settlements and workouts. It also discontinued the special treatment of state-owned banks to enhance competition, and asserted the right of private sector parties to own shares in state-owned banks. Nonetheless, these measures were insufficient to address the effects of pervasive state ownership and the ineffectiveness of the financial markets.

The non-bank financial sector in Egypt was characterized by underdeveloped bond, insurance, and mortgage markets, thin trading in equities, weak corporate governance, and poor financial infrastructure. Egypt's financial system was, and still is, mainly bank-based, with banks constituting over 95 percent of the financial system's assets—accordingly the contribution to growth by the non-bank sector has to date been minimal. Overall, Egypt's non-bank financial sector was very small and underdeveloped before the launch of the program.

Capital markets in Egypt were thin prior to the launch of the reforms in 2004. Of the 1,000 companies listed on the stock exchange approximately half did not trade, market capitalization amounted to only 35 percent of GDP, and the turnover ratio was extremely low at 10 percent. The share of government debt issued at market prices and traded was very small. The average maturity of traded government debt was very short (180 days or less) and the long-term government bond market was very small and illiquid. Private fixed-income instruments were negligible. The development of capital markets in Egypt remained below potential, especially in terms of primary markets. While the secondary capital markets were active, new capital market issuance—both bond and equity—have been very limited. Little external financing has been made available from either the equity or bond markets and to the extent there is such financing, it goes to the largest firms. The bond market in Egypt is poorly developed, with few outstanding bonds, very limited new issuance, and low levels of trading.

The equity market as a source of investment financing is limited in Egypt. There have been only a few corporate-bond and public-equity offerings in recent years. The total value per year of new issuances in Egypt averaged 1.2 percent of GDP between 2001 and 2004, compared to 6.0 percent and 13.6 percent for Chile and Korea respectively. The primary market is much smaller than those of high-performing emerging markets such as, Malaysia, and Taiwan, and even below what would be expected based on Egypt's income level. While there have been more equity issues than corporate bonds, many were public offerings or sales of government shares in large state-owned companies, which do not add to capital formation. Funds raised through corporate bonds were even less than those raised through equity financing. The corporate bond market is nascent and largely dominated by commercial banks. There were no bond issuances in 2003, and three bond issuances in 2004. Access to international capital markets is limited to financial firms and

large enterprises. The low activity of the primary market contrasts with a relatively active secondary equity market. Due to fast-rising stock prices and despite continued delisting of illiquid stocks, market capitalization to GDP was 87 percent at the end of 2004.

The insurance sector's assets accounted for less than three percent of GDP in 2004. Although the sector was opened to foreign competition in 1998, the absence of appropriate regulation, the necessary capacity building and the presence of a dysfunctional state-owned insurance sector, these reforms yielded limited benefits. The private pension sector was also small, with assets of less than three percent of GDP. Private pension funds were mainly voluntary occupational schemes primarily covering public sector workers and operating on a defined benefit (DB) basis with weak governance, regulation and supervision. The insurance and contractual savings sector is small when compared to the size of the economy. Although penetration has been higher than in other countries of the region, insurance and pension products have yet to gain broad public appeal. Only a small percentage of the working population participated in retirement plans. Furthermore, the sector had not yet effectively channeled resources to the private sector.

The insurance sector was largely state-owned prior to 2004, with the four largest insurers (including one reinsurance company) majority state-owned and accounting for approximately 70 percent of total premiums. The new foreign entrants in the insurance sector (particularly life insurers) grew faster than both domestic insurers and voluntary pension funds. However, while foreign life insurers have been able to make inroads, the largest domestic insurers seem determined to maintain their share of the market. The non-life sector was hardly developing at all, and non-life reserves were not a significant source of incremental long-term funds. The success of the new foreign entrants to the insurance sector reflected product innovation, mainly in investment-linked life products (often denominated in hard currencies), and efficient distribution (bancassurance). It is clear that the major institutional investors were keen on expanding the universe of investment opportunities; however, they were confronted with various regulatory and institutional constraints.

Mortgage finance. Prior to 2001, mortgage market developments and access to mortgage loans in Egypt were in general, severely impeded by the lack of a conducive legal regulatory and institutional framework, inadequate access to long-term funding, cumbersome property registration procedures, lax collateral enforcement and cumbersome foreclosure procedures. The banking sector over the past decade has offered little formal mortgage finance to households. Some developers have been providing term financing under deferred installment sales contracts, but these have not offered secure nor favorable conditions for borrowers. In 2001, the Real Estate Finance Law, Law 148 of 2001, was issued, setting the legal and regulatory framework for a mortgage market in Egypt. In February 2014 the Central Bank of Egypt announced a mortgage loan initiative for low and middle income earners by allocating 10 billion Egyptian pounds to banks

over a period of 20 years at low prices to be relent to low income earners at 7% and to middle income earners at 8%. The initiative should play an important role in boosting the construction and real estate sectors as well as availing housing units at affordable prices .CBE has announced this initiative under its corporate social responsibility role.

Moreover, housing affordability has not improved because loan maturities were too short and there was a lack of long-term financing. Until 2001, only some individuals buying houses in Egypt were able to obtain financing, and this would not be in the form of mortgage loans. The most common finance arrangement was the deferred-installment system, by which the developer sells a house and is paid by a down payment of around 10 to 25 percent of the purchase price, followed by installments over a period ranging from four to eight years. The title is formally transferred when the last installment is paid. Under this system, the purchaser pays a significantly higher rate of interest and higher repayments than if they could have secured a loan on the property. The system also ties up the funds of developers, who would rather invest in new projects, and can be constrained by an adverse cycle of real estate markets. In general, the system prevents many from entering the housing market, and only represents a second best to a genuine residential mortgage market.

Mortgage finance has also been constrained by poor and cumbersome property registration procedures. Limited titles have been registered in the past, mainly due to a costly and time-consuming registration process. Inadequate collateral enforcement and cumbersome foreclosure procedures is another key challenge. The repossession of real estate (notably through eviction) in the case of a borrower's default was a difficult if not impossible challenge (unsecured lending). Although some of these problems have largely been addressed through the enactment of the Real Estate Finance Law 148 of 2001, the effectiveness of enforcement remained untested, as lenders were to pursue their legal remedies until there was greater certainty that collateral could be recovered through the judicial system.

Regulatory setup. Prior to Phase I (2004–2008) of the Financial Sector Reform Program, regulators governing the NBFIs were scattered between the different line ministries. The Capital Market Authority (CMA) line ministry was the Ministry of Foreign Trade; the Egyptian Insurance Supervisory Authority (EISA) line ministry was the Ministry of Planning; the Mortgage Finance Authority (MFA) line ministry was the Ministry of Housing and Urban Development; and the other non-bank financial activities, such as financial leasing and factoring were regulated by the General Authority for Free Zones and Investment (GAFI). The consolidation of the regulatory setup was taken on two phases. Phase one was to combine all these regulatory bodies under one line ministry, namely the Ministry of Investment, to ensure the speed and ease of communication and coordination amongst these regulatory bodies from the one hand, and the consistency of reforms and policies to be adopted between the different sectors on the other hand. The second step of setting up the regulatory framework was to merge

all the non-bank regulatory institutions and spinning off the functions of financial leasing and factoring from GAFI and create the Egyptian Financial Supervisory Authority (EFSA) and per Law 10 of 2009 governing the non-bank financial markets and institutions.

The legal and information infrastructure for the financial system was deficient. The credit information systems were very poor. There was only the public credit registry at the central bank, which did not have accurate or timely data on the clients' credit worthiness, and the threshold was (LE 50,000–) The legal framework did not allow for the establishment of a private credit bureau, and the related credit information was restricted to banks only. NBFIs did not share, nor did they have access to clients' creditworthiness information located at the Credit Registry Department at the CBE. Overall, there was lack of transparency in corporate accounting and auditing standards.

Box 1.1: The Role of State-owned Banks and Government Intervention in Credit Allocation

Abundant evidence warns against financial regulatory strategies that give official agencies excessive power over the allocation of capital even when the alleged goals of these powers are to enhance the safety and soundness of credit allocation. For example, there are frequent calls for policies that funnel credit to lower-income households and smaller enterprises in the name of inclusive growth. Again, research indicates that powerful groups often hijack such policies and use them to promote their own interests rather than to expand the economic opportunities of the society as a whole. Whether it is developed or developing economies, state-owned, government-controlled and state-protected banks are associated with slower growth and less rates of economic development. Moreover, these government-influenced banks often lend the bulk of their funds to politically connected firms, not to the poor and economically disenfranchised.

There have been several findings suggesting that the government-owned banks stymie inclusive growth and work to help the politically influential. Cross-country experience has shown that government-owned banks favor firms with politically connected executives, but—and this is a critical distinction—privately owned banks do not; private banks do not lend disproportionately to politically connected firms. Furthermore, private banks lend relatively more to small and medium-sized enterprises than government banks, while government-owned banks lend comparatively more to large firms. Thus, government-owned banks are not expanding access; rather, they are supporting large, politically connected firms. Credit from government controlled banks flows disproportionately to politically important regions. These are regions where there is an election. Officials use the banks to maintain or obtain political power, not to expand access to credit. Analyzing the characteristics of the borrowing firm and the traits of the lender in developed countries, shows that government-owned banks in Italy charge lower interest rates to large firms than their privately owned counterparts, but do not charge lower interest rates to comparable small firms than do private banks. Furthermore, firms pay lower interest rates in localities where the local government-owned bank's chairperson has the same party affiliation as the ruling political party.

Similarly, cross-country comparisons indicate that direct government involvement in credit allocation, either through government-owned banks, directed credit programs, or powerful regulatory guidance on credit allocation, breeds corruption in the lending process and lower quality financial services, and hence curtails inclusive growth. Direct government involvement in the allocation of credit tends to increase the flow of capital to the politically connected, limiting opportunities and retarding economic activity. Dinc (2005) further emphasizes that in several countries, there are cases where politicians use government-owned financial institutions to maintain positions of power by increasing their lending in the lead up to elections. Empirical evidence reveals that government-owned banks increase their lending in election years relative to private banks. Again, government-owned banks are not necessarily used to promote inclusive growth: they are used to ensure that incumbent officials remain in power.

Although there are sound economic theories for government-owned banks, directed credit programs and policies to encourage the flow of credit to particular ends, these programs in practice frequently go awry. For example, governments might have superior information about the social returns related to particular investments and are able to internalize positive social externalities. Thus, government programs could enhance social welfare. Similarly, problems with very high costs of finance, contract enforcement and collateral requirements might prevent capital from flowing to high-return endeavors. Under such conditions, governments can play a catalyzing and signaling role in financial markets. Moreover, private financial institutions might find it more difficult than governments to diversify some risks, suggesting that government credit or guarantees could foster a more efficient allocation of capital, including extending contract maturities. In addition, during financial crises government-owned banks could play an important countercyclical role and help prevent a credit crunch. However, in practice, well-intentioned government interventions are frequently captured by the political and economically powerful and used to increase their slice of the economic pie, not to increase the slice of others or the size of the pie itself.

MAIN COMPONENTS OF THE FINANCIAL SECTOR REFORM PROGRAM

Acknowledging and confronting the challenges in the financial sector, and its potentials, the Governor of CBE, and the Minister of Investment launched in 2004 a far-reaching and comprehensive two-phased financial sector reform program (2004–2012) that was a central component of a broader reform program. Its objective was to foster the emergence of a sound, efficient, and diversified financial system, increasingly private sector-led, that could contribute more effectively to Egypt's growth performance. The reforms that the Egyptian authorities have undertaken over the past years were supported by The World Bank through technical support and advisory services from development partners, including the USAID, EU and African Development Bank (AFDB); based on international best practice.

Phase I (2004–2008) of the Financial Sector Reform Program

The main pillars of the first generation reforms (2004–2008) focused mainly on reforming the banking system, as well as strengthening the supervisory framework; reforming the insurance and pension systems; strengthening the capital markets; and developing the mortgage finance market.

In the banking sector, the reform program aimed at reducing in the state ownership and management of banks, and increasing competition by privatizing one of the four state-owned commercial banks;² divesting state-owned banks' shares in joint-venture banks; and consolidating the system through mergers and acquisitions of small and weak banks,³ by enforcing stricter prudential regulations.⁴ The remaining commercial state-owned banks underwent financial, institutional and operational restructuring. This included the settlement of more than 60 percent of the state-owned enterprises' (SOEs) NPLs in state-owned commercial banks, reaching settlements of 90 percent of private sector NPLs, and recapitalization through retaining capital gains realized on the sale of non-core assets and investments. In parallel, there was an in-depth program of improvement in information technology, risk management, governance, and staff skills. This allowed these banks to operate on a commercially viable basis in increasingly open and competitive markets, without running the risk of incurring new NPLs. The result of these reforms was a substantial strengthening of the balance sheets of these banks, validated by the resiliency of the system throughout the global crisis and an improvement in returns on capital and assets.

Concerning capital markets, deepening and strengthening the efficiency of capital markets was a key objective of the first generation reforms. Reforms since July 2004 included measures to improve liquidity in the equity market,⁵ create a sound basis for securitization, build the institutional investor base through separate reforms of insurance, investment funds and pension funds, and further strengthen the supervisory framework. Other measures included: the introduction of International Financial Reporting Standards (IFRS) for listed firms and securities companies in 2007, as well as international auditing standards (IAS); the issuance of regulations improving capital adequacy and risk management standards for securities firms; approval of an amendment to the Capital Market Law by the Parliament in 2008; simplifying the fragmented EGX listing schedules and abolishing the special treatment of SOEs; and the issuance of a Decree on takeovers and public tender offers. In 2008, a stock exchange for SMEs was established, the NILEX. The securities regulator made gains in terms of building its own capacity to supervise and monitor financial intermediaries and market activity. Regulatory obstacles to the establishment of investment funds were also eased.

The government debt market also developed, as indicated by the increase in tradable debt from 20 to 36 percent of total debt, and the increase in average maturity from 120 days to 2.1 years. The debt management

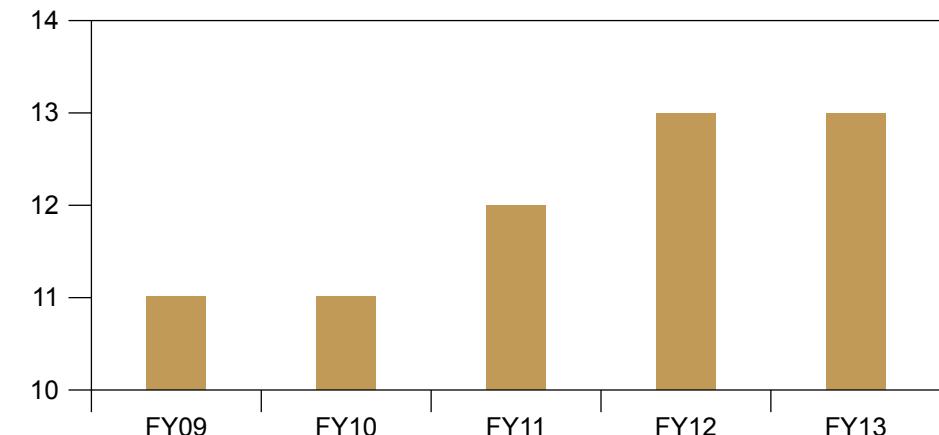
unit created at the Ministry of Finance in 2001 has followed a strategy that entails an increase in the share of tradable debt and increases in debt maturities; it has published an auction calendar and conducted its issues through the PD system introduced in 2001.

In the insurance industry, the main focus of the first generation reforms was rebuilding the balance sheets of the state-owned insurers and restructuring them to achieve operating efficiencies⁶. An Insurance Holding Company (IHC) was created, and the two major direct insurers and the state reinsurer were merged, leaving the smallest direct insurer independent in order to facilitate future specialization into life and non-life. Substantial efficiencies have been achieved, reserves have been significantly strengthened, and a new generation of management introduced. In addition, a strategy to deal with the property portfolio was agreed upon and directed investments were realized or transferred. The state-owned insurers' (SOI) total market share, as measured by gross premium, fell from 83 percent to 53 percent during the restructuring while profits increased in nominal terms by 67 percent, assets under management increased by 64 percent and three new life and two non-life Takaful insurers were registered.

Concomitant with the restructuring, action was taken to staunch huge real losses being incurred in the compulsory Motor Third Party Liability (MTPL) portfolio and to convert the insurance supervisor and industry association from control entities to, respectively, a modern risk based supervisor and a proper industry representative body. The financial performance of the third party motor vehicle market was significantly improved through actuarially determined price increases and claims capping. Other parallel developments included the development of a strategy to build relevant human capital, including in the actuarial profession. Overall market performance was improved through a 50 percent reduction of stamp duty on non-life insurance premiums, an increase in minimum capital levels and the authorization of corporate brokers. Reflecting these policy actions relevant metrics were sustained or improved in the face of high inflation rates, which are inimical to insurance and pension sector development.

On mortgage finance, the government worked on developing an enabling environment for a modern residential mortgage market that will allow most of the burden of housing finance to be shifted away from the government budget and onto the financial markets and the private sector. One of the central goals of the first generation reforms was to create a vibrant mortgage lending market. A number of major reforms have been undertaken to achieve this. The government started to prepare a mortgage law, setting the legal and regulatory framework. The enabling environment also included the policies, institutions and systems necessary to facilitate the emergence of an efficient, low risk residential mortgage finance system in which mortgage lenders compete on a market basis to make mortgage finance available to Egyptian households on economically attractive terms and conditions.

Figure 1.1: Number of Primary Lenders Extending Mortgage Loans



Source: EFSA.

Strengthening the regulatory and supervisory apparatus and the financial infrastructure was a major underpinning of the program. The CBE intensified its strengthening of regulation and supervision substantially under the new Governor. This strengthening included not only higher minimum capital requirements and other measures that led to the consolidation of the banking system into fewer, stronger banks, but also improvements in on-site and off-site supervision, movements toward risk-based supervision, and efforts to improve banks' risk management and governance. Moreover, an intensive program was conducted to upgrade CBE's banking supervision and shift it from compliance to a risk based supervision into heavy technical assistance program conducted to upgrade the staff. Internal restructuring dividing the sector into 7 different department and the set up of 3 new department namely: Regulations department, Macro-prudential department and Basel II implementation department.

Significant improvements also occurred in the institutional framework and financial infrastructure during the financial reform program. The legal framework for a private credit bureau was established. A law was passed for specialized economic courts and a substantial effort was made to train the judges in economic issues. Moreover, the CBE appropriately began its efforts to modernize the payments system with changes in policies, regulations and oversight and improvements in existing arrangements that reduced processing times for payments. The CBE also launched a real time gross settlement payments system (RTGS).

Phase II (2009–2012) of the Financial Sector Reform Program

While the first generation of financial reforms focused on the stability and soundness of the financial system, in January 2009 the government launched Phase II (2009–2012) of the Financial Sector Reform Program that focused more on enhancing access to finance,

the implementation of Basel II and sound governance practices. The objective of this reform program was to build a financial system that is more inclusive, competitive and effective in financial intermediation, with sound banking and NBFIs and that is driven by the private sector. Banking reforms focused on strengthening the regulatory and supervisory framework as well as governance structure. On the non-bank sector, the government's second-generation reforms were designed to create NIFI markets that are diversified and well-balanced, show healthy growth, display resilience when faced with shocks, and facilitate expanded access. This also encompassed continuing some of the reforms initiated during Phase I of reforms, which were not fully completed, such as developing NBFIs.

The third focused on reforming the insurance and pension sectors, and improving the efficiency of the capital market to expand the reach of the non-bank financial sector to remote and underdeveloped areas. The fourth included measures that strengthened the regulatory and supervisory framework for the non-bank financial sector to enable further expansion of access to finance through NBFIs. The fifth comprised measures to improve the financial infrastructure and the legal framework, with the objective of enhancing the financial stability and safety of the payments system, and extending payment access to low income and rural households.

On the banking sector, reform measures that aimed at enhancing the efficiency of state-owned commercial and specialized banks in financial intermediation and widening access to financial services through extensive branch networks. One major component of the second-generation reforms was the continuation of the operational and financial restructuring of the state-owned banks, starting with the commercial state-owned banks (NBE, Banque Misr, and Banque du Caire). The restructuring process began in 2005 and focused on three critical areas: (i) risk management functions, including NPL management; (ii) human resource functions, and alignment of organization and general management functions; and (iii) information technology and management information systems. While this process continued, the second-generation reforms also included setting profitability, efficiency and corporate governance benchmarks by the CBE to be revised quarterly, to assess the three banks' management performance. The second-generation reforms put special emphasis on state-owned specialized banks. The approach to the specialized banks was similar to that for the commercial banks: starting with independent audits.

Strengthening of the regulatory and supervisory framework of the banking sector remained a critical part of the second-generation financial reform program. A credible and independent regulator is the necessary anchor of an effective and resilient financial system that is able to prudently expand access to finance, especially in an environment where Egypt will be more integrated into the global financial system. The global financial crisis demonstrated the need for strong micro and macro prudential

surveillance capacity to preserve the improvements many countries have achieved in access to finance. Within this context and parallel to improving the efficiency of the banking sector through the financial and operational restructuring of state-owned banks, the CBE has been making substantial improvements to micro prudential and macro prudential regulation and supervision to support the stability of the financial system. These efforts focused on three main areas: (i) strengthening the risk-based supervision of banks in implementing the Basel II framework, (ii) enhancing macro prudential analysis by conducting routine stress tests and preparing a Financial Stability Report, and (iii) the implementation of sound governance practices of banks.

Concerning capital markets, the second-generation reforms also focused on developing the markets that contribute to enhancing both access and stability. It aimed at promoting competition among banks, encouraging them to go down market, and making new information and instruments available allowing for further gains in long-term financing. The government was committed to improving the regulatory regime for investment funds and other collective investment schemes (CIS). The reforms also aimed at providing additional protections to investors' investment funds by issuing EFSA Decree 88 of 2009 that required investment funds to use an independent fund services company to perform back-office functions and the calculation of the funds' net asset value (NAV).

For insurance, key measures included enactment of Insurance Law 118 of 2008 separating the life from the non-life insurance portfolio, putting compulsory MTPL insurance onto a sound long term financial footing, developing a sound and sustainable banc-assurance model, fostering the development of micro-insurance (largely working with MFIs) and increasing public awareness of the role and value of the insurance sector.

Strengthening the regulatory and supervisory framework was a major underpinning of the second-generation reforms. The CBE reforms included actions that strengthened the resiliency of the financial system through improving the regulatory and supervisory architecture of the banking sector. The aim was to ensure the sector's soundness and lay the foundation for broader access to finance NBFIs including the capital market, the stock exchange, insurance services, mortgage finance, financial leasing, factoring and securitization. With regards to NBFIs, the first step in this program was the issuance of Law 10 of 2009 that would regulate non-bank financial markets, institutions and instruments and has consolidated the regulatory bodies of non-bank financial sector through the establishment of the EFSA—the integrated non-bank financial supervisor. EFSA aimed at strengthening the legal framework for NBFIs and markets and implementing a relatively advanced risk-based supervision system for insurance and pension funds. The unification of these regulatory and supervisory objectives under EFSA, coupled with unifying the Auditors Oversight Board to cover all non-bank institutions,

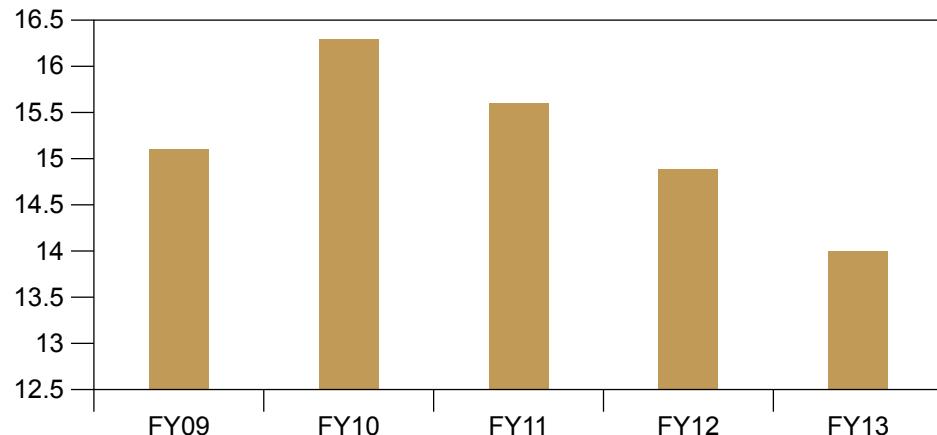
aimed at enhancing the transparency and reliability of financial reporting in the non-bank sector. Regulating pension funds was also one of the main objectives of the reform program.

On improving the financial infrastructure, the second generation reforms included key measures related to the payments system, including a RTGS and an automated clearing house (ACH); the new regulatory framework for mobile phone payments. Developing a timely and accurate credit worthiness database and credit information system at the private credit bureau was a key priority. All these measures aimed at attaining a financial institutional infrastructure that would be more conducive to better financial intermediation.

ACHIEVEMENTS AND MAIN OUTCOMES

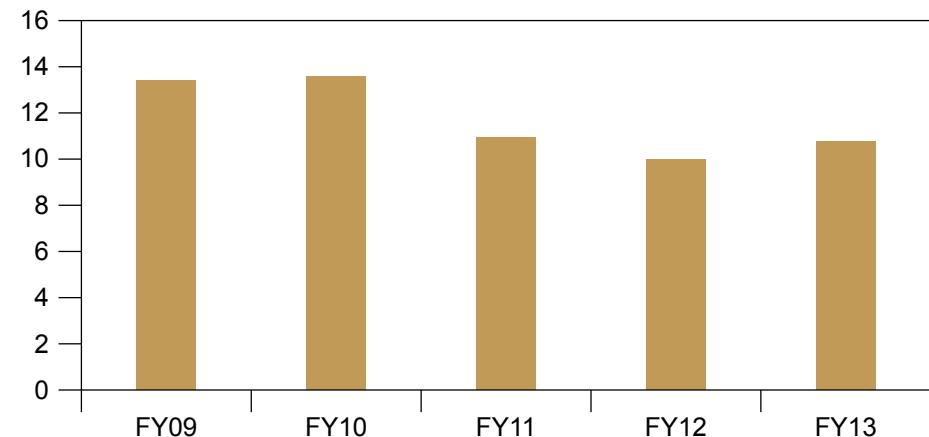
On the banking sector, the reform program produced positive results. For the first time in recent history, the banking sector became majority-owned by the private sector and open to competition—through the privatization of the fourth largest state-owned bank, Bank of Alexandria; and the divestiture of 94 percent of state-owned bank shares in joint venture banks. The banking sector was consolidated, and the number of banks was reduced from 57 in 2004 to 39 banks by 2009. Other achievements include the financial, operational, and institutional restructuring of the remaining three commercial state-owned banks. The operational restructuring of the state-owned commercial banks targeted three critical areas (human resource development, risk management, and information technology), as well as the adoption of a detailed program for capacity building in banking regulation and supervision.

Figure 1.2: Capital Adequacy of the Banking System



Source: CBE.

Figure 1.3: NPLs-to-Total Loans



Source: CBE.

Key profitability and efficiency indicators of the state-owned commercial banks have been substantially improved, due to financial and operational restructuring since the onset of the financial sector reform program. The three state-owned commercial banks—NBE, Banque Misr, and Banque du Caire, which account for about 46.1 percent of bank assets—have substantially improved their profitability, efficiency, and capital⁷. The reported ratio of capital-to-risk-weighted assets in all three banks in 2013 substantially exceeded the required 10 percent level. Moreover, as of end-2011, ratio of provisions-to-NPLs is approximately 86.50 percent. The NBE has increased efforts to recover on private sector NPLs, and Banque Misr that has inherited Banque du Caire's NPLs, continues to dedicate significant efforts to collection⁸. Moreover, all three commercial state-owned banks are now managed in line with good lending practices and a significant proportion of NPLs is a legacy of the past except Banque du Caire for which the operational restructuring was delayed, the two other state-owned banks are now competing at par with the private banking sector⁹.

Post the January 25th revolution, CBE has strengthened corporate governance in the banking system by issuing Corporate Governance Regulations on July 5, 2011. All banks, including commercial and specialized state-owned banks, are instructed to comply with the new regulations. The principles require banks to establish relations between their management, Board of Directors, and shareholders, as well as, other stakeholders with a clear definition of powers and duties of each of them. Further, banks need to have non-executive and independent members on their Boards. Moreover, banks are required to put in place appropriate committees on compensation, audit, and risk management apart from the already existing audit and executive as stated in the Central Bank, the Banking Sector and Money Law no 88 for 2003. They are also expected to develop policies to address conflicts of interest and related party transactions. According to the CBE, all banks will comply with the corporate governance regulations, including state-owned banks. The CBE has also amended the 'Central Bank Banking System and Money

Law 88 of 2003³ on October 8, 2011, introducing changes regarding improving the CBE's own governance, reconstituting its own board of directors to remove conflicts of interests, and tightening supervisory capacity and processes.

Commercial state-owned banks are now competing with private banks on a level playing field. State-owned commercial banks' accounting methods became in line with IFRS, and their financial statements reflect net asset values (NAVs) and their economic position. The quarterly balance sheets and income statements of the state-owned commercial banks are audited by two independent auditors, and published by the banks.

Box 1.2: The Principal Bank for Development and Agricultural Credit

Although PBDAC is a relatively small bank in terms of the system assets, it plays a disproportionate role in rural finance. Its impact on the total banking system in the event of failure may be small because of its relative size, but its social, and political, impact will be extremely high given its unique role. PBDAC's assets and deposits represent less than 1 percent of total system assets, and deposits. However, of total lending to agriculture, 70 percent is provided by PBDAC. Moreover, PBDAC is the only bank that provides loans to individual farmers. With its large network of over 1,200 branches, 46 percent of system total, PBDAC is overwhelmingly the bank of the small, rural village. Its role, and potential role, in financial inclusion is highly significant. It currently mobilizes deposits from 2.7 million people, with an average savings balance of LE 10,000. Its capital is now negative and its operations loss-making, in part because of the culture of periodic loan forgiveness by government, non-performing loans (NPLs) are high—19.4 percent. PBDAC has been the subject of earlier reform programs, which have so far had limited impact. A recent reform program (Rabobank) was making good progress at the time of the revolution. In particular, it helped improve the bank's liquidity management capacity without which it might have run into serious liquidity problems during the revolution. However, post revolution reform efforts were halted and the Rabo bank was discontinued.

Just before the January 25th revolution, The PBDAC had restarted to undertake a substantial program of financial and institutional restructuring, including increasing its mobilization of deposits to fund its lending, modernizing its branches and branch structure, connecting its branches by internet, and improving its risk management. The government had begun the process of changing the bank's legal status to a state-owned commercial bank, but this was postponed with the revolution and dissolution of the Parliament. The bank also started offering new lending products after the revolution, such as microfinance and Islamic finance products to cater to the demand of the people, especially farmers in rural areas. The bank continues to have a bad lending portfolio, weak internal systems, and redundancy, which can be a drag on the bank's ability to improve its efficiency and profitability. The bank has fallen short of the CBE's minimum capital adequacy requirements, which resulted in the government extending support. Because of its weakening cash income generating capacity, the bank's liquidity ratio is likewise close to the CBE's minimum requirement. Although restructuring of the specialized state-owned banks was at a slower pace, the PBDAC managed to improve its coverage ratio from 87.8 percent in 2008, to 90.7 percent in 2011, in addition to introducing 13 products in 2011, as opposed to 10 in 2008. Yet, the bank clearly needs recapitalization and a significant operational restructuring to avoid recurring losses.

The CBE has been involved in programs of restructuring with the state-owned specialized banks, but the restructurings and recapitalizations have slowed down as a result of the political and economic uncertainty post January 2011. The restructuring program with the EALB was furthest along. The small, state-owned specialized Investment Development Bank (IDB) has been gradually undertaking a program of financial, operational, and institutional restructuring. The merger of the small, Workers Bank into the IDB has delayed the restructuring of the bank. Currently there is visible progress in the restructuring of the bank. In 2014, post June 30 revolution, the new government put the restructuring of the specialized banks, especially PBDAC as a priority. It is expected that a full-fledged operational, financial and institutional restructuring will resume in all of these banks, once the uncertainty begins to clear up now that the presidential elections have taken place.

Table 1.1: Egypt—Banking Soundness Indicators (percent)

Indicators (percent)	FY10	FY11	FY12	2013			
	March	June	Sept	Dec			
<i>First: Capital Adequacy</i>							
Capital Base to Risk Weighted Assets	16.3	15.9	14.9	14.5	13.4	14	13
Tier 1 Capital to Risk-Weighted Assets	12.7	13.3	12.9	12.3	11.5	11.8	10.8
Net Worth to Assets	6.7	6.8	7.2	7	6.9	6.8	6.7
<i>Second: Asset Quality</i>							
Nonperforming Loans to Total Loans	13.6	10.5	9.8	10	9.5	9.5	9.1
Loan Provisions to Nonperforming Loans	92.5	94.5	97.1	98.7	98.9	99.5	99.7
Loans to Private Sector to Loans to Customers	80.5	81	82.2	82.9	83.6	83.2	82.7
<i>Third: Earnings</i>							
Return on Average Assets	1	0.8	1	1	1	1	1
Return on Average Equity	14.3	11.7	13.9	13.9	13.9	13.9	13.9
Net Interest Margin	2.3	2.6	3.5	3.5	3.5	3.5	3.5
<i>Fourth: Liquidity</i>							
Liquidity Ratio							
Local Currency	44.7	55.6	58.4	59.7	59.6	61.9	60.3
Foreign Currencies	40.6	51.8	56.3	57.2	57	57.1	55.9
Securities+ to Assets	18	18.7	21.9	19.5	19	18.5	20.2
Deposits to Assets	81	82.5	82.7	75.1	76.2	76	78.2
Loans to Deposits							
Total	51.8	50.2	48.1	47	46.3	44.9	42
Local Currency	44	45.7	45.8	43.7	43.1	41.4	38.5
Foreign Currencies	75.8	62.5	56.1	57.1	56.1	55.9	53.1

Source: CBE Database.

Overall, the banking system proved its soundness and resiliency in weathering the global financial crisis and the immediate ramifications of the January 2011 revolution. More specifically, this has been attributed to the successful financial and operational restructuring of the commercial state-owned banks.

The supervisory and the regulatory framework. The CBE has dedicated considerable efforts to improve its assessment and surveillance of macro prudential risks. The Banking Supervision Department has set up a macro prudential unit with the aim to assess and produce regular reports on major developments in the Egyptian banking sector at the aggregate level. The Banking Supervision Department strengthened the macro prudential unit with the aim of preparing and publishing a full-fledged Financial Stability Report, the first report of its kind in the Middle East and North Africa (MENA) region. Indeed, the macro prudential unit prepared the first Financial Stability Report at the end of 2011. However, there is a delay in the publication of the report because of political and economic uncertainty. Stress testing has become an integral part of the CBE's systemic surveillance of the banking sector. The Macro Prudential Unit has been conducting stress testing and standard financial soundness indicator analyses on the banking sector since 2009, which is also being supported by the World Bank.

Also CBE established a regulation department responsible for developing new and amending current regulations for the banking sector in accordance with the international best practices. Moreover, the department ensures the clarity of the rules and regulations issued by the Central Bank of Egypt, and avails all prudential regulations to interested parties whether inside or outside the CBE.

Moreover, CBE established a department Basel II implementation which was in charge of issuing the Basel II regulation in the banking sector.

On the non-bank front, the reform program entailed the deepening and strengthening the efficiency of capital markets, restructuring of the insurance sector (including reducing public ownership and overhauling the legal and regulatory framework), establishing a new mortgage finance system and a liquidity facility,¹⁰ beginning reforms of private pensions, and developing financial leasing and factoring. In addition, the program included developing a strategy for micro-lending through NBFIs to enhance access to finance and achieve a more inclusive financial system.

Regarding capital markets. Near-term capital market performance will be driven by political and economic developments. Confidence in Egypt's political stability, fiscal performance, and credit prospects could be expected to reverse the recent rise in Treasury bill rates and make banks somewhat more ready to consider business lending as an alternative to buying and holding government debt.¹¹ Development of a corporate bond market will remain constrained by Egypt's lack of a reliable yield curve, which reflects among other things a lack of secondary trading in government securities. Looking at equities, Egypt's regulatory regime for equities already compares favorably with other MENA jurisdictions and the authorities seem committed to implementation of recent rules (e.g., on disclosure,

on related-party transactions) and a strengthening of investment fund regulations. Moreover, EFSA's staff of equity market regulation has already started to shift from compliance-based to risk-based supervision. That being said, both domestic and foreign portfolio investors would want to see greater prospects for political certainty and economic growth before supporting higher equity valuations. Without higher equity valuations, corporations will remain reluctant to move forward with initial or secondary public offerings of shares.

The EFSA merger has been completed and in January 2011. The Chairman was able to issue a comprehensive report covering background, establishment, internal restructuring plans and achievements to date. However, the move to a fully integrated approach has been disrupted by the departure of the first Chairman of EFSA. Market trading practices and governance have improved. Efforts continue to protect minority investors from potential corporate governance irregularities, especially from insider and related-party share trading. In May 2011, the EFSA Board decided to require expanded disclosure by EGX-listed companies of the holdings of major shareholders (i.e. 5 percent or more), free float, Treasury stock transactions, and changes in the board of directors. In addition, regulations for disclosure and corporate governance were augmented by EFSA post-revolution. In order to strengthen compliance of listed companies with internationally recognized corporate governance standards and enhance transparency of equity markets, EFSA reinforced the revised code on corporate governance. EFSA has added important disclosure provisions to its listing requirements through two recent Decrees. EFSA also intends to add the "comply or explain" provision to its listing requirements. This means that any company listing shares on the EGX would have to either fully comply with the new code of corporate governance or explain for each provision why and how it deviates from the code. This reform is expected to strengthen corporate governance and transparency of listed companies.

EFSA Decision No. 88 of 2009 requires investment funds to appoint independent Fund Administration Companies to avoid conflicts of interest and protect investors by performing critical functions, per IOSCO best practice, in order to protect investment fund certificate-holders from adverse actions by fund managers. These critical functions include calculations of NAV, maintenance of fund records on investment transactions and certificate holders, and calculation of management fees and bonuses for fund managers.¹² As of mid-2009, Egypt's investment fund regulations fell short of IOSCO best practices in several regards, including the potential for conflicts of interest (e.g., possible related-party investment, lack of code of conduct); lack of separate directors for bank-sponsored investment funds; and limited standards on permissible advertising by investment funds. Prior to the revolution, the EFSA Board had submitted to the Minister of Investment draft amendments on investment funds for the Capital Market Law Executive Regulations. The Ministry of Investment Decree No.1 of 2010 introduced a number of measures (such as allowing bond issuance by public authorities, authorization of additional rating agencies, audited projections of main financial ratios in lieu of pro forma financial statements) to encourage the development of Egypt's corporate bond market. This enabled a quasi-sovereign agency, the NUCA,

to undertake three issuances of bonds (including a 5-year term) totaling LE 7.5 billion during the first half of 2010.¹³

The private pension fund sector has seen little progress, partly reflecting uncertainties as to the likely impact of the Law 135 of 2010, which proposes a radical restructuring of the social insurance regime in Egypt, and public pensions in particular. This law has been frozen by the interim government and its future and hence impact is now uncertain.

In the insurance sector, the legal and organizational restructuring of the state-owned insurers was completed in July 2010. Misr Life is now the only state-owned insurer selling life products and Misr Insurance only sells non-life products. The establishment of pure life and non-life operations has brought Egypt into line with global good prudential practices (2003 IAIS ICP 6, criterion G).¹⁴ Competent management is now in place in both the state owned direct insurers and Misr Insurance Holding Company (the group holding company), and assets are being professionally managed by the insurers and other group companies.

Table 1.2: MTPL Claims Ratios by Accounting Year¹⁵

Accounting Year	2007	2008	2009	2010	2011
State owned Insurers	846.8	635.2	261.1	452.3	377.9
Private insurers	267.1	131.2	28.5	59.2	66.7

Source: Misr Insurance Holding Company.

The balance sheets of both state-owned insurers are now largely repaired after approximately LE 2.5 billion of reserve strengthening over the restructuring period. The main technical challenges continue to be maintaining the stability of the MTPL non-life portfolio in Misr Insurance and containing the cost of certain legacy group life retirement arrangements that were incorrectly priced and poorly designed in Misr Life (formerly National Insurance). Although Misr Insurance has significantly strengthened its own technical reserves, it discovered that it had inherited an enormous technical reserve shortfall when it took over National Insurance's 'Act' insurance claims portfolio in 2009; moreover, claims' provisions for business written before claims were capped (under Law 72 of 2007) continue to prove to be inadequate as the claims are run off. This reflects National's former dominant role in the MTPL business and the dependence of a section of the legal profession on representing accident victims and their need to maximize returns from the old claims portfolio during its run off period. On the other hand, the business written since the claims cap was instituted and premiums were increased is providing an adequate overall return to underwriters, although some categories of vehicle continue to be highly unprofitable. Other positive insurance metrics are that both the life and non-life sectors have had an unexpected dividend from the revolution in that the corporate and tourist industry sectors (mainly for Strike, Riot and Civil Commotion (SRCC) Insurance) and individuals (life and medical) have become more conscious of risk. Reinsurers are imposing limits on the sum insured under SRCC policies and corporations are having to pay considerably more for full coverage (in the past this was added 'free' cover under most commercial insurance contracts).

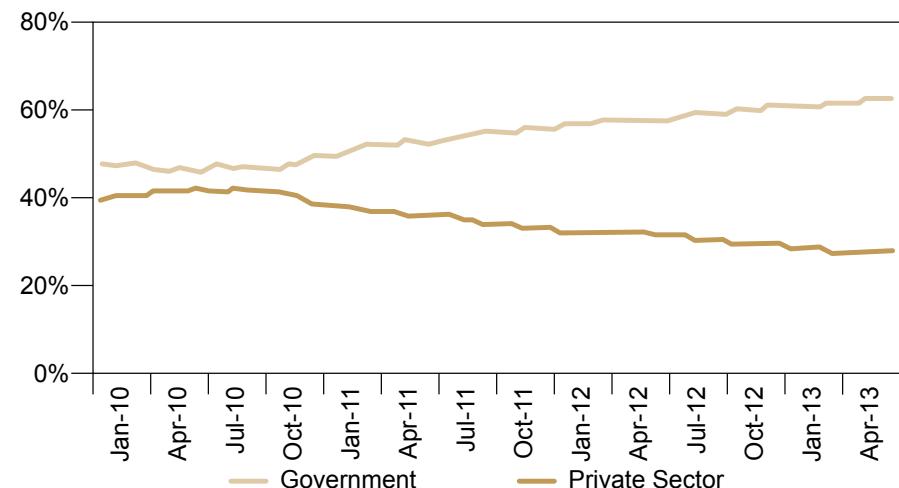
Strengthening the financial infrastructure was one of the main achievements of the reforms. The RTGS became fully operational in 2010. It has been operating successfully since that time including during the revolution, in combination with the ACH to continue to pay pensions to some retirees through ATMs. The ACH became fully operational in June 2010. Approximately 2.4 million payment cards have been issued to government workers and pensioners through the government payments system program. The scarcity of ATMs may become an increasingly problematic issue as more and more government employees and pensioners begin to use this system. Government employees and pensioners typically elect to withdraw cash when they are paid. A full ACH connection between the Ministry of Finance and the CBE was established by end of 2012. This connection will allow direct payments to government suppliers. Also, the National Inter Bank Switch for retail payments is now fully operational in all banks—a key development in the financial institutional infrastructure.

POST-REVOLUTION RISKS AND CHALLENGES

Although the reforms led to a sound and stable system, improvement in financial intermediation was not maintained, due to the developments associated with the events of January 2011, which led to the crowding-out of the private sector by the government with the budget deficit; and a weak appetite for borrowing with the overall uncertain economic environment and security situation. Credit provided by the banking sector to the government has continued its accelerated pace (Figure 1.4). The government's share in total credit increased to 63 percent in April 2013, up from 45.2 percent in January 2011. The private sector's share shrank to 28 percent in April 2013, from 50.7 percent in January 2011, which was starting to pick up immediately prior to January 2011.

Figure 1.4: Credit by Banks to the Government Versus Credit to Private Sector

(Percentage)



Source: CBE.

According to Kunt, Feyen, and Levine (2012), there is enormous cross-country variation in private credit. For example, the median value of private credit to GDP for high-income OECD countries was 114 percent in 2010, while it was only 33 percent in Egypt and for the median MENA country. While Egypt does not have a particularly low value of private credit to GDP, it does have a very low value of private credit by domestic private banks to GDP, suggesting that the private intermediation of credit to private firms is an under developed component of Egypt's financial system. For example, private credit by domestic private banks to GDP is about 63 percent for the median high-income OECD country, about 16 percent for the median MENA country, and about 4 percent for Egypt.

Despite the good performance and resilience of the banking system during the global financial crisis and the problems associated with the aftermath of January 2011 and June 2013 revolutions, various issues could arise during the coming period. Until there is clarity about the policy directions, these issues, discussed below, may affect both the Financial Sector Reform Program and, more generally, the financial sector's ability to mobilize resources and lend them efficiently to support sustainable development.

There are concerns of possible setbacks in reforms oriented towards private-sector led growth. Although economic research stresses that well incentivized, privately owned banks will tend to identify, fund, and monitor the best investment opportunities across private firms, with positive ramifications on economic development, sentiment regarding privatization and the sale of public assets has turned decidedly negative since the start of the revolution. Even the sale of Bank of Alexandria, which took place in October 2006, at well above its book value, has been attacked by the media. This accompanied condemnation of certain private sector participants who are alleged to have benefited from improper behavior, which could lead to a condemnation of market-oriented economies and private sector led growth generally. Assessment of these policies should be based on their implications on the financial sector and not solely their association with the previous regime. Particularly at this critical juncture in Egypt's economy, to jeopardize future development will not be in the best interests of Egyptian society.

In the aftermath of the revolution, commercial state-owned banks are facing various challenges. Due to the uncertainty of the times, lack of bankable opportunities and the growing financial needs of the government, the state-owned banks are buying large amounts of sovereign debt that represents now more than one third of their total deposits. At the same time, the loans-to-deposit ratios are depleting revealing an anemic economic situation.

A macro-financial issue of concern is the "crowding-out" of credit to the private sector by government borrowing. The higher government deficit and the sell-off of its bonds indicate the risk of public sector borrowing crowding out bank lending to the private sector. The fiscal deficit is mainly being financed from domestic sources, through the issuance of public debt that is being absorbed by financial intermediaries. If the government spends

in excess of its revenues from taxes and fees, plus its international funding from grants and borrowing, then it must borrow from the domestic economy, largely the banks, thereby crowding out private borrowing. In order for private activity to expand, the government must allow room for bank loans to the private sector for working capital and investments. This crowding out will also restrict the ability of corporate and SMEs to raise capital in the capital market through the issuance of fixed income instruments. To the extent that private entrepreneurs with sound investments are stymied from raising capital due to these credit allocation decisions Egypt's financial system is hindering economic growth.

An increase in NPLs in the banking system is a likely result of the contraction in economic activities and the turmoil following the revolution. A key sector that has been significantly affected is tourism, while construction, mining, and manufacturing have also suffered, this could have negative implications on the performance of the loans of borrowers in these sectors. Concerns over transfers of property or takeovers of assets could also lead to higher NPLs. The stress testing conducted by the CBE since the revolution showed that the capital cushion would be able to absorb such an increase. The CBE is closely monitoring and supervising all banks to ensure that any financial weaknesses are addressed in a timely manner.

On the banking sector, there remains a risk of deterioration of banks' resiliency and solvency, in terms of capital. The capital to risk-weighted assets ratio of December 2011 was around 15.6 percent well above the 10 percent requirement. However, risk will remain, particularly if growth remains low for a prolonged period or government policy and changes in the political environment lead to defaults by borrowers. Under populist pressure and condemnation of the private sector, the government may be tempted to allocate credit to sectors considered important or strategic. Although such a process may seem obvious to some, experience world-wide has shown that ultimately, it could add to the burgeoning volume of NPLs; further limit the availability of funds to non-preferred clients; and require government injections of funds into the banking system, problems that were similar to those of the Egyptian financial system some years ago—prior to the Financial Sector Reform Program. The CBE indicated clearly that they would not allow the allocation of credit on non-economic or commercially viable terms.

On the non-bank front, despite the reforms adopted in 2004, private fixed-income instruments have remained negligible. Mortgage markets continue to be limited in both scope and activity, due to high fees and inefficient procedures for land registration, weak regulatory authority and poor access to long-term credit. Egypt's capital markets remain thin. Financial leasing and factoring continue to be underdeveloped or almost non-existent.

NBFI reforms have been slow to be implemented due to a variety of reasons associated with the revolution, including the failure to replace the Minister of Investment. The Ministry of Investment and EFSA did not ensure

the effective implementation of the various reforms related to the non-bank financial sector and the sector lacked the vision to proceed with the reforms, and was overwhelmed by the cases filed.

A significant risk to insurers and pension funds in the medium term is that rates of investment return drop, and in the case that Misr Life state employee salary costs increase rapidly at the same time, adding significantly to the need to strengthen retirement fund group life reserves for certain categories of state employees. The contribution of investment income to insurers' results has already decreased (the return on investment for the state-owned insurers from 13.8 percent in 2006/7 to 9.1 percent in 2012/13 despite improved asset/liability ratios), although steps are being taken to counter this by, for example, moving term deposits into government paper and reducing equity exposures. The maximum salary issue is not currently a problem for the management of state-owned insurers because of reasonably high minimum salaries. Although, any moves to further reduce salary caps could see a significant loss of critical skills and experience, EFSA is likely to see some losses as some senior officer's salaries have been cut substantially.

The state-owned insurers currently have at least double the staffing levels they need to operate efficiently and many staff is effectively unproductive. Recent and imminent supplementary salary increases arising from decisions taken over 5 years ago are increasing costs rapidly, and while expense rates are still sustainable and competitive thanks to the scale of the state insurers and branch rationalization, this trend cannot continue without affecting the long term viability of the two insurers; particularly if investment returns are under pressure. DBs private pension funds will also see funding levels reduce materially if a combination of rapid salary increases and reduced returns continues for even a few years.

The dissolution of the Parliament has resulted in delaying the issuance of several key laws. This problem relates to the potential overload on the post June 2013 Parliament yet to be elected, which may face major political challenges in any new directions it decides to make as well as having to deal with a large volume of pending legislation, in particular, legislation to improve the functioning of the financial system and making finance more accessible. This potential problem could affect the ratifications of the Microfinance Law and Real Estate Law amendments to the Mortgage Finance Law and Financial Leasing Law, and the legal changes in the PBDAC Law, all of which were delayed initially by a legislative backlog at the end of 2011 and subsequently by the dissolution of Parliament.

Box 1.3: Lack of Legal and Regulatory Framework for Microfinance

Egypt suffers from various deficiencies that prevent further expansion of the microfinance sector. Lack of a conducive legal and regulatory environment is a main impediment. There is no clear supervisory responsibility or framework for the microfinance industry. Commercial banks, which have traditionally focused on serving large corporations and medium to high-income individuals, are supervised by the Central Bank of Egypt (CBE). Some of these commercial banks have begun to downscale and cater to micro enterprises but these are limited in number. The low-income are mostly served by NGO-MFIs for credit and are monitored by the Ministry of Social Solidarity. The two finance companies in the market (Reefy and Tanmeyah), currently providing microfinance, operate in a legal grey zone. As a result, the current system suffers from a fragmented set of rules, lack of level playing field, and an inadequate regulatory and supervisory framework. Growth of this sector is still constrained by the lack of an enabling microfinance regulatory and legal framework that is essential for strengthening the sector, encouraging its growth and allowing for further outreach.

In response to operational challenges faced by NGOs-MFIs, efforts have been made to improve the enabling environment for financial intermediation and to strengthen financial infrastructure. A licensing law for all NBFIs was submitted to the Cabinet of Ministers in March 2010. The draft law allowed for the creation of the first commercial micro finance institutions (MFIs) in Egypt and would have allowed NGOs that are actively involved in microfinance to convert into a full-fledged MFI under the oversight of EFSA, and enable NGOs to establish an MFI arm or continue to function as an NGO reporting to the Ministry of Social Solidarity. While establishing a supervisory board with membership of CBE and EFSA. With the dissolution of the parliament post revolution; this law never saw the light. It was only in 2013, with the appointment of a new cabinet, a new law drafted by EFSA that solely addressed the legal and regulatory framework for microfinance was presented and approved by the cabinet in May 2014.

With regards to financial infrastructure, licenses for mobile payments provision have been issued to three banks, the Housing Development Bank, National Bank of Egypt and BNP Paribas Emirates NBD and their partner-mobile phone companies. The operation of systems under these licenses was delayed by the events of January 2011, but they are expected to begin operation soon. The Central Bank Banking System and Money Law 88 of 2003 limits deposit taking to banks licensed and supervised by the CBE. This limit means that mobile payments systems and products involving deposit-taking are required by law to go through banks; mobile providers cannot offer deposit services independently from banks, as has been done in some countries, for example, Kenya. The purpose of the law is to ensure strong supervision of deposit-takers and avoid bank collapses that would be likely to require government ad hoc coverage of deposits and to protect depositors' rights, including the right to redeem their deposits.

Islamic Finance in Egypt

Egypt has the longest experience of Islamic finance since it started in 1960s, yet it is underdeveloped when compared to Gulf Co-operation Council (GCC) countries, Iran and Malaysia. The growth and progress of Islamic finance in Egypt during the last few decades has been slow. Despite the fact that Islamic finance started decades ago in Egypt, compared to the global Islamic finance experiences, the rules and regulations governing Islamic Banking continue to lag behind. Political factors have been unhelpful for Islamic finance where it was seen at being associated with banned Islamists.

Box 1.4: Evolution of Islamic Finance in Egypt

The global Islamic finance industry continues its quest to boost international competitiveness and to build a sustainably profitable business model. Islamic Banking is a growing worldwide phenomenon. The number of Islamic financial institutions has increased significantly in the Arab Countries. There are now around one hundred Islamic Banks and financial institutions working in the private sector. Islamic finance was less affected by the financial crisis and downturn than some parts of conventional finance, although some Islamic Banks have been exposed to the volatile real estate markets, and a number of Sukuk issuers have defaulted on payments. While less affected by the financial crisis and global economic downturn, Islamic finance faces various ongoing challenges, including management liquidity, compliance issues and governance.

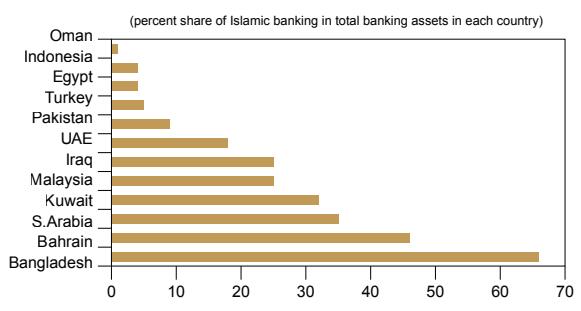
According to Maher Hasan and Jemma Dridi (2010), Islamic Banks performed better than conventional ones in 2008 in terms of profitability, credit and asset growth. The Islamic Banks' profitability crunch was less than 10 percent, whereas the CB's profitability slumped more than 35 percent in 2008 compared with 2007. Moreover, Islamic Banks have maintained stronger credit growth compared to Commercial Banks. The Islamic Banking system's features make its activities more closely related to the real economy. This reduces its contribution to excesses and bubbles.

Moreover, the global crisis highlighted the need to address important challenges faced by the Islamic Banking industry, including: (i) the infrastructure and tools for liquidity risk management, which remains underdeveloped in many jurisdictions; (ii) a legal framework, which is incomplete or untested; (iii) the lack of harmonized contracts; and (iv) insufficient expertise (at the supervisory and industry levels) relative to the industry's growth.

A pioneering experiment of putting the Islamic principles governing financial dealings into practice was conducted in Mit-Ghamr, Egypt, from 1963 to 1967 by Ahmad El-Naggar. This bank laid the seeds of modern Islamic Banking and pointed the way for subsequent undertakings.¹⁶ In 1971, the government of Egypt created Nasser Social Bank (NSB). This bank provided a number of Islamic financial products, including interest-free loans to the poor, student scholarships and small business credit on a profit/loss sharing basis.¹⁷ Although it offered interest free loans subject to administrative and service charges, it was not specifically Islamic in terms of its ethos or products. In response to the lobbying by advocates of Shari'a compliant financial products, the Islamic Finance Law 48 of 1977 was passed, permitting the establishment of Islamic Banks, and their regulation by the CBE. The Faisal Islamic Banking of Egypt obtained a license from the CBE on June 14, 1979, to become the first Islamic Banking established in Egypt, shortly followed by Al Baraka Bank of Egypt, which was awarded its license on May 8, 1980.

Egypt is ranked fourteenth among countries with Shari'a compliant financial assets, for an equivalent of US \$7.9 billion, accounting for less than one percent (0.7 percent) of total global Islamic finance assets, which given the size of Egypt's economy is very small.¹⁸ This was a drop from the initial rank of 12th during the period 2006–2009 in global Islamic finance. This indicates that the growth rate of Islamic finance in Egypt was less than that of some other countries.

Figure 1.5: Islamic Finance Penetration in Selected Countries



Source: The Banker, Maris Strategies.

Islamic Banking, as a share of Egypt's total banking assets was about four percent in 2010; this was very small when compared with many other countries offering Islamic financial instruments. Islamic Banking only accounts for 3 to 4 percent (Islamic banks' assets to total assets of the banking sector in Egypt 4.2%, and the share including the Islamic windows is 6.7% as 2013) of Egypt's \$193 billion banking industry. Compare that with 46 percent in the United Arab Emirates. Egypt continues to have an extremely low Islamic Banking penetration rate when compared to other countries. It is likely that the political factor prevented the growth of Islamic finance as it was seen at being associated with the previously banned Islamist political movements. Another reason is very likely the lack of Islamic law and regulations. There is no comprehensive Islamic Banking law apart from the limited provisions made under Islamic Finance Law 48 of 1977. The licensing requirements for Islamic Banks are similar to those for CB in terms of capital requirements, liquidity ratios and financial reporting. These are not always accommodating to Islamic Banks however, as they are often placed at a disadvantage in relation to CB with regard to regulatory requirements. Moreover, there is a lack of knowledge of Islamic Banking, due to the limited public awareness programs and marketing by the few Islamic Banks in Egypt.

Islamic Financial Products in Egypt: Sukuk

Sukuk is one of the instruments that play an important role in funding investment. Although the Capital Market Law 95 of 1992 and its Executive Regulations include Sukuk as one of the securities that can be used to finance the economic activities, the implementation did not result in activation of this instrument due to the lack of integrated regulations for Sukuk issuance. However, in early 2012, the government announced that they would be issuing foreign currency denominated Sukuk or certificates of deposits mainly targeting the Egyptians abroad.

As part of the plan to develop and diversify the financial instruments and to increase the ability of corporations and other different entities to access finance, EFSA and the Ministry of Finance prepared a proposal in order to provide a legal framework for using the Sukuk as one of the financing instruments for both government and private sector companies, and assess a fair balance of rights for each issuer, underwriter and all participants in the capital market. The Sukuk law was ratified by the Shura Council (upper house of the parliament) before June 2013.

Even though Egypt was the first country to start Islamic Banking in 1963, Islamic Banking assets in Egypt account for a mere three percent of the total banking system in 2007. During this period, there were still only two Islamic Banks with a branch network of 33 branches offering limited financial products, mainly Murabaha and Mudaraba.¹⁹ During the period 2008–2010, the Islamic Banks' activities increased, showing growth rates in assets of 10.5 percent, 14.3 percent and 9.7 percent in the years 2008, 2009 and 2010 respectively. However, these growth rates were less than those of GCC countries. It is worth noting that the government under Mubarak was hostile to Islamic finance, keen on keeping a secular country concerned primarily with political matters rather than recognizing the relevance of Islamist groups. Although some Islamic Banking was permitted, it was confined to the fringes of the banking system. Despite the fact that Egypt had over three decades of Islamic Banking experience, Law 88 of 2000, contains no provision relating to Islamic finance.

The Islamic Banking industry in Egypt consists of full-fledged Islamic Banks (Faisal Islamic Bank of Egypt, Al Baraka Bank and Abu Dhabi Islamic Bank), Islamic branches, Islamic windows and certain other banks possessing an Islamic Banking license. Although Egypt has the longest experience of Islamic finance, there are still many obstacles facing Islamic finance. One obstacle is the lack of the rules and regulations governing Islamic Banking up until now.

Major Islamic Banking Players in Egypt

Banks are the main source of Islamic finance in Egypt. The Islamic Banking sector can be divided into three modes or groups. These modes are:

- **Full-fledged Islamic banks:** There are three fully-fledged Islamic Banks in Egypt. These banks are: Faisal Islamic Bank of Egypt, AL Baraka Bank and Abu Dhabi Islamic Bank.
- **Islamic branches:** There are mainly two state-owned banks that have Islamic branches. These banks are: Bank Misr and NBE, a private-owned bank, United Bank which has also recently established Islamic branches.
- **Islamic windows:** There are two banks that have Islamic windows, Principle Bank for Development and Agricultural Credit (PBDAC), specialized state-owned bank; and Al National Bank of Kuwait-Egypt, private-owned bank, both of which introduced Islamic financial products.

Table 1.3: Islamic Banks Share in Total Banking Sector (2006-2010)

		2010	2009	2008	2007	2006
Total Assets	Islamic Banks	10058	8901	7850.1	7347.3	4826.3
	Banking Sector	2144.510	1951.381	1901.546	1646.634	1322.615
	Share of Islamic Banks (percent)	4.690	4.561	4.128	4.462	3.649
Loans Advances	Islamic Banks	6884	5997	5707	5102.82	3703
	Banking Sector	818.675	759.394	704.625	621.043	562.767
	Share of Islamic Banks (percent)	8.409	7.897	8.099	8.217	6.580
Customers' Deposits	Islamic Banks	9046.000	8107.000	7175.000	6686.600	4357.600
	Banking Sector	1567.976	1446.916	1311.566	1141.069	987.914
	Share of Islamic Banks (percent)	5.769	5.603	5.471	5.860	4.411
Shareholder Equity	Islamic Banks	607.000	566.000	559.800	509.800	311.400
	Banking Sector	131.911	112.439	100.648	80.037	70.389
	Share of Islamic Banks (percent)	4.602	5.034	5.562	6.370	4.424

Source: 1-Data information center, EMIS.

Table 1.4 shows the aggregate main financial indicators for the three fully-fledged Islamic Banks. The date of the table shows that the three Islamic Banks achieved a moderate growth rate in financial items (Total Assets, Loans Advance, Deposits and Shareholders' Equity). In addition, the Islamic Banks (Faisal Islamic Bank of Egypt and Al Baraka Bank) met the international standards of minimum capital requirement, which is 8 percent. The performance of Faisal Islamic Bank of Egypt and Al Baraka Bank was much better than the performance of Abu Dhabi Islamic Bank because of the weak performance of the bank before it was acquired by Islamic Bank of Abu Dhabi in 2007 and transferring its activities to Islamic Banking activities.²⁰

The Future of Islamic Finance in Egypt

The pre June 2013 new Islamist parties and government have had the development of Islamic finance, one of the key priorities in their reform agenda. According to data from Bank scope and Thomson Reuters, Egypt could see Islamic finance assets grow to \$10 billion in 2013 from \$6 billion in 2007. Moreover, there is also interest for Islamic insurance, Takaful, which makes up five percent of Egypt's US \$1.45 billion insurance market but is expected to grow dramatically. The Islamic finance industry faces several challenges. Some of the major constraints are very similar to those of CB, while others are uniquely related to Islamic finance. The most significant challenges are in the areas of regulation, supervision and international harmonization; risk management; innovation and financial diversification; and human resources.

On the legal framework Islamic Banks generally operate under conventional legal frameworks and institutional arrangements. In many cases, these are not suitable for their operations. Although there has been over three decades of Islamic Banking experience in Egypt, as mentioned earlier, the recently issued banking law does not contain provision for Islamic finance. In terms of corporate governance, the ownership structure of Islamic Banks depicts high concentration. This introduces the possibility of monopoly power and undue influence by a few major shareholders.

Human resources development is another major challenge because there is a serious shortage of scholars who possess a working knowledge of both Islamic fiqh and modern economics and finance. This shortage may pose reputational risks to the industry and slows down product development. Most of the managers of Islamic Banks are not very well trained in the use of Islamic modes of finance. Another challenge, which is also at the global level, is that there is an issue of harmonization. Shari'a interpretation is different among countries and regions. The absence of a single deciding authority concerning the Shari'a is a major challenge.

Risk management is impeded by the relatively short track record of Islamic financial institutions. Most Islamic Banks active in Egypt have their transparency; corporate governance and risk management at large still work in progress. Special risks associated with Islamic finance include displaced commercial risk,²¹ Shari'a-compliance risk, entanglement of market and credit risks in Islamic Banks' asset classes, heightened liquidity risk due to large maturity mismatches and scarce liquidity management tools, and reputational risk.

In terms of product innovation, the Egyptian Islamic financial institutions are lagging behind due to the absence of one central Shari'a board, to make decisions on the Shari'a-compliance of banking products; multiple boards are active on different levels: starting with international institutions, to country and bank levels.

CONCLUDING REMARKS

In conclusion, the financial sector in Egypt has evolved and gone through numerous transformations as previously discussed, and has reached a point where it has been resilient to a great extent in weathering the global economic and financial crisis, the Euro crisis, and the implications of the Egyptian revolution. However, it is important that the banking sector reforms proceed, focusing on attaining a more inclusive system catering smaller enterprises and marginalized areas. Restructuring the specialized banks, especially those with huge branch networks in the underserved governorates would be key. At the same time, promoting the growth of non-bank institutions is important in ensuring a more balanced financial sector, capable of performing the full spectrum of intermediation functions, diversifying risks, and the presence of a meaningful domestic institutional investor base that contributes to the sound development of securities markets. Egypt has been debating fundamental issues and the economic orientation of the new regime needs to be clear because there is a pressing need to maintain financial sector and market-oriented reforms, as well as sustain and promote private sector led growth. The urgency to broaden opportunity without disregarding the achievements of the past reforms is essential taking stock of the lessons learnt. It is critical to ensure that the benefits of the reform are reaped by all segments of the society.

ENDNOTES

- 1 The subsidies were covered by injections of Government funds from time to time, and external loans that were repaid by the Government.
- 2 The first generation reforms included the privatization of Bank of Alexandria through sale of 80 percent of the equity to Bank San Paolo (later merged with Intesa to form Intesa San Paolo). Although the privatization of Banque du Caire was not part of the reform program, the government decided in early 2007 to privatize the bank. The government's commitment was evident in completing all the necessary steps for a strategic sale. Specifically, in July 2007, it had announced that 70 percent of the bank would be sold to a strategic investor, and in October 2007 the government selected JP Morgan as sales advisor and received three bids in May 2008. However, the sale transaction was not completed, mainly due to the price was much lower than that estimated by the evaluation committee headed by the Central Audit Agency (CAA), and the global financial crisis paralyzed the bank privatization world-wide.
- 3 More than 94 percent of the state-owned bank shares in joint venture banks were divested.
- 4 Consolidation of the banking sector was through higher minimum capital requirements and stricter prudential rules, which resulted in the exit of small and weak banks through mergers, acquisitions, and closure of foreign bank branches, which reduced the overall number of banks from 57 in 2004 to 39 in 2008.
- 5 The upward rise in liquidity reflects sustained efforts to de-list companies that do not trade or do not meet corporate governance requirements. The number of listed companies steadily declined from 795 at the end of 2004 to 373 at end of 2008. The delisting of small companies contributed to a rise in average market capitalization, from LE 294 million in 2004 to LE 1633 million at the end of 2008. Moreover, whereas only 53 percent of listed firms traded in 2004, 94 percent traded in 2008.
- 6 In excess of LE15 billion of non-life reserve strengthening occurred over the 3 years to June 30, 2008.
- 7 According to their annual reports and CBE data.
- 8 Its NPLs-to-total loans ratio is at 7.2 percent at the end of March 2012.
- 9 Banque du Caire should have been merged with Banque Misr then privatized. For the time being, the bank is still owned by Banque Misr but it operates its activities independently from Banque Misr.
- 10 The World Bank supported the development of the mortgage finance market through two different operations, the Mortgage Finance Project and the Affordable Mortgage Finance Program DPL.
- 11 Highlights include: (i) EFSA has decision making, budgeting and organizational autonomy; (ii) a cadre of new younger graduates not tied to past structures and approaches has been recruited after an exhaustive selection process and trained (including time with the Singapore Monetary Authority). New cadres of such individuals will be recruited on an annual basis; and (iii) an Institute for Non-banking Financial Services has been established to enable local personnel to attain international qualifications (e.g. through sitting the CII insurance exams in Cairo).
- 12 Market participants indicate that six Fund Administration Companies are operating and performing these critical functions. This may have encouraged greater public confidence in investment funds. According to EFSA, 89 investment funds were operating by May 2013 compared to 68 in December 2009 and only 49 in December 2008.
- 13 Other corporate bond issuances, however, were down. During 2010, 5 corporations undertook 12 bond issuances totaling LE 5.2 billion. Thus, the combined 15 bond issuances in 2010 are down from the 22 corporate bond issuances in 2009. Unsettled market conditions presumably had some negative effect. Market participants note, however, that Egypt has yet to develop a real secondary market in government securities. The resulting lack of a reliable yield curve may significantly dampen investor appetite for corporate bonds and discourage development of a corporate bond market. The Ministry of Finance has made major improvements in its primary issuance practices and development of benchmark issues. Additional measures are needed to encourage secondary trading in government securities.
- 14 MENA is the only region where a significant number of composite insurers are still allowed to operate, however strict separation is now being introduced (UAE, Algeria) in some nearby jurisdictions. A partial list of G20 countries requiring separation of life and nlife activities includes the relevant EU countries the US, Canada, Australia, Indonesia, Mexico and South Africa.
- 15 Claims ratio is claims cost over corresponding earned premium.
- 16 CHACHI, ABDELKADER, 2005, "Origin and Development of Commercial and Islamic Banking Operations", J.KAU: Islamic Econ., Vol. 18, No. 2, pp. 3-25 (2005 A.D/1426 A.H), http://www.kau.edu.sa/Files/320/Researches/51027_21164.pdf. - African Development Bank, 2011, *Ibid*.
- 17 Gait, A.; Worthington, A. C., 2007, "A Primer on Islamic Finance: Definitions, Sources, Principles and Methods", University of Wollongong, School of Accounting and Finance Working Paper Series No. 07/05, 2007.
- 18 This is based on the Banker's survey of 500 organizations showing the leading countries for Shari'a compliant assets as a percentage of total global Islamic finance assets. The first country is Iran with \$388 billion (35percent), Saudi Arabia \$151 billion (13.9 percent), and Malaysia \$133 billion or (12.2 percent).

- 19 BlomInvest Bank, 2009, "Islamic Banking in the MENA region", Economic research department, February, www.bloominvestbank.org
- 20 Nasr, Sahar, 2011, "Islamic Finance in the Arab World: Challenges and Prospects", World Bank, 2011 Cambridge Business & Economics Conference (CBEC), June 27-29
- 21 "Displaced commercial risk" is a term reflecting the risk of liquidity suddenly drying up as a consequence of massive withdrawals should the IFT's assets yield returns for unrestricted investment account-holders lower than expected, or worse, negative rates of profits.

2. BANKS, ECONOMIC GROWTH AND OPPORTUNITY

This chapter makes a case for further financial sector reform in post-revolution Egypt. Based on international comparisons, we show the important role that financial sector deepening and broadening can play in creating a more inclusive and more prosperous Egypt. While Egypt has undertaken impressive financial sector reform over the past decade, it has still not reaped the benefits in terms of a deeper and more inclusive financial system. We will discuss a new reform agenda to (i) expand access to finance by both enterprises and households, (ii) lengthen the maturity of financial instruments and (iii) safeguard the financial system against fragility. This will require continued macroeconomic stability and further institution building. It also implies a further redefinition of government's role in the financial sector, but also in the real economy, increased competition within and from outside the financial system and a new regulatory approach that relies more on market discipline and allows for more innovation. We finish with recommendations for some concrete policy actions.

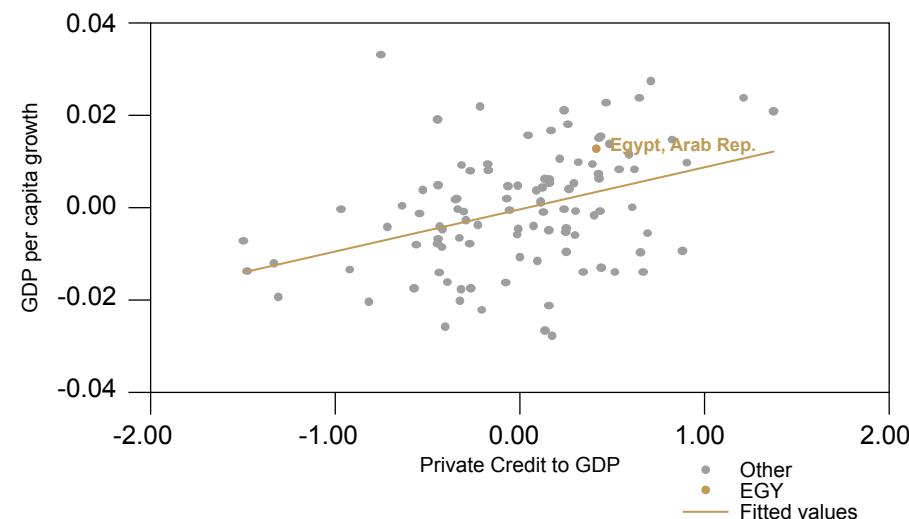
FINANCE: PRO-GROWTH AND PRO-POOR

The economic development paradigm of the 1960s and 70s did not envision a meaningful role for financial sector development. Even the Washington consensus of the 1980s did not include financial sector reform as a priority apart from an emphasis on private actors and free prices. Over the past 20 years or so, however, financial sector policies have become a centerpiece in the debate on how to foster growth in low-income countries,

reduce stark poverty levels, and, ultimately contribute to the achievement of the Millennium Development Goals. Even taking into account reverse causation, research has established the robust positive impact of financial sector deepening on economic development. Figure 2.1 illustrates the conclusion of a well-established body of empirical evidence: countries with higher levels of credit to the private sector relative to GDP experienced higher average annual real GDP per capita growth rates over the period 1980–2007.

The effect of finance on growth is not only statistically, but also economically significant, as the following example illustrates. Over the period 1980 to 2007, Private Credit to GDP averaged 33 percent in Egypt, but 87 percent in Thailand. The cross-country comparisons illustrated in Figure 2.1 suggests that Egypt's real GDP per capita would have grown 0.9 percentage points faster per year, had it had the same level of financial development as Thailand, or 3.4 percent instead of the actual 2.5 percent. This would have resulted in over 50 percent higher GDP per capita in 2007. This is notwithstanding the financial crisis that Thailand went through in the 1990s. The graph, however, also illustrates that the financial sector has not contributed as much to growth, as would have been predicted by the cross-country comparison, since Egypt actually achieved a higher growth rate than predicted by its level of financial development and other factors controlled for in this regression. This shows the limitations of our indicator of financial depth, but also points to the “quality” of financial intermediation being an important dimension of financial sector development, that is not necessarily captured by this crude indicator of financial intermediation.

Figure 2.1: Finance and Growth across Countries (1980–2010)



Source: World Bank Database.

The positive impact of financial development on growth does not mean that growth has no influence on financial deepening and broadening. On the contrary,

by helping to increase incomes, financial deepening can create additional demand for financial services, thus generating a virtuous cycle of financial and economic deepening. Moreover, many of the policies that foster financial sector deepening and broadening, including legal system reforms, reforms to improve transparency and governance and macroeconomic stability, also have a direct positive impact on economic development and poverty alleviation.

What are the channels through which financial development helps increase economic growth? While financial systems assist in pooling savings, transforming maturity, and converting savings into capital accumulation, it is ultimately through improvements in resource allocation and productivity growth that finance helps economies grow more quickly (Beck, Levine, and Loayza 2000; Love 2003; Wurgler 2000). The functions of attracting deposits and investment and transforming short-term claims into long-term assets, thereby financing investment, should obviously not be ignored; they are the basis for the ultimate function of finance, which is to put the savings of society to their best use, that is, put savings where they can reap the highest (expected) returns, thus translating into growth. Below, we will argue that Egypt's financial system has been relatively efficient in mobilizing savings, though much less so in intermediating them efficiently.

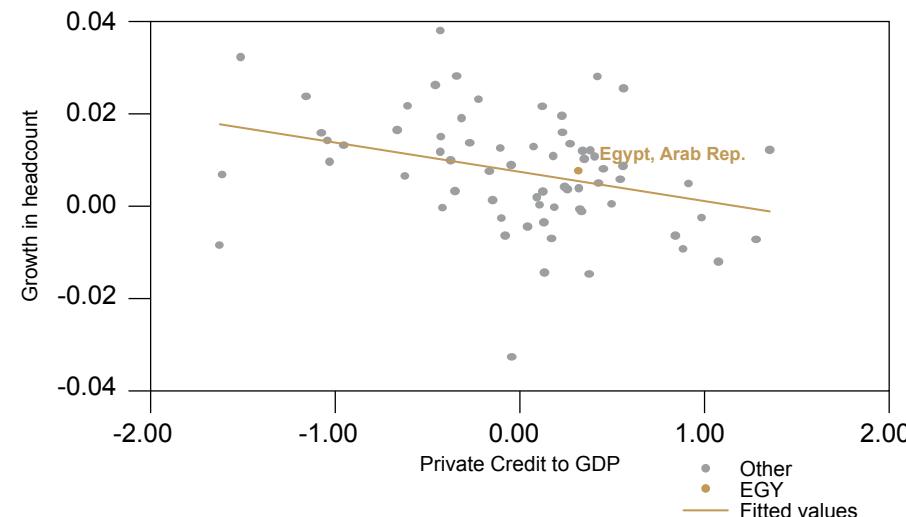
Financial systems can have a transformative impact on sectoral and industrial structures of countries. Financial deepening helps industries that rely heavily on external finance, but it also helps reduce the financing constraints on enterprises, particularly smaller firms (Rajan and Zingales 1998; Beck, Demirgüç-Kunt, and Maksimovic 2005). Financial deepening thus has a transformative effect on economies by shaping industrial structure, distribution by firm size, and even organizational structures (Demirgüç-Kunt, Love, and Maksimovic 2006).

Financial development is also critical for entrepreneurship. Finance provides opportunities for new entrepreneurs and fosters innovation and competition. Policies that ease enterprises' access to external finance have been shown to help especially smaller firms grow faster (Aghion et al., 2007, Klapper, Laeven and Rajan, 2006). A vibrant financial system can support a private sector characterized by new successful entrants gaining traction and growing quickly, while withdrawing support from failing entrepreneurs. Access to external finance can even help in the start-up phase, though not necessarily through traditional channels. A well-diversified financial system offers different financing tools for start-ups and small enterprises. In many developed countries, household finance, e.g. credit cards, can help finance start-ups, while venture capital companies are an important vehicle in financing high-risk ventures. Leasing is an attractive financing tool for small and less mature enterprises, as it is based on the cash flow of the financed asset, such as machinery or vehicles, rather than reputation of the enterprise or the asset base of the enterprise. Factoring, the discounting of sales receivables, is attractive for small suppliers of large credit-worthy buyers, as it does not rely on information about the “borrower”, but rather on the credit-worthy buyer.

Financial sector development is important not only for fostering the economic growth process, but also for dampening the volatility of the growth process. As shown by Aghion et al. (2010), financial systems can alleviate the liquidity constraints on firms and facilitate long-term investment, which ultimately reduces the volatility of investment and growth. Similarly, well-developed financial markets and institutions can help dampen the negative impact that exchange rate volatility has on firm liquidity and thus investment capacity (Aghion et al. 2009). This is especially important in economies that are subject to high terms of trade and real exchange rate volatility. The recent crisis has shown that countries with less developed financial systems and less exposure to international financial markets were less affected by the first-round financial contagion effects of the Global Financial Crisis, but more heavily affected by the second-round effects through the real sector links, as their financial systems could not serve as shock absorbers (Beck et al., 2011).

Financial deepening is not only a pro-growth, but also a pro-poor policy. Figure 2.2 illustrates the pro-poor effect of finance: countries with deeper financial systems see poverty levels drop more rapidly. As in the case of economic growth, the economic effect of financial deepening on poverty reduction is strong, as again the comparison between Egypt and Thailand illustrates. A level of financial development as in Thailand would have led to a strong reduction in poverty levels rather than the slight increase that Egypt experienced over the 1990s. As in the case of the finance-growth relationship, the relationship between financial depth and changes in poverty levels is robust to controlling for other country characteristics, omitted variables and reverse causation.

Figure 2.2: Finance and Poverty Alleviation across Countries (1980-2007)



Source: World Bank Database.

What are the mechanisms of this poverty-reducing impact of financial deepening? In this context, it is important to distinguish between two different concepts: Finance and Poverty Alleviation and Finance for the Poor. Recent research has pointed to a significant indirect impact of financial deepening on poverty alleviation. By changing the structure of the economy and allowing more entry into the labor market by previously unemployed or underemployed segments of the population, finance helps reduce income inequality and poverty, as evidence from Thailand and the U.S. has shown (Gine and Townsend, 2004, Beck, Levine and Levkow, 2010). By doing so, financial deepening can help achieve more inclusive growth and, also, help overcome spatial inequality in growth benefits. Recent evidence also suggests that financial deepening can contribute to employment growth in developing countries, a critical priority in Egypt in the coming years (Pagano and Pica, 2011). It is thus important to understand that the effects of financial deepening on employment and poverty alleviation do not necessarily come through the “democratization of credit” but rather a more effective credit allocation. This also implies that microcredit is not necessarily the most important policy area to reap the benefits of financial deepening for poverty alleviation.

For the poor to benefit directly from financial sector deepening and broadening it is important to look beyond credit to other financial services that are needed by the poor, such as simple transaction or savings services. This is also consistent with the distinction below between Finance for Markets and Finance for Growth (Box 2.1). While it should be a goal to achieve access to basic transaction services for as large a share of the population as possible to thus enable them to participate in the modern market economy (Finance for Markets), the agenda in boosting access to credit should focus on improving the efficiency of this process, replacing access through political connection and wealth with access through competition. By channeling society's resources to the most credit-worthy enterprises and projects, the financial system can enhance inclusive growth (Finance for Growth). Both policy areas relate to the Finance for All (or Finance for the Poor) agenda—expanding basic transaction and savings services to a larger share of households and expanding access to external finance to a larger share of credit-worthy firms and entrepreneurs. While the Finance for Markets and Finance for Growth agendas aim for more efficient financial systems, the Finance for All agenda aims for a more inclusive financial system.

Box 2.1: Three Concepts of Finance

Finance for Markets relates to financial services that underlie short-term commercial market transactions, such as trade finance, remittance payments, and various types of short-term credit facilities. This concept relates primarily to the financial system function of enabling market-based transactions within the economy and across borders. By facilitating commerce, financial systems allow the market-based exchange of goods and services beyond the immediate family and community. Finance for Markets thus refers to financial services for enterprises and households, thus cutting across all possible beneficiary groups. The concept covers transaction and payment services, including remittances from emigrant workers to their families back home. It covers deposit services for households and enterprises, as well as short-term credit facilities for enterprises of all sizes, including trade credit. These basic services are provided by almost every financial system in the world, even the most rudimentary ones, although at different degrees of efficiency. They are mostly provided by banks, but may also be provided by non-bank financial service providers, including telecommunications companies. The recent crisis and the global reduction in the supply of trade finance underline the importance of Finance for Markets.

Finance for Growth relates to the finance for enterprises, households and governments that supports medium- and long-term activities (longer than 12 months). Finance for Growth is finance mainly for investment purposes, and it is here that financial institutions and markets fulfill their key function of the maturity transformation of short-term liquid claims—be they deposits or marketable securities—into long-term investment finance. Finance for Growth thus involves a key function of financial systems: pooling society's savings and putting them to their best use. This comprises risk management techniques and the screening and monitoring of entrepreneurs and projects. It relates to large-scale finance, including for infrastructure and agriculture, and finance for SMEs and to debt and equity instruments, as well as hybrid instruments, such as mezzanine debt and guarantees. These services are provided by an array of institutions, including banks, insurance companies, pension funds, mutual funds, and private equity funds, and relate to activities on different financial markets, including stock and bond markets. Moving from Finance for Markets to Finance for Growth constitutes a major challenge for many low-income and even middle-income countries.

Finance for All relates to the process of expanding financial services both for markets and for growth to the largest possible segment of the population, including households, small enterprises, and large firms. Finance for All overlaps with the concepts of Finance for Markets and Finance for Growth, but refers to the process by which short- and long-term financial services, including payments, savings, credit, and insurance services, are pushed out to previously un-served segments of the population. It overlaps with Finance for Markets to the extent that access to basic transaction services is being extended to all segments of the population. It overlaps with Finance for Growth to the extent that more segments of the population gain access to contractual savings services, while microenterprises gain access to investment finance. In discussing Finance for all, we refer to all types of formal financial institutions, but also semiformal financial institutions such as cooperatives or savings and credit cooperatives. Finance for All has been a challenge throughout the world not only for low-income countries, but also for many middle-income countries that have made substantial progress in the dimensions of Finance for Markets and Finance for Growth.

Source: Beck et al.

What has the recent crisis taught us about the role of finance in the growth process of countries? The Global Financial Crisis of 2007/8 and the ensuing Great Recession have put in doubt the paradigm that financial deepening is good for growth under any circumstance. For students of financial systems, the bright (growth-enhancing) and dark (instability) sides of financial development go hand in hand. The same mechanism through which finance helps growth also makes finance susceptible to shocks and, ultimately, fragility. Specifically, the maturity transformation from short-term savings and deposit facilities into long-term investments is at the core of the positive impact of a financial system on the real economy, but also renders the system susceptible to shocks. The role that finance has as a lubricant for the real economy likewise exacerbates the effect of financial fragility on the real economy. We therefore argue that instead of throwing out the baby with the bathwater, it is important to construct a regulatory and governance framework that minimizes the risk of fragility and provides policy makers with better possibilities for managing bank failures in a way that is incentive-compatible. If there is a lesson to be learned in emerging markets such as Egypt from the crisis, we think it is that the growth benefits of a well-developed financial system can only be reaped in a stable macroeconomic environment protected by an appropriate legal, regulatory and supervisory framework and strong internal bank governance. This implies more transparency and accountability in bank management, less direct government intervention in the regulatory and supervisory process, and a focus on building up mechanisms of market discipline.

FINANCIAL SYSTEM—GROWING FROM A LOW LEVEL

This section uses an array of different data to gauge the development and structure of Egypt's financial system.

The Environment

One approach to assess Egypt's financial system is to gauge the environment in which it operates. Following Honohan and Beck (2007) and Beck et al. (2011), we focus on four characteristics: size, informality, volatility and governance. The small scale of many developing economies does not allow financial service providers to reap scale economies. Compared to other countries in the region and other developing countries, however, Egypt's population and economy has a size that is conducive to sustaining a relatively diversified and competitive financial system. This is also obvious from the variety of markets and institutions that Egypt supports, even though they are not as developed. Unlike most countries in the African continent, Egypt does have relatively well developed capital markets, as we will discuss below. Unlike other small economies, Egypt can create critical mass internally, including the basis for a higher intensity of competition among financial sector providers and an active financial sector dialogue. It is less likely to experience bottlenecks in capacity, and can afford a relatively broad institutional underpinning for financial sector regulation.

The **informality** of large parts of the population increases costs and risks for financial service providers: As in many developing countries, informality in Egypt's enterprise sector is high, at an estimated 37 percent of GDP. Egyptian Labor Market Survey Data for 2006 indicate that over 83 percent of enterprises operate in the informal economy and over 70 percent of private sector wageworkers are engaged in informal activities. This high degree of informality increases costs and risk for financial service providers, as these households and enterprises cannot provide formal documentation and lack access to formal collateral.

Volatility on the individual and aggregate levels increases costs and undermines risk management for financial institutions. On the individual level, informality is related to high volatility of income flows, which brings us back to the issue of informality. On the aggregate level, trade-of-terms shocks and socio-political unrest are the main drivers of volatility. While until recently, the macroeconomic management provided a stable backdrop for financial transactions, Egypt has suffered from irregular bursts of terrorist attacks, which undermined the tourist sector, with negative repercussions for the financial sector. More importantly, the 2011 revolution—while offering large opportunities for financial sector reforms as we will discuss below—has also increased uncertainty. The recent political turmoil in the run-up to the elections has increased the volatility and made the environment for the financial sector more challenging.

Governance problems continue to plague many private and government institutions in Egypt. They affect directly the ability of financial institutions and markets to manage idiosyncratic and systemic risks. The governance challenge and the related agenda contain a large number of dimensions, related to state ownership in both financial and real sector, deficiencies in the legal system, lack of transparency and accountability as well as corruption and graft. The Financial Sector Reform Program discussed above has made significant progress in the governance agenda within the financial system, but the positive effects have been limited by continuing governance challenges in the political area and real sector. The new political situation after the 2011 revolution and the change to a democratically elected government, however, offers a window of opportunity for major reforms.

Financial Sector Reform Program, Phase I (2004–2008)

Beginning in 2004, significant reforms were implemented in the context of a Financial Sector Reform Program that included privatization of one of the four commercial state-owned banks and financial, operational and institutional restructuring of the remaining three government-owned banks. The smallest of the four state banks—Bank of Alexandria—was restructured and sold to Bank Sanpaolo, though plans to divest from a second government-owned bank had to be aborted due to the Global Financial Crisis of 2007/8, reduced demand for banks in developing countries, and political opposition. In addition, the government divested their shares in several joint-venture banks. The banking sector experienced a consolidation process driven by higher minimum capital requirements and by the exit of several weak banks, with the number of banks

dropping from 57 banks in 2004 to 29 in 2010. Bank supervision has undergone significant changes, moving from a compliance-based toward a risk-based system.

As result of the reform program, Egypt's financial system has transformed itself during the past decade, becoming more stable, mostly due to addressing loan losses in state-owned banks, increasing provisioning and capital and the aforementioned increase in minimum capital. The NPL ratio dropped from 18.2 percent in 2006 to 13.6 percent in 2010, while the risk-weighted capital-asset ratio rose from 14.7 percent to 16.3 percent during the same period. The resilience of Egypt's banking system to the global financial crisis reflects the improved personnel and institutional capacity, including risk management and loan procedures, as well as the stronger regulation and supervision of the CBE as well as limited connections with the international financial system.

There has also been progress in the financial infrastructure, most notably through the establishment of the credit bureau I-Score as well as improvements in the payments system. Established in 2005, I-Score functions as a private (majority-owned by banks) but regulated monopoly, collecting both negative and positive information on all bank borrowers. In many aspects, it complies with international best practice as it is open to financial service providers beyond banks, including leasing and finance companies and microfinance NGOs. In payments, the RTGS payments system became operational in 2010 and was extended by making the Automatic Clearing House operational. This reduces the problems of default in payments that have proved very costly in some countries, such as India.

In 2007, Nilex, a second-tier market, was established by the government to offer funding to SMEs by offering relaxed listing rules. Nilex is meant to attract promising companies that cannot comply with the listing rules of the regular market.

Benchmarking Egypt's financial system. Today, Egypt's financial system is relatively large, when compared to most peer countries. A benchmarking exercise shows a financial system corresponding to its level of income per capita and other country characteristics including size, population density and demographic structure. Specifically, Figures 2.3 and 2.4 show the actual and predicted values of two aggregate financial depth indicators, corresponding to the two sides of banks' balance sheets—Bank Deposits to GDP and Private Credit to GDP. The predicted value is the result of a broad cross-country regression exercise that predicts the level of financial depth with (i) GDP per capita and its square, capturing the positive but non-linear relationship between income levels and financial depth, (ii) total population, capturing the scale effect discussed above, (iii) population density to proxy for the easier provision and delivery of financial services in more densely populated countries, and (iv) the age dependency ratio to control for the demographic structure and its impact on savings and thus demand for financial services.¹

Figure 2.3 shows that the level of saving mobilization by the banking system has been higher than predicted by country characteristics, although the gap has been recently closing. We also note that the level of Bank Deposits to GDP has actually decreased over the past years. Figure 2.4 shows that the

actual value of Private Credit to GDP has also been above the predicted value for many years, but has moved below it for 2009, both due to the drop in the actual level of private sector lending as to the increase in the expected value. The progress made in financial sector reform has thus not been reflected yet in aggregate financial sector indicators. While savings mobilization as captured by Bank Deposits to GDP has stagnated, private sector lending actually declined. This can be explained by the fact that banks started building provisions and tightening their procedures and controls in response to regulatory pressures. Notwithstanding this caveat and while quantity is certainly not be equated with quality, the lack of a medium-term increase in Private Credit to GDP following the financial sector reform programs is somewhat disappointing and matches the development of demand-side indicators, as we will discuss below.

Figure 2.3: Actual and Predicted Level of Bank Deposits-to-GDP

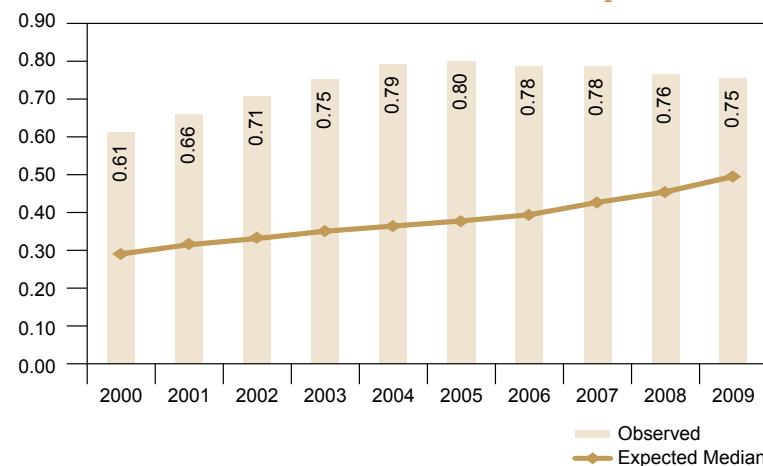
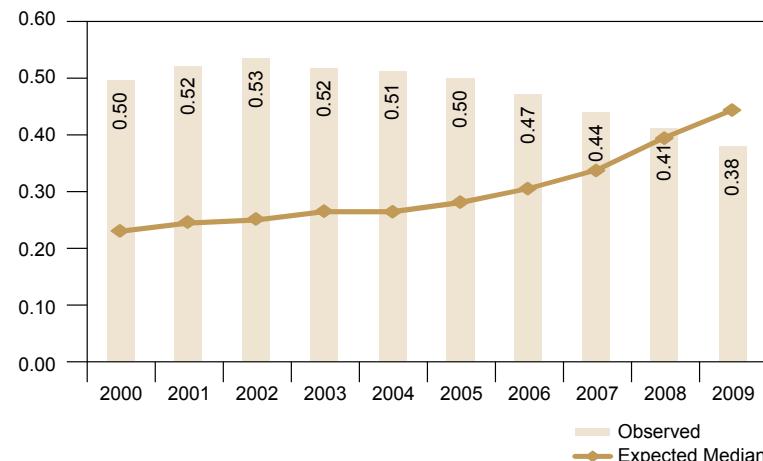


Figure 2.4: Actual and Predicted Level of Private Credit-to-GDP

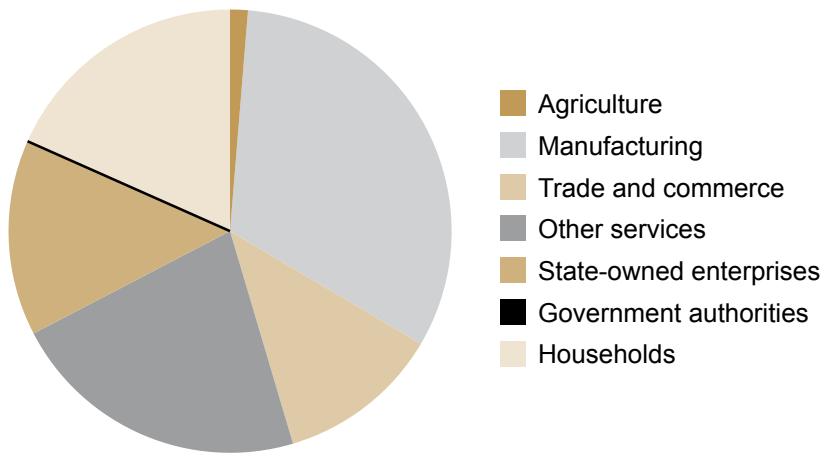


Source: CBE.

Egypt's financial system is bank-based, with banks constituting over 95 percent of the financial system's assets. Even though there are many other institutions, including finance and leasing companies, they are often linked to banks through ownership. This can also be seen in the fact that banks are allowed to own insurance companies, leasing companies and other subsidiaries in the financial sector.

Intermediation efficiency. While Egypt's financial system is relatively large and of the predicted size for its level of income, the loan-deposit ratio is very low at 52.7 percent (as of 2009), evidence of low intermediation efficiency, in spite of high savings mobilization capacity of the banking system. The explanations are numerous. Government's financing needs crowd out credit to the private sector, reflecting the (perceived) lower risk of government securities and the fact that they count towards the 20 percent liquidity requirements. In the process of post-revolution political changes, even higher financing needs from the government can be expected, which will lead to further pressure on banks in terms of providing credit to the private sector. Finally, and as we will discuss in more depth below, credit is concentrated among a few borrowers, with the large majority of the enterprise population being left out.

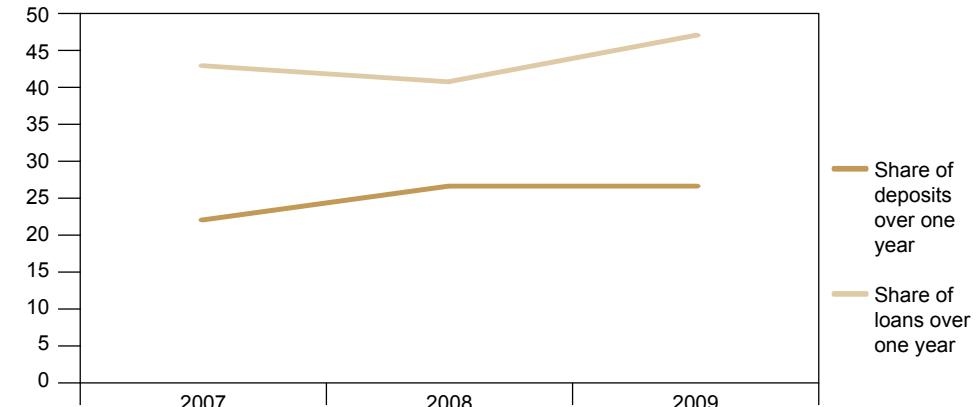
Market structure. The Egyptian banking system shows a concentration ratio of 46 percent for the largest three banks and 56 percent for the largest five banks, which is comparable to other middle-income countries of Egypt's size. As result of the privatization process, the share of state-owned banks has fallen to below 50 percent. However, in terms of physical presence and outreach, the three state-owned banks still constitute more than half of the system. While the system—consistent with its scale—does not seem to have an excessive degree of market concentration, the market structure says relatively little about competitiveness. While there is a lack of data to gauge the degree of contestability and competition within the banking sector, several indicators point to a lack thereof. First, no new bank has been licensed over the past few years and there is an implicit moratorium by CBE on new banks; this reduces the contestability of the market and pressure on incumbent banks. Second, the continuing large share of government-owned banks and the absence of market discipline and lack of exit of failing banks, a topic we will come back to below. There is also little competition from outside the banking system, consistent with the bank-based nature of the Egyptian financial system. Microfinance institutions are restricted by the lack of a proper regulatory framework and the prohibition to take deposits. Lack of competition also characterizes financial markets; for example, participation in government bond auctions is limited to a number of PDs with direct access. On the other hand, recent steps are likely to have helped move the Egyptian system towards more competition, including the introduction of I-Score, but much more remains to be done, as we will discuss below.

Figure 2.5: Sectoral Lending Share of Egypt's banking sector (2009)

Source: CBE.

Sectoral distribution of lending. As of 2009, bank loans to SOEs constituted 16 percent, up from 15 percent in 2007 and 14 percent in 2008. Lending to households has grown to over 20 percent, though most of this has been for consumer lending, with only a small share for mortgage lending, which is contrary to most developed countries in Europe, where often over 50 percent is for mortgage lending. Among private sector firms, the manufacturing sector receives the largest share, with overall 36 percent, while trade, commerce, and other services receive 13 percent and 24 percent, respectively. Given that small enterprises are over-represented in the services sector, including in trade and commerce, this is a first indication that small enterprises have limited access to credit. Estimates by CBE indicate that overall, less than one percent of private sector credit goes to small enterprises.

Maturity structure. There has been an increase in the share of deposits and loans over one year in the past few years, though the ratios of short to medium- and long-term assets and liabilities are still relatively low, when compared with other countries. In Egypt, only 47 percent of loans are for more than one year as are 27 percent of deposits. This compares to Morocco's share of loans over one year of 68.3 percent and 32.1 percent share of deposits over one year. South Africa's share of medium- to long-term loans is 55 percent, although its share of deposits over one year is lower than Egypt's, with only 16.5 percent. Access to long-term finance is limited for both households and enterprises. Mortgage finance constitutes less than one percent of GDP (compared to 14 percent in Morocco), with fewer than 75,000 customers. Deficiencies in the institutional framework (no centralized property registry) as well as regulatory restrictions prevent the emergence of a thriving mortgage market, as discussed in more depth in other parts of this report.

Figure 2.6: Maturity Structure of Egyptian Banks (2007–2009)

Source: CBE.

Outreach. There is very limited physical outreach of the banking sector. Egypt has a branch penetration of 5.6 branches per 100,000 people, compared to an average of 13.8 for the MNA region. This also compares unfavorably with comparator countries, such as Morocco, with 11.6 or South Africa with 8 branches per 100,000 people. On the other hand, not included in these numbers is Egypt Post, which provides basic financial services to over 17 million clients through 3,700 offices across the country.

Looking beyond banking. As discussed earlier, the Egyptian financial system is diversified with many different institutional segments, most of which, however, are not achieving their potential to the maximum with respect to financial system users. While significant progress has been made in strengthening this important segment of the financial system, the NBFI segment continues to play a minor role when one considers the possibilities offered by the scale and development of Egypt's financial system. Take the example of microfinance in Egypt, which has remained limited in size, with only a small portion of the potential market being served. There were only about 1.3 million active microfinance borrowing clients as of end-2008 and market participants estimate that the outreach of the microfinance industry in Egypt covers only 25 percent of the potential borrowers among microenterprises and less than 10 percent of the overall potential borrower population. In addition to several banks having dedicated microfinance operations and two service companies working on behalf of banks, only NGOs can be active in the microfinance area, as the current legislation does not foresee any regulated corporate entity providing such services. This also implies that the NGOs rely completely on donor funding or development bank funding, through the Social Fund for Development (SFD) or government funding to SFD. Yet, the new micro finance law does regulate MFIs and creates a committee to oversee the NGO's with participation of both EFSA and CBE which still remain under the auspicious of ministry of solidarity.

As in the banking sector, there is also a geographic disparity in microfinance penetration. The estimated penetration rates for microfinance, as proxied by the number of microfinance clients as a proportion of the estimated microfinance market, are significantly higher in the Urban Governorates (14.7 percent), and in particular in Cairo, than in the Lower Egypt Governorates (3.5 percent).

Little financing has been made available for enterprises through the primary capital market. Feyen (2010) reports that more than 50 percent of listed firms have a share of freely trading shares in total shares (“free float”) of less than 15 percent, and only 5 percent have free floats exceeding 70 percent. This also explains why the boom in listings and market capitalization was not accompanied by a similar increase in liquidity; the turnover ratio, reaching 47 percent in 2007, is similar to the ratios in other middle-income countries, while market capitalization to GDP is well above the average for middle-income countries. More recently, in 2008, in a move to show preference for quality over quantity, the exchange changed its listing rules. The changes were aimed at strengthening governance and improving disclosure among listed companies to enhance market liquidity. This reduced the number of listed companies to 218, down from 550. Trading statistics significantly improved after these changes were implemented.

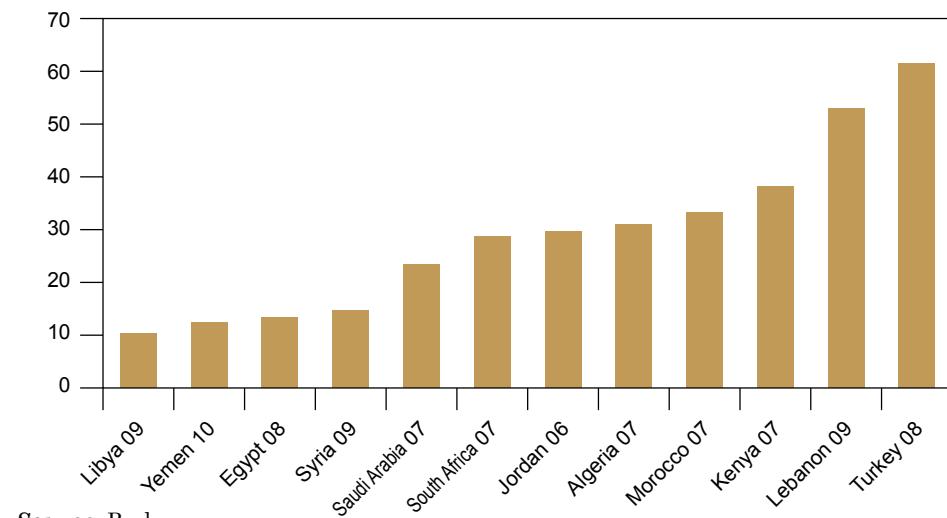
One of the reasons for limited progress in developing capital markets is the absence of a meaningful domestic institutional investor base, which brings us to contractual savings institutions. The insurance sector is still dominated by one large state-owned enterprise, though foreign companies have gained market share. State-owned companies continue to dominate the non-life market, which has made limited progress over the past decade. Strong growth in the life insurance business is related mainly to the strong growth among foreign-owned insurers. Investments of insurance companies and private pension funds are concentrated in government debt and bank deposits. Private pension funds show risk aversion, investing mostly in government bonds and bank deposits, although regulations allow for up to 20 percent investment in equity and up to 20 percent investment in corporate bonds. In the case of private pension funds, this can be explained by the fact that they are mostly managed in-house rather than by professional fund managers, which partly explains their risk-averse investment strategies.

Trading on Nilex, the second-tier board of the stock exchange is mostly by individual investors. The size of the available investments and trades might not be sufficiently attractive for institutional investors, such as insurance companies and private pension funds or their risk aversion might be too high, as already discussed above. It seems that there is also a segment of firms that are considered too big for Nilex, but for which the listing requirements of EGX are too burdensome, such as enterprises with equity between LE 70 million and LE 200 million. So far, companies have not been keen to list on Nilex mostly for demand-side reasons, including the fear of losing control by

complying with enhanced disclosure requirements, limited resources to pay listing fees, and the lack of understanding of the benefits of listing and of the need to pay listing fees.

Limited enterprise access to credit. Up until now, we have used supply-side data to gauge the depth and efficiency of Egypt’s financial system. User data provides a complementary and mostly consistent picture, but also allows us additional insights into demand-side constraints. The Enterprise Surveys—undertaken in over 100 mostly developing countries with a consistent survey instrument—give important insights into the access to and use of financial services by enterprises of different sizes, legal forms and ownership structures. As discussed above, providing credit to enterprises with the most promising investment projects is a critical function of the financial system and ultimately the channel through which it fosters economic growth. In the following, we will use data from the 2008 Enterprise Survey, unless noted otherwise. We compare data for Egypt with both data from countries of the region (North Africa and Middle East) and data from several peer countries outside the region, specifically Kenya, South Africa and Turkey.

Figure 2.7: Enterprise Use of Bank Credit across Countries – Percentage of Firms that have Access to Banks’ Credit

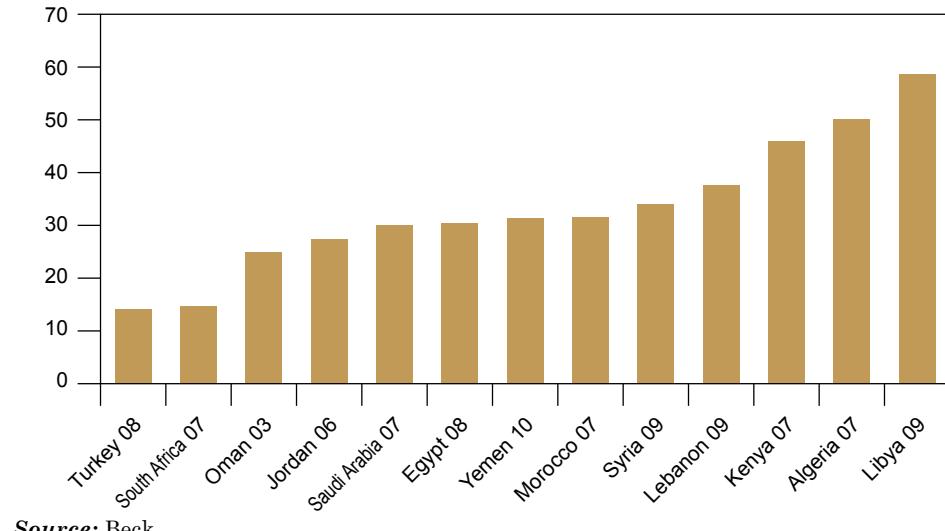


Source: Beck.

Figures 2.7 and 2.8 give a first insight into the access to and use of credit by Egyptian enterprises, comparing it to other countries. We find that a very low portion of enterprises (13.3 percent) reports using bank credit, higher only than Libya and Yemen, with the former being a resource-based economy and thus expected to have a low level of enterprise access to credit (Beck, 2011) and the latter being a country with significantly lower GDP per capita. All other comparator countries, including several resource-based economies in the region have significantly higher shares of enterprises that

use banking credit services. On the other hand, relatively few enterprises report financing as a major obstacle to their operation and growth (Figure 2.8), including compared to several economies that show a much higher share of enterprises with bank credit.

Figure 2.8: Enterprises' Financing Obstacles across Countries – Firms Identifying Access to Finance as a “Major” or “Very Severe” Obstacle



Source: Beck.

Figure 2.9: Financial Depth versus Enterprise Use of Bank Credit

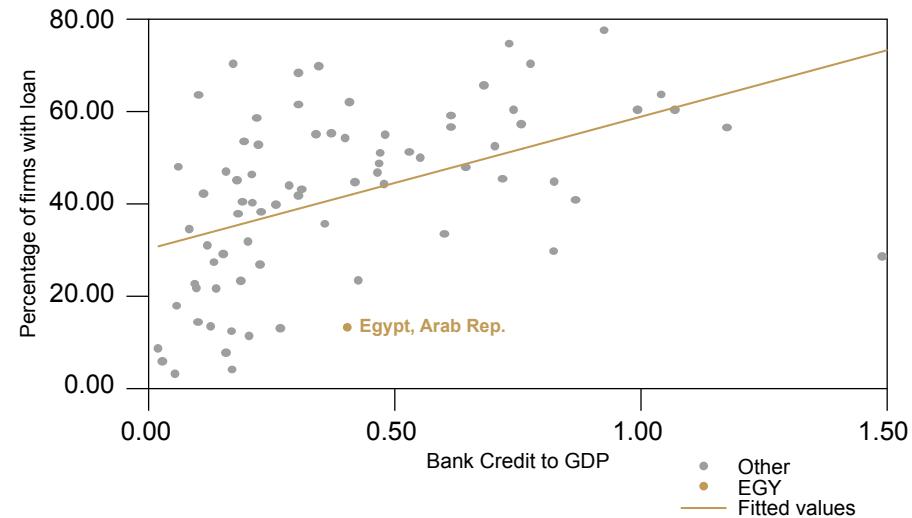
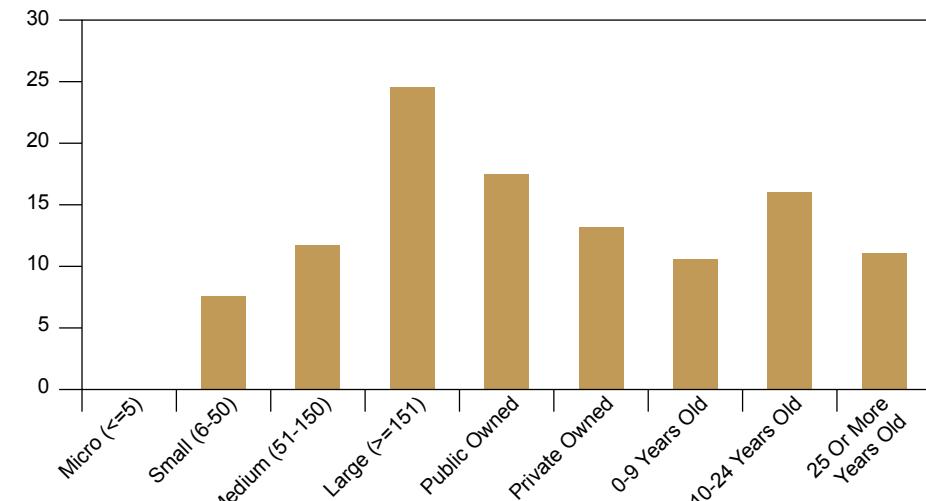


Figure 2.9 shows a positive, though non-linear relationship between the level of Bank Credit to GDP and the share of enterprises that use credit, though there is significant noise in this relationship. Not surprisingly, Egypt

has a much lower share of enterprises that use credit than predicted by the cross-country comparison. Specifically, corresponding to its level of Bank Credit to GDP, more than twice as many enterprises should have access to bank credit, as for example in Cape Verde, which has a similar level of Bank Credit to GDP (42.5 percent). The reason for Egypt being such a big outlier lies in the banking sector focusing historically on mostly corporate lending, based on names or connections, with the large majority of enterprises being excluded from the formal banking sector due to their own lack of formalized stance thus lack of formal documentation and financial statement. This also puts in perspective the high value of Private Credit to GDP documented above and might explain why its growth effect is lower in Egypt than elsewhere (Figure 2.10).

Figure 2.10: Use of Bank Credit across Different Enterprise Types in Egypt – Share of Firms with Bank Credit



Source: Egypt ICA.

The use of bank credit varies significantly across firms of different size, ownership and age (Figure 2.10). Large companies (more than 150 employees) are more than twice as likely to use bank credit as medium-sized enterprises and more than three times as likely as small firms, with none of the surveyed micro/informal firms reporting to use bank credit. Publicly owned enterprises are significantly more likely to use bank credit, while we see a hump-shaped relationship between enterprise age and use of bank credit; the “mid-aged” firms (10 to 24 years of age) are more likely to use bank credit than young or older firms.

Self-reported financing constraints also vary significantly across firms of different size and ownership, though not systematically with age. There is a clear and significant negative correlation between the size of firms and the likelihood of reporting access to finance as a major obstacle to the operation

and growth of the enterprise. Similarly, privately owned enterprises are almost three times as likely to report access to financing as a major obstacle as publicly owned firms.

Figure 2.11: Access to Credit over Time in Egypt - Percentage of Firms Having Access to Banks Credit in Egypt

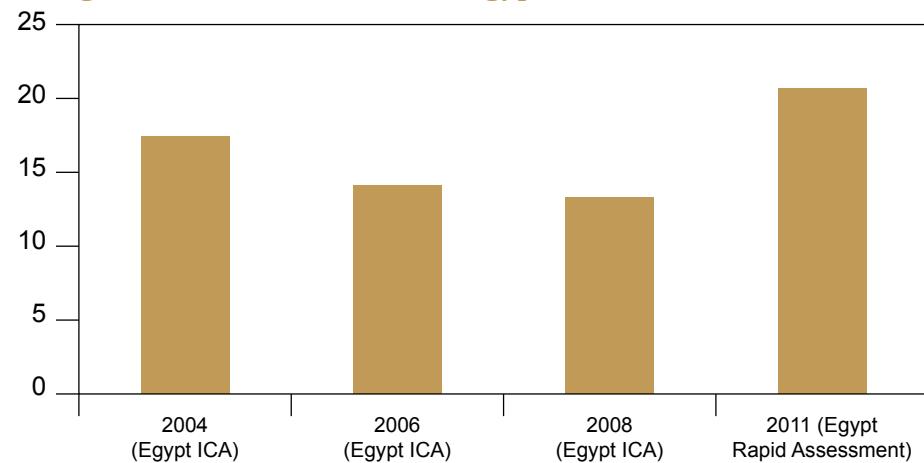
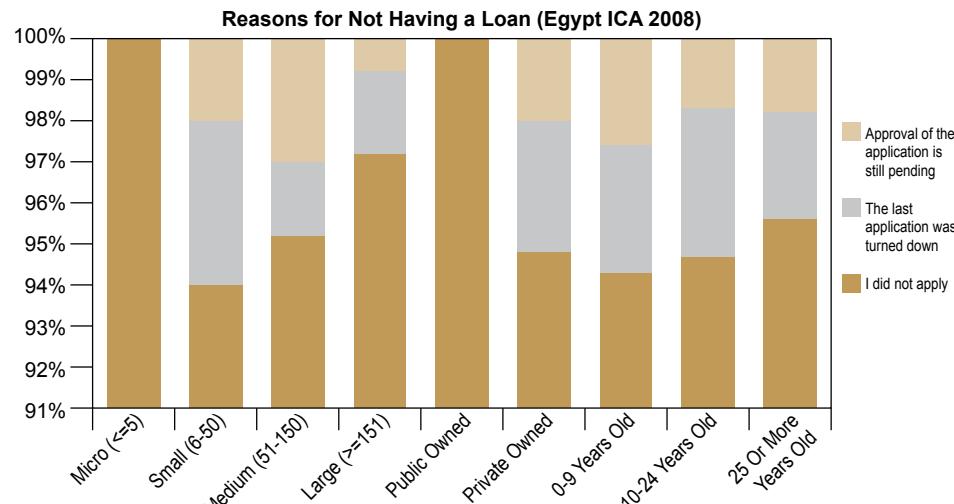


Figure 2.12: Reasons for not having a Loan in Egypt across Different Firm Types



Source: Egypt ICA.

The Enterprise Surveys also provide us insights into the reasons why firms do not use formal bank credit and allow us to distinguish between demand and supply-side constraints. While 95 percent of all Egyptian firms without bank credit did not apply for such, the share is even higher among

larger firms. While the only reason that publicly owned firms do not have a loan is that they did not apply, this holds for less than 95 percent of privately owned enterprises. As enterprises get older, they are less likely to not have a loan because they have not applied for one. It is important to stress, however, that the differences across different firm types are smaller than the graph might suggest; across all firm types, more than 90 percent of enterprises do not have a loan because they have not applied for one and less than five percent because they were rejected.

Given these limited differences, it is actually more interesting to explore why firms did not apply for a loan in the first place. Figure 2.12 and Table 2.1 state the reasons of why Egyptian firms do not apply for credit, the average across developing countries, and several peer countries. Compared to the average across developing countries and in the region, a smaller share of Egyptian firms states the lack of demand as reason for not applying, a difference even larger when comparing with South Africa and Turkey, with Kenya being an outlier in the comparator group.

Table 2.1: Reasons For Not Applying For A Loan or Line of Credit

	Average developing countries	Egypt	Kenya	South Africa	Turkey
Do not need loans	59.3	53.2	41.9	64.7	81.1
Application procedures for bank loans are too burdensome	8	9	11.5	9.8	2.4
Collateral requirements of bank loans are too strict	7.1	4	15.4	3.2	0.8
Interest rates are too high	14.7	12.2	19.9	11.5	7.7
Did not think that it would be approved	3.1	1.8	3.2	5.9	1.6
Size of loan and maturity are insufficient	2.2		2.9	1	1.2
Did not want to deal in interest rates		15.6			
Other	6.9	4.2	5.2	3.8	5.3

Source: Egypt ICA.

A larger share of enterprises indicated that application procedures are more burdensome than in the average developing country and the average across the MENA region, though the share is lower than in Kenya and South Africa. Interest rates are seen as more of an impediment in Egypt than in the

average MENA country and in Turkey, though this percentage is lower than in the average developing country and in Kenya. One striking finding (which cannot be compared across countries) is the high share of enterprises that have not applied for a loan as they do not feel comfortable with conventional, interest-based banking. This segment of the enterprise population certainly constitutes a possible clientele for Islamic Banking.

Overall, it seems that there is a large share of enterprises that do not access bank credit as they do not see a need for it, which points to other non-financial constraints for these firms, relating to lack of market possibilities or other constraints in the business environment. However, a large share of enterprises is discouraged by supply-side constraints in the banking system, which points to structural impediments.

FINANCING EGYPT POST-REVOLUTION—NEW OPPORTUNITIES AND NEW CHALLENGES

As discussed above, Egypt has the potential to significantly deepen and broaden its financial system over the years to come. Such a deepening and broadening might not necessarily become obvious from improved aggregate indicators, but a steeper relationship between these and economic growth and rates of poverty alleviation. This deepening and broadening will have to take the form of a more inclusive financial system, with more enterprises and households having access to a broader variety of services and products. As already discussed, Egypt has the necessary scale to sustain a diversified and competitive financial system. The new political regime post-revolution offers (but does not guarantee) the chance to improve the governance and provide impetus for a more transparent, competitive and ultimately more inclusive financial system. Box 2.2 discusses reform experiences from other countries and lessons learned. This section discusses three main challenges going forward. First, expanding access to a greater share of households and enterprises; second, lengthening financial contracts; and, third, safeguarding the financial system in a more volatile environment, especially if the financial system indeed succeeds in lengthening maturities and expanding access to financial services.

Expanding Access to Financial Services

A discussed above, access to financial services, both credit and non-credit services, is very limited among Egyptian enterprises. While hard quantitative evidence is missing, the share of households with access to adequate financial services is very low. In this context, it is important to look beyond credit services to other services, including savings and payments services. Ideally, the reform agenda in expanding access should move on two levels: expanding access to credit for small and medium-sized enterprises (SMEs) and expanding access to basic transaction and savings services to a larger share of households. Both objectives are consistent with the Finance for All agenda, the first also with the Finance for Growth and the second with the Finance for Markets agenda.

Box 2.2: Reform Experience from Transition Economies and Turkey

The reform process of the transition economies after 1990 provides some interesting lessons for financial reform. Financial sector reform was part of a larger structural transformation of countries from planned towards market-based economies. Most transition countries suffered banking crises in the 1990s, due to cycles of borrowers' repayment problems, previously non-recognized non-performing assets in the banking system that grew, and recapitalization of banks by the government that were subsequently monetized and led to inflation. The escape from these cycles was a hard-budget constraint on enterprises and banks alike, and greater macroeconomic stability. At the same time, the successful reformers privatized their banking systems, mostly to West European banks, simultaneous with a privatization process in the real sector. This broke long-standing relationships between banks and (formerly) SOEs and enabled the entry of new firms. Supporting this process were also wide-ranging institutional reforms, including in the contractual framework, and the establishments of credit registries.

Similarly, the experience of Turkey provides interesting insights for the reform process in Egypt. After the financial crisis of the early 2000s, Turkey adopted a more stable macroeconomic framework, reduced the public sector significantly over 4 years, to less than 1 percent of GDP, borrowed substantially from the IMF and reduced other foreign debt, and aggressively addressed banking sector fragility, by taking over and either closing or restructuring and selling off banks and by substantially strengthening its regulatory and supervisory framework. Specifically, a special resolution framework for banks was established and the banks were forced to increase capital and move rapidly toward Basel II (IMF 2007 Article IV Consultation; IMF, Financial Sector Stability Assessment; and World Bank, Financial Sector Assessment). There was a rapid decrease in the market share of government-owned banks (three large commercial banks effectively remained state-owned) and an increase in share of foreign-owned banks. Critically, there was a simultaneous process of privatization in the real economy. Turkey's recovery took place in an internationally much more benign environment than currently, with low interest rates and foreign banks looking to expand, before the 2008–2009 Global Financial Crisis. However, Turkey's reformed financial system proved resilient to the Global Financial Crisis and avoided a domestic, systemic financial crisis.

Source: Laeven and Valencia.

To achieve both objectives, more competition is needed. As discussed above, the bank-based and segmented nature of the Egyptian financial system undermines competition, with negative repercussions for users. The lack of competition prevents the adoption of new technologies and methodologies to reach out to previously unbanked clients, be it in the form of new products or new delivery channels. It is important to stress that competition does not necessarily have to come from within the banking system or even the financial system. As the example of M-Pesa in Kenya has shown, innovation and competition can come from outside the financial system. Policy makers have an array of levers available to increase competition in the financial system, a topic to be discussed in more depth in the next section.

One area of increased attention over the coming years will be Islamic finance. The first African Islamic Bank was created in the 1960s in Egypt, but little has happened since then, for several socio-economic and political reasons. First, North African countries follow for the most part a less conservative interpretation of the Shari'a, along with a large part of Muslim Asia, compared with the Gulf countries. Second, banks' customers in North Africa have for a long time preferred CB for their transparency and lower costs. A final reason behind this shallow emergence could be found in the political will to avoid any religious tensions or the risk of perception that CB in the system are unlawful if an Islamic Banking is authorized. Today, Islamic finance in Egypt has a market share of around seven percent, both in the form of Islamic Banks and of Islamic branches or windows. The new political regime might provide more possibilities for Shari'a-compliant finance in the future. As discussed above, there seems to be demand for Shari'a-compliant bank finance among enterprises, although it is not obvious that this is the primary constraint for accessing bank credit. At the same time, more resources flowing into Islamic finance, especially from Gulf countries, are looking for a home in Shari'a-compliant institutions.

Another important area will be SME finance. While some innovation has taken place, more is needed. Some of this innovation has taken place in state-owned banks, as the example of Banque Misr has shown, which has targeted the SME segment by allowing lending to SMEs to be conducted in a completely different way relative to corporate lending. This included hiring young graduates as loan officers without the preconceptions of experienced loan officers in terms of risk assessment. More broad-based innovation, with a stronger focus on SME finance, is needed, in both publicly and privately owned financial institutions, supported by the necessary regulatory reforms. Moreover, Banque du Caire is putting more emphasis in his strategic direction on micro finance and National Bank of Egypt is focused on SMEs.

While the focus in the access debate has been on credit services, broadening access to payment and deposit services is as important. As discussed above, the physical penetration of the banking system is limited and anecdotal evidence suggests limited access of households to formal financial services. Recent experiences from other countries, including Brazil, Kenya, the Philippines and South Africa, show the promise of new delivery channels for financial services, such as mobile phone based payment services and agency agreements. In the context of exploring new delivery channels, the use of the Post Office's extensive branch network for financial service provision by other publicly- or privately-owned financial institutions should be explored. Expanding access to financial services will also need a stronger focus on the demand side, including financial literacy and business development services. Efforts on this regard include the formation of a financial literacy committee at the EBI to draft a national strategy for illiteracy with member of the board from CBE, EFSA, ministry of Education, and banks. The lack of proper financial statements constitutes a barrier for many SMEs to access formal bank credit. It would be helpful to develop and propagate the use of simplified financial statement rules for SMEs.

Lengthening Financial Contracts

The availability of long-term financial products is still limited, for both enterprises and households. As discussed above, the Egyptian capital markets still do not play their role sufficiently well as a financing source for corporations. The segment of institutional investors, including insurance companies and private pension funds, is still too small and does not play a meaningful role in the capital markets, being too timid in their long-term investment strategies, as discussed above. The lack of long-term financing possibilities for firms matches the dearth of funding possibilities for working capital, described above. The lack of mortgage finance opportunities—analyzed in more depth in other parts, is a symptom of the lack of long-term savings and credit possibilities for consumers in the formal financial system. Mortgage finance is critical to allow for a more organized urbanization process.

To achieve better access to long-term finance, the development of the non-bank segment of the financial system, especially of capital markets, is critical. Developing capital markets, including derivative markets would also increase the ability of banks and other financial institutions to better manage their maturity risks. Critical in this context is to develop the contractual savings industry further as well as the broader segment of institutional investors. In order to achieve this, governance reforms should top the agenda for this segment of the financial system. The policy agenda in this area comprises two levels, which will be outlined in more depth below. On the one hand, there is the agenda of long-term institution building, while maintaining and improving overall macroeconomic stability. On the other hand, there are more short- to medium-term policy solutions, including the development of risk mitigation tools, such as guarantee schemes and policies to develop capital markets further, such as started with Nilex. Some of these policies are discussed in more depth in other parts of this report.

Safeguarding the Financial System

The on-going economic and political uncertainty poses significant risks for the financial system. The regulatory authorities have played a positive role in securing the stability of the financial system. Going forward, this will be even more important. While the financial system has proved to be resilient during the global financial crisis and also to the political turmoil so far. If the promises of more private sector lending, both to enterprises and households, take place, many banks might need more capital, as private sector lending requires more capital charges than supposedly safer government lending.

Financial stability relies on a balance of supervisory and market discipline. Currently, however, the emphasis in Egypt is excessively on supervisory discipline. The emphasis on supervisory discipline goes hand-in-hand with an implicit government guarantee for all banks, not just government-owned ones. Effectively, no bank has been allowed to fail. This, however, undermines market discipline as well as competition. Going forward, the improved supervisory discipline should therefore be complemented and

balanced with more emphasis on market discipline. As discussed above, financial sector governance reforms also play a critical role in this context. Critical in the context of more market discipline is the introduction of an incentive-compatible resolution framework for failing banks.

Priority Policy Areas and Classification

Having discussed the three priority areas of action, specific policy areas that can help achieve the three goals will now be discussed. To classify the policies to achieve progress along these three dimensions, the concept of a financial depth frontier is introduced (Beck and de la Torre, 2007; IMF 2012). This frontier is the point of the maximum possible commercially viable outreach or depth of the formal financial system given the technology and the macroeconomic and institutional framework (Beck and de la Torre 2007).

The concept of the financial depth frontier builds on the two main barriers that financial institutions and markets face in deepening and broadening: (1) transaction costs and the resulting scale economies of financial services at the level of the user, the institution, and the market and (2) systemic and idiosyncratic risks. Fixed transaction costs in financial service provision result in decreasing unit costs as the number or size of transactions increases. These fixed costs exist at the level of the transaction, client, institution, and even financial system. Processing an individual payment or savings transaction entails costs that are, at least in part, independent of the value of the transaction. Maintaining an account for an individual client also implies costs that are largely independent of the number and size of the transactions the client makes. At the level of a financial institution, fixed costs span a wide range—from the brick-and-mortar branch network to computer systems, legal and accounting services, and security arrangements—and are independent of the number of clients served. Fixed costs also arise at the level of the financial system, including regulatory costs and the costs of payment, clearing, and settlement infrastructure, which are, up to a point, independent of the number of institutions regulated or participating in the payment system. The resulting economies of scale at all levels make it unprofitable to stay in the business of financial service provision unless the associated scale economies are captured in some form.²

In addition to costs, the expansion in the supply of financial services, especially credit and insurance services, is constrained by risks particularly the risk of default. The risks can be either contract specific or systemic. Systemic risk can be defined as risk that is non-diversifiable within a given economy and stems from high macroeconomic uncertainty (reflected in high inflation and exchange rate volatility), weaknesses in the contractual and informational environment, or geographical limitations. As systemic risk increases, it enlarges the set of borrowers and projects that find the cost of credit unaffordable and are thus priced out of the credit market. Similarly, this makes insurance policies unaffordable for larger segments of the population. Idiosyncratic risks are specific to individual borrowers, projects

or policy holders, but their management is influenced by the systemic risk environment. Two factors are particularly important in explaining the differences in idiosyncratic risk: agency problems, stemming from information asymmetries between debtors and creditors, and limits to the possibility of diversifying risks not related to agency problems.

The financial depth frontier is determined by state variables that are either exogenous to the country—such as country size and state of technology, exogenous to the financial sector policy makers—socio-political stability, economic structure—or policy areas that are not subject to short-term changes—including contractual and information frameworks, market development, etc. These State variables provide not only a floor for the costs of financial service provision but also the environment in which financial institutions can manage their risks. Better macroeconomic management allows better risk management, better developed contractual and information institutions reduce the costs of screening and contract enforcement and again allow better risk management. Technology can reduce the costs of financial service provision. Using the concept of State variables allows us to define the financial depth frontier as a rationed equilibrium, that is, the maximum sustainable depth and breadth of a financial system. This frontier is different for savings and payment services, in which the transaction costs are the decisive market friction, and credit and insurance services, in which the risk dimension is an additional important friction. However, the frontier is also determined by demand-side constraints, including voluntary exclusion or exclusion for religious reasons.

The concept of the financial depth frontier allows us to categorize policies according to whether they can move the frontier outwards, move the financial system towards the frontier or prevent an unsustainable equilibrium beyond the frontier to emerge. Following Beck and de la Torre (2007), these policies can also be classified as market-developing (moving out the frontier by developing new markets), market-enabling (moving towards the frontier by exploiting existing opportunities) and market-harnessing (avoiding overshooting) policies. It also gives a timeline for different policies to take effect. While policies to move the frontier outwards will take some time to take effect, policies to move the financial systems towards the frontier are of a more short-term nature. While a move beyond the frontier towards an unsustainable equilibrium seemed an unlikely outcome only a few years ago, more competition, a more open regulatory environment and possibly political pressure will make this a more possible outcome. Finally, the classification of different policies also allows us to distinguish between necessary policies (pushing out the frontier) and sufficient policies (moving towards the frontier). While a broader set of data would be needed to locate the frontier in the case of Egypt, the previous discussion has shown that Egypt's financial system is far from its frontier of possibilities, while there is also significant room for the frontier to move out.³

In the following paragraphs, five areas will be discussed. First, macroeconomic stability is a pre-condition for financial deepening, to sustain

a high frontier and push it further out. Second, institution building in the areas of contractual and information framework and is critical to push out the frontier. To benefit from a wider frontier, however a redefinition of the role of the government is necessary, beyond the substantial reforms of the past years. Similarly, the lack of competition and regulatory constraints prevent the financial system from reaping the benefits offered by new technologies. Finally, a new regulatory approach that gives more space to market-based financial innovation is advocated, while at the same time helping to foster greater market discipline. It is important to stress that the further deepening and broadening of the financial system can only take place in the context of a stable, but open political environment. A stable political environment will also be critical in terms of attracting urgently needed foreign capital flows, both directly but also through the banking system.

Macro and Socio-Economic Stability

A sound and effective financial system depends critically on the macroeconomic environment in which it operates, as the current Euro crisis has shown again. Maintaining fiscal discipline will be crucial in the coming months and years, as public pressure on fiscal policy will increase, partly due to the democratization of the political process. However, it will be more than ever critical to reduce crowding out effects on the banking systems and in bond markets and thus give sufficient space for private sector lending.

It is important, however, to understand that a stable macro-environment—i.e., a low and stable inflation rate, a sustainable fiscal position and stable exchange rate—is a necessary, though far from sufficient condition for further financial deepening and broadening. Macroeconomic stability determines the location of the financial depth frontier; however, it does not determine the location of the financial system with respect to the frontier. Egypt had achieved a certain degree of macro- and socio-economic stability over the past decade or so, without having been able to reap the benefits in terms of a deeper and more inclusive financial system.

Institution Building

Building the institutional framework for financial institutions and markets to function effectively is the quintessential market-developing policy area. Such reforms address deficiencies in the State variables that keep the frontier too low. On the one hand, important reforms have been implemented over the past years, which earned Egypt the title “Doing Business Reformer of the Year” on several occasions. Most notably, the establishment of I-Score, the privately owned and managed credit bureau, constitutes an enormous improvement in the informational framework as already discussed above. Anecdotal evidence suggests that the introduction of economic courts has also been helpful.

Nevertheless, further reforms, are urgently needed as a basis for enabling more long-term finance and expanding the universe of bankable entrepreneurs. Specifically, the lack of a centralized property register holds back the mortgage

market; currently, mortgages are registered with a local notary public, which does not allow for checking claims on a national basis. There is no legal and institutional framework for movable collateral. Further, the insolvency regime is ineffective, focusing exclusively on liquidation rather than allowing for restructuring of viable enterprises, which undermines its effective use. Many of these reform needs are discussed in other parts of this report.

Reforms of the contractual and information frameworks will help push the frontier out, they will enable the creation of new or the deepening of existing market segments—such as mortgage finance, derivative markets etc.—and thus provide possibilities to deepen the market. As in the case of macroeconomic stability, however, these measures are necessary but not sufficient conditions for deepening and broadening the financial system. This will require additional policies that will be discussed next.

Redefining the Role Of Government

The Financial Sector Reform Program has significantly contributed to a redefinition of government’s role in the financial system by substantially reducing the ownership share of government in banking. It is important however, that this progress be not reversed under current political pressure in the political transition process. It is important to understand that a private-sector led financial system is critical for its positive impact on economic growth, notwithstanding an important role for government, a topic to be discussed shortly. Such a private-sector led financial system, however, has to function within a competitive environment and within a regulatory framework providing the right incentives for sound risk decisions. This has critical repercussion for corporate governance and the relationship between market participants (including banks) and supervisory authorities. The failure over the past years has not been so much in shifting towards private ownership but falling short in the governance agenda, lack of competition and failure to properly redefine the relationship between market participants and authorities.

Beyond the significant reforms under the Financial Sector Reform Program over the past years, there is thus a need to redefine the role of government in financial markets along two dimensions. First, a further reduction in direct government involvement on the retail level through government-owned commercial and development banks, and, second, a redefinition of the relationship between market participants and supervisory authorities.

Consider first, direct government involvement in the financial system. While the long-term objective should be that of a privately led financial system, the short- to medium-term objectives should be to minimize government interference in the commercial operations of government-owned financial institutions. This implies pushing forward with the restructuring of the three remaining commercial banks in state ownership as well as redefining the role of the development banks and restructuring these institutions accordingly.

There is a need to strengthen governance in three major government-owned banks even further to isolate them from any government influence, which will most likely increase in the coming years. Potential issues are raised by the chairing of the general assemblies of state-owned banks by the Governor of the CBE. Beyond the government-owned banks, this would also imply eliminating the conflicts of interest in the CBE Board and Bank Supervision Department. The chairmen of two active commercial banks have been appointed to the CBE Board as representatives of the Ministry of Finance and Ministry of Planning and Foreign Trade, while CBE acts at the same time as regulator of these institutions. In addition, the access of these board members to confidential information on other banks creates a potential conflict of interest. In more general terms, a level playing field between banks of different ownership and of different sizes has to be ensured.

Given popular opposition, alternatives to the privatization of government-owned banks should be explored, including management contracts. Examples from Sub-Saharan Africa — such as the National Microfinance Bank in Tanzania—have shown that such an approach can be useful. Under a management contract, a private firm assumes the overall responsibility for the operation and maintenance of a service delivery system and retains the freedom to make day-to-day management decisions. In the context of further restructuring of government-owned financial institutions, it is critical to come up with a clear ownership policy that defines objectives and role of government authorities in government-owned financial institutions. This ownership policy should be published and should not be subject to frequent change. An interesting option, also applied successfully in several Latin American countries was to move away from offering retail services, through specialized DFIs, towards a wholesale model, such as through the Social Fund for Development. In more general terms, it is important that the government undertake a holistic review of the sector and, for each institution and program, explore and define (i) mandate, (ii) different options, and (iii) funding of subsidies. If the government considers subsidies in the financial sector necessary, then such programs should be made available for both private and state-owned financial institutions to the same extent, to thus create a level playing field.

As important as addressing the governance issues in public-sector banks and leveling the playing field between public and private financial institutions is to redefine the relationship between private market participants and supervisory authorities. This would imply adjusting the regulatory framework for privately owned banks, with the goal of balancing supervisory and market discipline, where the emphasis is currently completely on the former. Specifically, the regulatory approach is currently one of guidance of market participants. Two examples include the branch regulation policy although it takes into account branches expansion in remote areas outside greater Cairo and Alexandria and the lack of a bank resolution framework, yet it is evident that any bank wishing to exit the market is free to do so (ex.

Exist of French banks in 2013) the exit of weak banks is subject to other resolution techniques such as mergers acquisitions with the purpose to safeguard the clients' deposits. This regulatory and supervisory approach is best understood on the background of several decades of financial repressions with heavy-handed regulatory involvement. The further rebalancing of supervisory and market discipline is thus as much an issue of attitude as it is an issue of specific regulations. Redefining the relationship between market participants and supervisory authorities has benefits both in terms of market-enabling and market-harnessing policies. It can help foster the necessary innovation (partly through more competition as discussed below) and help increase financial stability by strengthening market discipline and fostering more adequate risk decisions.

While a reduced role of the government in retail provision of financial services is advocated, there are other ways that the public sector can help move the financial system towards the frontier beyond macroeconomic stability and institution building. One of these market-enabling policies is to provide risk mitigation tools, such as credit guarantees, which can help overcome market frictions, including the lack of collateral by many SMEs and mitigate liquidity and maturity risks. As so often, the devil is in the detail of pricing, funding, and institutional structure. The important assessment criteria for credit guarantee schemes are additionality and sustainability; how credit-worthy borrowers, who never accessed a loan, could be included because of a given or potential scheme, not only requires an assessment of the additionality effect itself, but also an assessment of the credit-worthiness of those additional borrowers. The other important criterion is financial sustainability. The design of the scheme can be critical for reaching these two goals.

Competition and Innovation

Redefining government's role is still on the more general policy level, but is not an objective per se. Rather, defining the relative roles of public and private sectors ultimately has the goal of ensuring competitive and sustainable financial markets. Competition is critical for setting incentives for financial institutions to maximize the exploitation of the possibilities created by a conductive macroeconomic environment and technology and thus push the financial system towards the frontier. However, this entails a sophisticated approach that has to balance the need for innovation and the need to reduce the risks of fragility. Competition has been shown to be critical for deepening and broadening the financial system, but can also have negative repercussions for stability if coupled with a weak regulatory framework. In this context, it is important to understand that market structure is not the same as competition; even concentrated banking systems can be highly competitive if there is a level playing field among several strong players, contestability achieved with the threat of entry, and competition from players outside of the sector. On the other hand, a dispersed banking system of niche banks typically shows a low degree of competition.

There is an implicit de facto moratorium on new bank licenses as evidenced by the fact that since 2006 no new bank has obtained a license. Egypt seems to be lacking a clear policy concerning new bank entry, be it domestic or foreign players. The background for this seems to be the consolidation process of recent years, which led to the exit of several weak banks and the emergence of overall larger—and better capitalized - banks. To ensure the necessary competitive pressure, opening the banking sector for new players is critical. In addition to allowing new entry, there are other means to encourage competition between incumbent institutions and thus deepen and broaden the financial system. In terms of access to markets—and as noted in other parts of this book—the playing field across banks is not level, with only some banks being PDs for government banks, while others having only indirect access. Using the franchise value and the network coverage of the Post Office for outreach purposes can increase significantly access to banking services, as the example of Brazil has shown.

Fostering competition implies looking beyond the banking system. As noted in several previous instances, the non-bank component is extremely underdeveloped. One segment that can complement the banking system as well as provide competition is the microfinance segment. Currently limited to the NGO model, new legislation foresees them taking corporate form and being supervised by EFSA. However, they would still be limited to credit services. In the medium-term, it might be advisable to allow sound microfinance institutions to start collecting deposits—a move that would imply supervision by CBE rather than EFSA. Alternatively, one could think of a separate regulatory form, such as micro-deposit taking institutions, such as in Uganda.

Innovation for the financial system can also come from outside the financial system, such as from telecom companies providing mobile payment services. It is important for regulators to focus on the specific financial services offered or proposed, not the nature of the institution providing or aiming to provide the services. This view encourages the unbundling of financial services across banks and nonbank actors. As long as the risk of consumer abuse is adequately guarded against, different actors should be encouraged or at least not discouraged from providing narrowly defined services. This could include deposit collection services by non-financial corporations, including supermarkets and others, working with banks in the form of agency agreements, or payment services offered by telecomm companies.

Competition can also be fostered by broadening the use of financial infrastructure. For example, it is important to encourage the use of credit information by microfinance institutions, if necessary with a subsidy on the costs. Another important policy tool to foster competition is through transparency, by, for example, starting with publishing more information about banks. The decision by CBE to begin disclosing and making public on its website the consolidated banking sector financial statements and related indicators is a welcome first step. Other areas where more transparency and disclosure can help relate to account-related fees and conditions for customers.

Regulatory Framework That Balances Stability And Access to Finance Concerns

The role of competition to push the financial system towards the frontier and the necessary changes in the role of government that this implies has already been discussed. In the following final sub-section, the focus is specifically on regulatory policies that can help push the financial system towards the frontier, while at the same time preventing it from moving beyond the frontier. Some of these policies will also have an impact on competition.

Looking at the specific affirmative regulatory policies that have the goal to move the financial system towards the frontier, the Egyptian authorities have introduced an exemption from reserve requirements for the amount that banks lend to SMEs. Rather than having exemptions or regulatory “subsidies” for SME lending, it would be better to have a regulatory framework that is flexible towards lending to different client groups. Regulations more conducive to fostering SME lending would be to allow for more flexibility in terms of which asset classes can be used as collateral in terms of loan provisioning rules. Similarly, relaxing the rule that all corporate borrowers (including SMEs) have to have audited financial statements can help expand the bankable share of enterprises.

Another important area for regulatory reform in the coming years will be on Shari'a-compliant finance. As discussed above, there is most likely more latent demand for Islamic financial products. It is important that the regulatory authorities keep an open mind about this. In this context, it might be important to introduce the necessary infrastructure for Islamic products, including a Shari'a-compliant discount window. However, it might also require careful risk-based supervisory monitoring. There are also areas where there is regulatory overreach, such as the branch requirements that seem rather burdensome, including the requirement that banks need a certain capital to open a new branch and have to submit a business plan. Similarly, a less restrictive approach in terms of permitting new products can be conducive for the necessary financial innovation to deepen and broaden Egypt's financial system to the benefit of many users.

Regulatory policies that allow for more innovation and focus less on prohibition should be accompanied by a stronger focus on accountability and market discipline; this should include encouraging more banks to list on the stock exchange, and to obtain a credit rating from international credit rating agencies, as well as establishing an incentive-compatible bank resolution framework that allows for the failure of banks without disrupting the remaining financial system and the economy at large. Ongoing governance reforms for commercial banks, including the forthcoming Corporate Governance Code for the banking sector and including governance criteria in the supervision process are welcome developments in this context.

CONCLUDING REMARKS

Financial deepening is pro-growth and pro-poverty reduction, as shown by a substantial amount of empirical evidence over the last 20 years.

In mobilizing deposits, Egypt has done somewhat better than comparators. However, its intermediation of deposits into credit to the private sector—a key factor in allocating savings well and increasing growth and employment has not been as good. Private sector credit has grown even more slowly than deposits in the last few years. This lack of financial intermediation reflects crowding out of banks' credit to the private sector by government borrowing to finance its deficit and to replace the government debt that foreigners have sold off recently. This lack of intermediation limits credit to micro, small, medium and large private enterprises. The funding of enterprises is also limited by a capital market that is not particularly large (although it includes an exchange for small enterprises), and the lack of micro financial institutions. Egypt has done better in increasing the resiliency of the financial system; it avoided a systemic crisis that would have reduced GDP during the global financial crisis that began in 2008 and in the aftermath of the January 2011 revolution, so far. It also has done well recently in developing financial infrastructure, for example a credit information bureau (I-Score) that improves lending decisions, a safe and secure payments system that can handle low value transactions, payments cards that permit over 2 million government employees and retirees to receive payments through ATMs, and licensing of 2 mobile payments networks.

As discussed, a number of actions would improve the functioning of the financial system, increasing its size, increasing its funding of the private sector and providing financial services—Finance for Growth, Finance for Markets, and Finance for All. These begin with greater macroeconomic financial stability to make more funds available for the private sector. Macroeconomic stability—low inflation and lower government deficits consistent with the growth of the financial sector and manageable inflows—macroeconomic stability is a necessary but not a sufficient condition for financial deepening, faster growth, and faster reduction in poverty. Other actions include continued attention to financial stability by the CBE, in particular a stronger early warning and prompt corrective action framework with a legal system for bank intervention and resolution. At the same time, actions could be taken to reduce regulations that limit access to financial services and competition, such as limits on ATMs and bank branching. Strengthening the PBDAC would take advantage of its large branch network to provide increased financial services and increased competition, particularly in the rural areas; consideration should also be given to enhancement of the capacity of the Egypt Post in these areas. Competition with banks and increased access could also be improved by a non-bank financial intermediary law that strengthens the role of micro-finance institutions, advancing the use of the licenses for mobile banking, and by improving credit information in I-Score to cover micro-borrowers. Finally, although Egypt has the longest experience of Islamic finance, there are still many obstacles facing Islamic finance. The most important is the lack of rules and regulations governing Islamic Banking up until now.

ENDNOTES

- 1 For more detail, see Beck et al. (2008).
- 2 See Beck and de la Torre (2007) for a more detailed discussion.
- 3 Such data would include high-quality firm- and household-level survey data on the access to and use of financial services plus detailed data on geographic and contractual barriers to access the financial system.

3. THE DEVELOPMENT OF THE CAPITAL MARKETS

EQUITY MARKETS

National economic development is a critical objective of all governments. In countries with market-based economies, a well-functioning capital market is viewed as an essential component of a national economy. Capital markets are a tool to enable companies and entrepreneurs to raise investment capital to develop and expand businesses. They are a price discovery tool, to enable investors and companies to determine the market value of a company and its stock. The process of “going public” is one effective exit strategy that enables early investors to sell their interests for a profit to other investors. By providing an “exit strategy” vehicle, capital markets make early stage investing more attractive, and more available. Capital markets are also essential for retail and institutional investors that are interested in expanding and diversifying their investment portfolio and, in the process, obtaining a higher return on investment. Governments that have substantial ownership interests in the national economy can use capital markets to privatize these assets through an open, fair and transparent process, which can maximize the sales price and reduce the potential for corruption or cronyism.

The equity market witnessed several phases since its reinvigoration in the early 1990s. The first phase was associated with the Economic Reform and Structural Adjustment Program implemented by the government with the assistance of the IMF in the early 1990s that led to the reinvigoration of the dormant equity markets via floating several SOEs through the stock market, ratifying the Capital Market Law 95 of 1992. The second phase was a

stagnation period that commenced with the South East-Asian financial crisis in 1997 that was associated with the implementation of several measures, such as imposing a price band of ±5 percent for traded stocks, which were not reversed until 2002. The third phase was associated with the implementation of Phase I (2004–2008) of the Financial Sector Reform Program mentioned earlier. The equity markets reforms pertinent to Phase I, aimed at improving the regulatory framework governing the equity market in Egypt in addition to activating the secondary market via partially floating SOEs, and introducing several measures, *inter alia*, margin trading, intra-day trading, establishing a special trading market (listing schedule) for SMEs, activating the Settlement Guarantee Fund (SGF) and establishing the Investor Protection Fund (IPF).

The Revolution of 2011 has had a deleterious impact on Egypt's economy, and negatively affected the implementation of Phase II (2009 - 2012) of the Financial Sector Reform Program for the capital markets. Furthermore, economic growth has declined. A significant decline in capital inflows has put pressure on national currency reserves and the value of the Egyptian pound. The national credit rating has been downgraded, as has the credit rating of major Egyptian banks. Several highly publicized lawsuits have challenged the legitimacy of the former government's privatization program. The EGX closed for eight weeks in 2011 and it has yet to fully recover. At this point in time, it is uncertain whether Egypt will continue the initiatives of the past decade or pursue a different approach to economic growth. This section describes the capital markets of Egypt and the developmental efforts of the past decade. Recommendations are included on how to use the foundation laid in the past decade to build a robust capital market in Egypt.

Overview of the Egyptian Equity Market

The Egyptian Exchange (EGX). The Egyptian Exchange is the oldest stock exchange in the MENA region. The EGX was created by the consolidation of the Cairo Stock Exchange (founded in 1903) and the Alexandria Stock Exchange (founded in 1883) by the Law 123 of 2008 amending the Capital Market Law 95 of 1992. The combined exchanges were the fifth largest in the world in the 1940s. After a dormant period from 1961–1992, the exchanges were revived as part of a national privatization program.

The EGX has an ambiguous legal status. It is wholly owned by the Egyptian government and has an independent status but it is not a corporation. It is governed by Presidential Decree 191 of 2009 and subject to regulatory oversight by EFSA. A Board of Directors (minimum five and maximum nine members) governs the EGX. The Chairman and Vice Chairman of EGX are appointed by the Prime Minister; the remaining members are selected by member firms (brokerage firms, asset management firms, banks) and listed companies. In 2014 a presidential decree amended the EGX charter, adding to its board two independent directors.

Market capitalization in the EGX rose from LE 172 billion at the end of 2003 to a peak of LE 768 billion in 2007 (Table 3.1). This represented

an increase from 30 percent to 107 percent of GDP. At the end of 2010, the total market capitalization was LE 488 billion, approximately 40 percent of Egyptian GDP. During its boom period, 2006–2008, the market cap of the EGX compared favorably to stock exchanges in other emerging market countries. Following the global financial crisis of 2008, the EGX has not recovered as well as other emerging market exchanges. In 2010, its market cap to GDP ratio ranked sixth of the seven exchanges in this sample.

Table 3.1: Stock Market Capitalization as a Percentage of GDP

	2010	2011	2012	2013
Market Capitalization per end of year in billion EGP	488.2	293.6	375.6	426.8

Source: EGX.

While the total trading volume on the EGX has grown over the decade, the value of shares traded has reflected rises and falls in the market. Total shares traded grew from 5.3 billion shares in 2005 to a peak of 36.6 billion shares in 2009. It dropped slightly to 33.4 billion shares in 2010. The value of this trading volume also grew from LE 160.6 billion in 2005 to a peak of LE 529.6 billion in 2008 when the market rise crested. The value of shares traded declined since this peak, to LE 448.2 billion in 2009, and then to LE 321.4 billion in 2010.

As of 2010, there were 212 listed companies on EGX, a decline from 435 in 2007 and 744 in 2005 (Table 3.2). The decline was part of the reform efforts of the EGX to enforce EGX listing standards, to delist dormant and family held companies with negligible if no trading activity. The EGX has pursued a program to encourage private companies to undertake an initial public offering (IPO) and list on the EGX. In 2010, there were three IPOs (Table 3.3). In addition to IPOs, the EGX gained 16 new listings in 2010 totaling LE 1.9 billion and 6 new listings totaling LE 3.3 billion in 2009. Once again, Egypt lags other emerging markets in the number of IPOs.

Table 3.2: Number of Listed Companies

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Egypt, Arab Rep.	1,110	1,148	967	792	744	603	435	373	305	211
<i>Selected Peers</i>										
Indonesia	316	331	333	331	335	344	383	396	398	420
Philippines	232	235	234	233	235	238	242	244	246	251
Saudi Arabia	76	68	70	73	77	86	111	127	127	146
Thailand	385	398	421	464	504	518	475	476	535	541
Turkey	310	288	284	296	302	314	319	284	315	337
Vietnam	-	-	22	26	33	102	121	171	188	164

Source: World Bank FINSTAT database.

The EGX is dominated by trading in a small number of equities, the largest company, Orascom Construction Industries (OCI), before its

delisting used to represent over 12 percent of total market cap. The ten largest companies equal over 44 percent of total market cap and account for almost 46 percent of total trading value. In 2010, the 30 largest companies (EGX30) represented 53 percent of the total market capitalization and accounted for 68 percent of the total trading volume and 63 percent of the total value of shares traded. This level of market concentration in the largest companies is typical of stock exchanges in emerging markets. Ideally, the level of concentration declines over time, as the market matures, new companies are listed and listed companies grow in size. Since 2008, the EGX has experienced an increase in concentration while all of the countries in the sample group, except Saudi Arabia, have experienced some level of decline in market concentration.

Table 3.3: Number of Initial Public Offerings

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Egypt	2	2	3	0	3		2	1	

Source: EGX and Bloomberg.

The limited amount of free-float stock continues to hamper EGX liquidity and development. It has been reported that more than 50 percent of all listed companies have free floats of less than 15 percent, and only 5 percent have free floats exceeding 70 percent. While there is no clearly defined “best practice” standard for the appropriate minimum free float, it is common for exchanges to require a free float of 25 percent or 30 percent to ensure broad based share ownership and sufficient liquidity. The current listing, delisting and disclosure requirements require a minimum free float of 5 percent. Despite that, the EGX deems this figure insufficient for liquidity development, the negative repercussions associated with increasing this ratio in terms of the expected delisting remains a deterring factor for the EGX and ELSA’s board to increase this percentage.

Egypt lags behind other emerging markets in the annual turnover ratio of listed company stock. This reflects the low free float in most Egyptian stocks. The turnover ratio of the EGX is the second lowest of the comparison group and substantially below Turkey, Vietnam and Thailand. Only the Philippines exchange is lower than Egypt (Table 3.4). The EGX is largely a momentum-driven market with a high degree of price synchronicity and a low level of effective price discovery. The World Bank Flagship Report on the MENA Region attributed this region-wide phenomenon to “the lack of a diversified private institutional investor base combined with a large number of uninformed small individual investors, a few high net worth (HNW) individual investors, and large state investors all of which raise questions about the quality of price discovery. While liquidity indicators seem reasonable, there is also evidence that MENA equity markets have a high degree of price synchronicity, suggesting that the quality of price discovery may be deficient.”

Table 3.4: Stock Market Turnover Ratios

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Egypt, Arab Rep.	14.7	10.1	12.3	17.1	43.0	54.8	45.6	61.9	60.1	43.0
<i>Selected Peers</i>										
Indonesia	38.8	49.2	34.9	43.1	54.2	44.3	64.4	71.3	83.3	48.1
Philippines	9.3	7.7	8.4	14.0	20.1	20.7	34.1	22.2	26.0	22.6
Saudi Arabia	31.7	48.2	137	204	232	288	162	138	119	60.5
Thailand	109	115	115	91.7	73.9	75.8	64.2	78.2	112	105
Turkey	133	174	195	177	155	141	135	119	141.7	158.4
Vietnam	-	-	-	31.2	24.8	22.4	87.9	28.8	43.2	141

Source: World Bank FINSTAT database.

NILEX trading was initially conducted through a one-hour daily auction. Member firms may submit customer bid and ask prices throughout the trading session. Trades are executed at a closing price that enables the highest volume of shares to be traded. Trading on Nilex is mostly by individual investors. The small size of the companies and limited liquidity in the market, combined with the inherent risks of smaller companies likely contributes to the lack of institutional investor interest. Currently, the NILEX trading is conducted through a continuous trading auction similar to the main market of EGX for four hours per day.

EGX also provides facilities for OTC trading. There are nearly 1400 companies that may be traded OTC. OTC trading occurs twice weekly in 90-minute sessions for the “orders” market and 30 minutes for the “deals” market. The orders market is an open trading process with orders executed on a price and time priority basis. The deals market is an execution publication process for negotiated bilateral transactions not exceeding LE 20 million. The value and volume of OTC trading has declined sharply in recent years, with total share value dropping from LE 115 billion in 2009 to LE 15 billion in 2013. Over the same period, share volume traded declined from 8 billion to 1.7 billion shares. OTC trading accounted for 9 percent of total market value traded in 2013, down from 26 percent in 2009. It is worthy of mention that EGX is considered the registrar for all non-listed joint stock companies shares related transactions. This implies that all transactions that incorporate transfer of ownership needs to be conducted through the EGX as per the Capital Market Law.

The EGX offers a narrow range of securities products. In addition to the listed company equities there are a small number of other securities traded, including 3 closed end funds and 1 Egyptian depository receipt (EDR) in Orascom Development Holding (listed in Switzerland). The EGX does not provide trading in options, futures or other derivatives. While the EGX does not have any index-based products or exchange-traded funds (ETFs), these products are traded in other markets. For example, several different index products based on the EGX30 are traded in Milan, Luxembourg, Frankfurt and Stuttgart. In addition, Van Eck

Global launched in 2010 an ETF based on 25 companies that are either listed on the EGX or generating at least 50 percent of company revenues in Egypt.

The EGX is interested in developing additional investment products, such as exchange-traded funds (ETFs). Ministerial Decree 294 of 2007 created a regulatory framework for ETFs and several brokerage firms are interested in creating an ETF based on one of the many EGX market indices. Final approval by EFSA is required. Several proposed regulatory requirements pending EFSA's approval have delayed final action, including a requirement that the ETF originator must guarantee a high correlation ratio (90 percent) between the ETF price and the underlying index, a requirement that there must be a minimum of two market makers who can originate ETF shares by creating pools of underlying stocks.

The Egyptian regulatory structure includes a number of regulatory principles designed to reduce market volatility. Stocks traded on the EGX are subject to daily price limits. 179 of the 212 listed companies on EGX are subject to a ±10 percent daily price limit. The remaining smallest-capitalization thinly traded stocks are subject to a ±5 percent daily price limit. Additionally, stocks traded with the ±10 percent price limit are subject to a circuit break whereby trading halts for thirty minutes if the stock price change exceeds ±5 percent. Licensed market intermediaries (stockbrokers) are prohibited from engaging in proprietary trading, although affiliated entities under the same parent company, may engage in proprietary trading with the appropriate license from EFSA. Intra-day trading (buy and sell in the same day) is permitted only for actively traded eligible stocks, and during periods of general volatility, it has been prohibited. Brokers may provide margin lending only for actively traded eligible stocks (this may be evaded in practice). While market volatility must always be a regulatory concern in emerging markets, the consequences of adopting rules to limit volatility is often a reduction in market efficiency, effective price discovery and market liquidity. Oftentimes these restrictions serve only to discourage potential investors and exacerbate market volatility. In situations of general economic uncertainty, investors may prematurely leave a market for fear that regulatory interference in market trading will make it difficult to sell at a later date.

Equity Market Intermediaries

The market intermediary sector in Egypt is small and concentrated. As of June 2013 (latest available data), 211 firms were members of the EGX and licensed by EFSA. The 30 largest firms accounted for more than 80 percent of EGX traded value in 2010. Intermediaries may be wholly owned subsidiaries of banks or other financial services companies, including foreign banks. Brokers rely upon commission fees and margin loans for revenue. EFSA permits margin lending for the purchase of liquid eligible stocks. Currently 83 EGX stocks are eligible collateral for margin loans. Clients interested in borrowing from brokers to purchase non-marginable stock are frequently

provided with "overdraft" protection by brokers. Some brokers apparently provide overdraft protection for an extended basis to favored clients. In addition to violating EFSA limits on margin lending, it may create significant risks for other clients, as the cash used to purchase the securities may be withdrawn from the omnibus account for client funds.

Investors in the Equity Market

Egypt's capital market is dependent on retail investors. In 2013, retail investors accounted for 48 percent of the total value traded, a decline from 63 percent in 2009. The dominant position of retail investors in the EGX has been a long-term phenomenon. Retail investors represented over 51 percent of the market in 2000.

Table 3.5: Mutual Fund Assets *(Percent of GDP)*

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Egypt, Arab Rep.	1.0	-	-	0.8	2.0	5.5	-	-	4.6	-
<i>Selected Peers</i>										
Indonesia	-	-	-	4.5	-	-	-	-	-	-
Philippines	0.3	0.6	0.9	1.0	1.4	1.3	1.4	0.7	0.9	1.1
Saudi Arabia	7.3	6.9	6.7	6.4	11.6	6.3	7.3	4.2	6.4	5.8
Thailand	1.5	10.2	14.3	12.6	15.6	17.5	18.8	16.1	21.6	-
Turkey	2.0	2.7	4.4	4.4	4.5	2.9	3.1	2.5	3.1	2.8
Vietnam	-	-	-	-	-	0.2	-	-	-	-

Source: World Bank FINSTAT database.

There were 91 mutual funds in Egypt as of February 2014, including 5 closed end funds. These funds are managed by 21 fund managers (44 fund managers are licensed). The mutual fund sector has grown steadily over the past decade (Table 3.5). In 2001 there were 22 local mutual funds with total assets under management of LE 3.9 billion, managed by nine fund management firms. There were 68 funds in December 2009 and 49 in December 2008.

Mutual funds are not significant investors in equities. The largest mutual funds are money-market type funds that invest in short-term debt or finance instruments. These funds control 90 percent of all mutual fund assets under management (AUM) in Egypt. This is a high allocation of assets compared with other countries in the MENA region—for example Saudi Arabia 73 percent, Morocco 31 percent and Kuwait 15 percent. Several offshore funds managed by Egyptian fund managers are significant investors in Egyptian capital markets. EFG-Hermes, the largest fund manager in Egypt (US\$ 5.3 billion assets under management in 2009) operates two off-shore funds.

The current regulations for mutual funds state that the fund originator cannot issue new stocks/certificates more than fifty times the paid-in seed capital, which in turn should not be less than LE 5 million. If the subscription

period expires without full coverage of the offered investment certificates, the fund may modify the amount being raised to be equal to the value of the subscription provided it is not less than fifty percent of the total value of the issued certificates. In such a case, all documentation of the Fund shall be amended accordingly. If subscription applications to certificates exceed the number of offered investment certificates, the fund may adjust the amount to be invested to incorporate the surplus in applications. If this adjustment causes an increase above the amount mentioned above, appropriation will be made among subscribers each in proportion to his subscription. Fractions resulting from allocation process shall be rounded up in favor of small subscribers.

The executive regulations of the Capital Market Law impose diversification requirements on fund investments. A fund may not invest more than 10 percent of its assets in a single company, including related affiliates. Also, a fund cannot own more than 15 percent of the total shares issued by one company. A fund may not invest more than 20 percent of its assets in another mutual fund or own more than 5 percent of another mutual fund. Investments in other funds, except money market mutual funds (MMMF), must be in unaffiliated funds. A fund may not invest more than 20 percent of its assets in an affiliated company or in the debt (including commercial paper and short-term notes) of any one company. Funds are not permitted to engage in short selling or buying on margin. Funds may not trade with affiliates of the fund originator or fund manager. Finally, funds may not invest in an entity where it would have unlimited liability. ESFA issued in April 2014 specific regulations for Real Estate Investment Funds, mandating a minimum of 70% of the assets to be revenue generating, a ceiling of 30% to be invested in one single project, in addition to defining the areas such funds can invest in.

Mutual funds are required to keep an unspecified amount of the fund assets liquid to satisfy anticipated redemptions. If the liquid funds are not sufficient to meet redemption requests, a fund may borrow up to 10 percent of fund assets for a maximum of one year, with Board approval. Other institutional investors, such as pension funds and insurance companies, are not significant investors in the Egyptian equity market. Many factors partially explain this limited role. Pension funds lack professional third party management requirements, and are significantly underfunded. Investments of insurance companies and private pension funds are concentrated in government debt and bank deposits, although regulations allow for up to 20 percent investment in equity and up to 20 percent investment in corporate bonds.

Efforts to develop a venture capital / private equity (VC/PE) sector in Egypt have had mixed results. As of 2010 (last figures available) there were 19 licensed venture capital firms. Several major private equity firms, including EFG-Hermes and Citadel Capital are major presences in the Egyptian capital markets. Ideally, these firms should be early entry investors in first stage companies, providing investment funding and management

expertise. If successful, these companies should later become candidates for a public offering and EGX listing, with the offering and listing providing an exit strategy for the VC/PE investors. To date the impact of these firms on the development of the capital market has been limited. In 2011, an OECD study found that ambiguities in the regulatory framework had resulted in a number of entities registering as VC/PE to obtain beneficial tax treatment. The same study concluded that the current EGX/OTC market failed to provide an efficient exit strategy.

Recommendations for Equity Market Development

The Benefits of a Strong Equity Market

National economic development requires a system to effectively mobilize and allocate investment capital. Capital markets develop as one component of national economic development. An effective capital market strategy cannot be built in isolation, or independently, from the other components of a modern market-based economy. While banks are an essential component of this financial intermediation function, NBFIs working through sound capital markets provide an alternative to traditional banks. A vibrant and well-capitalized NBFIs can be an important complement to the banking sector. It can provide short-term financing at a lower cost than banks. NBFIs can facilitate large-scale investment financing for longer terms than a bank and at fixed rates. Equity financing enables corporations to attract investment without the immediate obligation to pay interest on the investment. An efficient and active secondary equity market plays a pivotal role in the efficient asset allocation in any economy. It enables investors to share and diversify the risk in an efficient manner, improves the price discovery process for equities, and enables investors to rely upon this market for an exit from their investments.

Critical Pre-Conditions for Successful Development

The effectiveness of a capital market development strategy will be dependent upon overall macro-economic conditions in the country. Egypt's future fiscal and monetary policies will have a substantial impact. Governmental borrowing can crowd out the private sector's efforts to raise funds, from bank lending, from the sale of equities and the issuance of corporate debt. The interest rate on sovereign debt is the baseline for pricing private sector securities. As the private sector has a greater risk profile, it must offer a higher return than government securities. If the government's borrowing needs continually consume the bulk of the available investment capital and if the interest rate on sovereign debt is so high that companies cannot pay a higher cost of capital, it is unlikely that any capital market strategy will be successful. Similarly, the stability of a country's currency will have a profound impact on foreign investors. An unstable currency, that poses a high risk of exchange rate decline, is a significant investment risk for foreign investors.

In order for Egypt's private sector to expand, the government must address the problem of "crowding out". A macro-financial issue of concern is the potential "crowding-out" of credit to the private sector by government borrowing. As the government deficit grows, public sector borrowing will consume available bank lending to the private sector. In 2010, a World Bank document noted a sharp decline in the already falling ratio of bank's loans to deposits, from 55.9 percent at the end of 2008 to 51 percent at the end of 2009 and 48.5 percent at the end of 2010. While the limited growth of credit to the private sector in 2009 and 2010 was mainly due to the post-2008 economic situation, since 2011, government borrowing is a significant macroeconomic issue that will undermine any effort at private sector capital market development. Credit allocated from the banking sector to the government-to-total credit has been rising to reach 62 percent of total credit, while that to the private sector credit dropped to 28 percent as of April 2013.

An effective legal system, in which contractual agreements are honored, is essential to capital market development. Investors must be confident that their investments will be honored in any legal proceeding. In this regard, the legal actions in 2011 to rescind privatization deals that occurred years, and even decades, before will be a substantial impediment to future efforts to privatize SOEs. This is particularly significant if the rescission efforts are brought against successor owners of a company, who purchased an ownership interest in good faith negotiations from the persons involved in the original disputed transaction. While governmental corruption and cronyism can have pervasive and deleterious consequences on national economic development, the proper recourse is through criminal prosecution of the culpable individuals and not through rescission of valid commercial agreements with successor bona fide third parties who had no involvement in the questioned transaction.

Tailoring the Strategy to Egypt

An effective capital market strategy should be built upon and tailored to reflect the economy of the country, its investment base and its culture and history. There is not a single capital market's development strategy that is applicable to every emerging market country. The specific characteristics of each country are different. In Egypt, the government has traditionally played a dominant role in economic development and in the allocation of finance. Historically, government ownership or government participation in the largest companies and in startup companies or developing industries has been significant; government ownership continues to be a defining characteristic of the economy in Egypt.

After a decade of efforts at privatization, the government continues to be a significant owner in companies listed on the EGX, and in many of the major financial services companies. This pattern must be carefully addressed in a comprehensive capital market strategy. The continued ownership of large or controlling interests in privatized companies is reflected in the

limited free float of major public companies. The lack of sufficient free float in companies on the EGX adversely affects the overall turnover rate on the EGX, lower than all but one of the comparison countries. This adversely affects the overall development of the EGX as a viable secondary market. It also adversely restricts or hampers efforts to develop an institutional investor base in Egypt. Simply put, pension funds, insurance companies, and mutual funds that would like to increase their allocation of assets to the equity market are hampered by the lack of available shares in the "blue chip" investment grade stocks.

The limited availability of investment financing sources to the private sector has been a long-standing problem. In a 2010 report, the OECD estimated that only roughly 3 percent of businesses access capital markets. The EGX to date has not provided an effective alternative source of capital. Little financing has been made available for enterprises through the primary capital market. Even during its high point, there were few IPOs on the EGX, less than in other comparison developing market countries. As discussed elsewhere in this report, the private debt market in Egypt is even less developed than the equity market. While the availability of bank lending is greater, it has been concentrated in short-term lending to the larger corporations.

A three-prong development strategy is proposed. Expanding the functionality and capacity of the EGX is the first prong. Building a robust institutional investor base to increase the supply of investment capital and the demand for equity securities is the second component of this strategy. Finally, the third prong focuses on growing the number of public listed companies on the EGX through three complementary initiatives.

Building the Capacity of the EGX

The EGX has a narrow range of securities products and few ways of engaging in profitable investing. There are no exchange-traded funds. The EGX does not have derivatives products and there are no standardized equity options. The EGX operates with a number of prudential rules that are intended to reduce trading volatility but also reduce market liquidity and efficiency. These rules include limitations on intra-day trading, limitations on margin trading in some stocks, a prohibition on short selling, price limits and trading halts. The statutory prohibition on brokers engaging in proprietary trading, although likely ineffectual, also adversely affects market efficiency and liquidity. These limitations are common in new, undeveloped markets. Reducing market volatility is also a common regulatory priority in new markets. However these types of restrictions should be viewed as temporary and transitory. If a secondary market is going to develop into an effective vehicle for price discovery and investment opportunities, it must evolve and its rules must, over time, balance the risks of volatility with the benefits of market liquidity.

Regulatory policies designed to reduce market volatility can have the unintended consequence of contributing to market volatility. As a

consequence of this combination of factors, the only profitable investment strategy available on the EGX is “long-only” momentum investing. While a rising stock market is always desired, a stock market that is structurally biased to the long-side inevitably becomes a volatile momentum-driven market that rises too far and too fast. When stocks become overvalued, they drop dramatically. Well-regulated short selling is an effective method of counteracting excessive momentum-driven market runs. The participation of proprietary trading by intermediaries can offset the “irrational optimism” of retail investors.

EFSA should strongly support EGX efforts to expand and diversify available traded instruments such as ETFs and EGX efforts to develop broad-based index futures and standardized single stock options products. There are a multitude of financial derivatives products, with very different purposes, very different risk characteristics and very different levels of complexity and leverage. In the early stages of capital market development, a conservative approach to derivatives trading is the norm. This is understandable, as derivatives, with their inherent complexity and leverage, can be perceived as contributing to market volatility and instability. However, as markets develop and mature and market professionals and institutional investors become more sophisticated the benefits of derivatives products can outweigh the deleterious consequences. It is a recognized phenomenon that the trading of derivatives in a sound regulatory environment in which suitable risk management measures are in place helps to smooth significant volatility swings.

Interest rate derivative products provide benefits to the banking sector by providing tools to manage overall bank risk and to reduce a bank's exposure to sudden changes in interest rates. Futures contracts based upon broad market indices can be useful tools for institutional investor portfolio managers. Most importantly, when derivative products are standardized for trading on an exchange, there is a reduction in market opacity and the risks inherent in trading non-standard derivative contracts OTC. While it is not recommended that EFSA and the EGX immediately permit any and all securities products to be traded, the development of the EGX would be facilitated by an incremental plan to trade some forms of derivatives and other products. A useful first step would be to develop broad-based index futures and standardized options on individual stocks. These can contribute to effective price discovery and market efficiency. A transparent plan and timetable to expand the products offered and to expand the types of trading offered is an important first step in market development.

EFSA and the EGX restored intra-day trading on May 2013. While short-selling is often viewed as contributing to market volatility and on occasion used to facilitate market fraud, in reality well regulated short-selling typically improves market liquidity and price discovery and reduces volatility. When markets prohibit short-selling, they create a structural bias to upward price movements. Simply put, without short-selling investors can only make money when a market goes up. This structural bias encourages

market momentum trading strategies in which investors buy stocks as soon as the price rises. Inevitably, this can lead to overpriced stocks, which then drop precipitously as soon as the buying momentum decreases. This sharp upward and downward movement is an example of undesirable market volatility. Frequently the retail investors who are late to buy and late to sell suffer the greatest harm. Well-regulated short-selling, in which persons can profit by selling when price momentum is going up and then buying when stocks are falling provide an effective counterweight to momentum buying and selling. By modulating these sharp up and down movements, they improve price discovery and reduce volatility. Intra-day trading, when it is carefully regulated, can also improve market liquidity and price discovery. The Egyptian regulatory strategy of limiting intra-day trading to the most liquid securities, by controlling the quantity of shares in one company that one investor can purchase intra-day, and by increasing the capital requirements for firms whose clients trade intra-day is a sound strategy.

The Capital Market Law prohibition on proprietary trading by licensed brokers should be relaxed. One of the core principles of stock exchanges is the concept of price discovery. By bringing together all buyers and sellers and permitting them to submit and disclose prices to buy and sell a security, the market becomes an engine to discover the best price for that security. The more buyers and sellers in the market, the better the price discovery function works. Similarly, if there are a greater number of knowledgeable investors willing to provide short-term and consistent market liquidity, price discovery is improved and price volatility, due to a short-term imbalance between buyers and sellers, is reduced. Brokerage firms trading in their own proprietary accounts can play an important role in this process. Conversely, if brokerage firm trading is not carefully supervised, firms can take advantage of their superior access to market information, particularly to information on trade imbalances and on upcoming trades by large players. For this reason, the Capital Market Law prohibits brokerage firms from engaging in proprietary trading.

Unfortunately, the prohibition is ineffective and counterproductive. It does not apply to firm trading that is conducted by an affiliated, but separately created, company that is under the common control of the firm's holding company. All of the major brokerage firms in Egypt operate as licensed subsidiaries of a holding company that controls a separate entity, typically called a private investment company or venture capital firm that actively trades for proprietary accounts. This structure makes it difficult to effectively regulate and monitor trading that is the functional equivalent of a proprietary trading account at a brokerage firm. It also means that this trading is not incorporated into the capital adequacy calculations for the licensed brokerage firm. A better approach to this problem would be to permit proprietary trading through the licensed brokerage firm where it could be monitored more effectively. Improved transparency of industry practices would also improve public confidence in market integrity.

EFSA should have the regulatory authority to license brokerage firms without consideration of “market need” and to revoke brokerage licenses. The number of licensed brokerage firms in Egypt has remained largely constant for a decade. Because a small number of firms dominates the industry, many brokers are barely functioning or dormant. Because of this excess capacity, EFSA has been reluctant to license new firms, because the licensing decision requires consideration of “market need” for more firms. Because it is difficult for new entrants to obtain a license, new firms must instead purchase an existing license from a dormant licensed firm. These firms retain their licenses even if inactive because EFSA lacks the authority to revoke licenses because of inactivity. This is an example of unintended and unwarranted regulatory benefits conferred on firms. A more effective approach would be to revoke licenses for firms that no longer are active and then award licenses to new entrants without regard to “market need”. An effective open capital market should be based upon success leading to benefits and failure leading to consequences. Firms that fail should not benefit from having once received a license.

EGX problems of limited free float and low liquidity and turnover could be ameliorated by an orderly, transparent and disciplined government sale of some portion of its shares in companies that are publicly listed on the EGX. This would provide a stimulus to the EGX. The resulting increase in the number of available shares of the “blue chip” Egyptian companies would also assist in the growth of an institutional investor sector in Egypt. In Egypt, the government has historically played a pivotal role in economic growth. Given how engrained this role is in Egypt, it would be unrealistic to abandon it entirely. However, the government must recognize that the benefits of its role in the economic development of specific companies will likely decline over time as the company grows and becomes well established. This is the basis for the privatization efforts of the previous decade, as well as the various public-private partnership projects that have been undertaken. While there have been some well publicized instances in which a privatization program has resulted in preferential contracts or ownership transfers, these occasions should be recognized as failures of execution rather than a fundamental flaw in the privatization process.

Building a Robust Institutional Investor Base

During the past decade, domestic individual investors played a dominant role fueling EGX growth. A strong pool of retail investors is an important component of a growing equity market. However, it may not be the optimal “buy-side” for long-term market development. Individual investors often do not provide investing sophistication, critical to price discovery. They are frequently momentum investors who invest in a rising market and sell when a market falls. The relatively low level of efficient price discovery in Egypt is likely a consequence of the dominance of retail investors.

A successful equity market requires a deep and diverse pool of investors with different risk capacities and time horizons. This pool of investors should include individuals, institutional investors and professional traders. It should include investors with long-term investment horizons and investors with short-term

investment objectives focusing on active trading. Professional intermediaries who provide daily liquidity are also vital. Foreign investors, who bring sizeable amounts of capital and investing sophistication, are typically important participants in emerging markets. The absence of a meaningful domestic institutional investor base has been a significant constraint on EGX development.

A robust institutional investor sector should include pension funds, insurance companies, large professional investment pools and mutual funds. Life insurance companies and pension funds are financial intermediaries with long investment horizons who can provide long-term investments and professional market sophistication to an equity market. As professional managers control existing pools of assets, they can be early entrants into a developing equity market. Mutual funds can also perform a similar and complementary role. However, mutual funds must first build an investor base of individuals and this frequently occurs only after a stock market has begun to grow. As such, they will typically become significant participants in an equity market at a later stage of development than pension funds and insurers.

Egypt’s regulatory system can be a useful tool in building the institutional investor sector. In Egypt, the appropriate regulatory agencies should review their prudential guidelines on asset allocation to ensure that insurance companies and pension plans allocate an appropriate portion of their assets to equities. This approach would be highly beneficial to equity market development and it would be consistent with international best practices for the regulation of insurance companies and pension plans. In the same vein, the legal proposals to require pension plans to retain professional investment managers and permit the use of pooled investment vehicles, would also achieve both objectives—market development and effective regulation of these institutional investors.

Parliamentary action to adopt the proposed amendments to the private benefit plans Law 54 of 1975 should be a high priority. The existing law is out of date and there are significant gaps in regulatory coverage. EFSA authority should encompass all private pension and benefit plans, not just those in which employees contribute. Private funds should be required to have internal oversight boards, and fund accounts should be externally audited annually. Pension fund officers, directors and asset managers should be required to have sufficient professional qualifications and appropriate fiduciary standards should apply. EFSA should have full licensing authority, including application of a fit and proper standard. Funds should be permitted and encouraged to outsource asset management to independent third parties. Funds should be required to disclose publicly the fund’s expense ratios, and provide clear explanations of fund benefits, including risks and uncertainties.

Increasing the Number of Listed Companies

Stock markets are not the exclusive vehicle for providing companies with access to investment capital. It is one of several options. A private company seeking investment funding can also obtain it from bank lending, from

government loans or investments, from strategic private investors, including other companies, VC/PE firms, foreign companies and banks and through mergers with other companies. The decision to engage in a public offering of equities is based on whether this provides the most attractive source of funding. When a stock market is at an early stage of development, valuations on that market may be low, resulting in a high cost of capital. The costs of public listing, including greater disclosure burdens and other legal requirements may also weigh against public listing. An increase in the number of public listed companies may not be the initial catalyst for stock market development. Instead, it may be a consequence of successful market development.

Frequently development efforts to build equity markets in emerging countries focus efforts on development of a special small-cap market for the smallest and least seasoned companies. The Alternative Investment Market (AIM) in London is the best-known example. In fact, AIM is the model used by EGX for its NILEX platform. To date the success of this model is uncertain. The instances of companies that migrated successfully from AIM to the LSE have been few. The valuation of companies on AIM has been low and the trading liquidity has been disappointing. This pattern has been repeated in other countries, large and small. NILEX has, to date, followed this pattern.

Egypt should emphasize the importance of growing its PE/VC industry. An alternative model emphasizes the use of venture capital/ private equity as the initial provider of investment capital and managerial expertise to small promising companies. First stage companies may be too speculative for public investors and too small to be of interest to institutional investors. The fixed costs of being a public listed company may be too great and too burdensome for first stage companies. VC/PE can be more effective sources of investment capital. In this model, the listing and IPO should be viewed as the goal for the second stage of growth, after the company has become viable and has grown to a sufficient size. The companies that succeed and grow following private investment can go public through an IPO. The IPO provides the exit strategy for VC/PE, and given the availability of a relatively mature exchange-based market such as EGX, opportunities exist that many less mature markets cannot offer. The investing public benefits from being able to invest in a larger company with a track record of performance and a clearer understanding of further investment potential.

Egypt should renew its commitment to public-private partnership development initiatives. The private-public partnership model is the analogous first stage for companies that are government-owned. The government is able to continue to maintain an ownership interest and the company gains access to private sources of investment capital and business expertise. The successful completion of the PPP can transition into government divestiture through a transparent public offering process that avoids the taint of corruption or cronyism. Following January 2011, several PPP projects are in limbo due to government uncertainty over the merits of the projects, and possibly because of concerns over the terms of the project. These projects could be vital to

stimulating the Egyptian economy. The government should carefully review the merits of projects and the terms of the relevant project. Going forward on the most important and most attractive PPPs would not only provide a stimulus to the Egyptian economy at a time when it is most needed. It would also be an important signal to foreign investors that Egypt should continue to be viewed as an attractive emerging market country, as it has been for the past decade.

Completion of the reorganization and privatization of the state-owned insurers should be a priority. EFSA has taken the important intermediate steps of reorganizing and separating the life and non-life programs. Rationalizing the premiums for MTPL insurance was also a necessary and important step. The critical next step will be to complete the privatization program through IPOs. In addition to improving the overall insurance services sector, this will also result in adding two large new companies to EGX.

Future government privatization efforts should be conducted through public offerings via the EGX. In countries where the government plays a key strategic or dominant role, the creation of a government exit strategy is often a critical missing piece of the puzzle. In many countries, the process for government exit, via privatization or sale, can be distorted by corruption or cronyism. The lack of a well-developed and disciplined government exit strategy can result in a government retaining an ownership interest for years or decades, well beyond the period of development. One of the benefits of a functioning, transparent secondary market, is its use as a vehicle for a governmental “exit strategy”. Instead of engaging in a private, negotiated deal to privatize government ownership, which can create the perception of corruption or cronyism, a government can sell its interest via an equity offering on a stock exchange. The market will set the fair price, and all investors can participate equally.

A deeper and more liquid EGX will provide share valuations that incentivize private companies to go public. Greater institutional investor demand, combined with a more robust NBFI sector will, if successful, promote higher share prices. It will raise price/equity ratios and make listing more attractive. This will attract larger established companies who have not been interested in public listings at the low prices historically on the EGX. To that end, the new listing rules issued by EFSA on February 1st, 2014 allowed a wider range of companies to be listed, extending to newly established ones and those not meeting the 5% return on capital requirements. Such exceptions are conditional to proving credibility of the founders and providing additional disclosures including an independent financial advisor report addressing the future prospects of the company and its valuation.

The Importance of Investor Protection Regulation to Equity Market Development

An effective equity market must be deep, liquid and efficient. Moreover, it must be fair. An effective regulatory program must encompass a wide array of duties. The chapter on NBFI regulation in this report discusses the areas

where EFSA should build its capacity. Several of the recommendations in that chapter are intrinsically related to the developmental strategy described in this chapter. They are summarized below.

Mutual fund sales materials and sales practices should be comprehensively and consistently regulated. EFSA does not directly regulate mutual fund sales practices and personnel. EFSA does not review fund sales materials, other than the prospectus. Mutual funds should be required to make NAV publicly available on an Internet site daily. Funds should be required to send investors updated disclosure on fund performance, investment strategies and information on fund holdings on a regular basis, at least annually but preferably semi-annually or quarterly.

EFSA and CBE should develop a uniform procedure for regulation of mutual fund sales practices by bank employees. While the Capital Market Law executive regulations impose suitability or “know your customer” requirement on fund sales personnel who work for a mutual fund or brokerage firm, CBE has not adopted a parallel requirement for bank employees who sell mutual funds. Because banks actively sell mutual funds they originate through their extensive branch networks, this regulatory inconsistency should be addressed.

FIXED INCOME MARKETS¹

Introduction

Starting in 2004, the government embarked on implementing the home grown Phase I (2004–2008) of the financial sector reform program. The program was designed along four main pillars: (i) introducing a comprehensive and transparent Monetary Policy Framework; (ii) improving the functioning of the Foreign Exchange Market; (iii) implementing Banking Sector Reform; and (iv) strengthening the Non-Bank Financial Sector, including the equity, fixed income, insurance, financial leasing and mortgage finance markets

Relevant progress was achieved in fixed income markets, particularly in the organization of a reliable primary market for government debt, capital market regulations, and the development of an active and promising mutual fund industry based on money market mutual funds. This is in addition to the significant progress in setting the entire regulatory framework for securitization and issuing asset-backed and mortgage backed securities.

Phase (II) of the reform plan was designed for the 2009–2012 period that had a stronger focus on capital markets. Reforms in government debt markets were taken to a level that placed Egypt in a position to attract greater international investor interest as well as implementing a series of important changes in the non-government fixed income market. The government yield curve was lengthened to 7-years on a sustainable basis, a comprehensive OTC secondary market architecture was designed, yet not implemented, and several regulations to reduce the regulatory burden on non-government

fixed income markets and to support mutual funds were enacted. While the January 2011 revolution temporarily put some of these reforms on hold, little if any regression appears to have occurred.

In spite of the above-mentioned efforts, liquid secondary markets remain absent in government debt and the corporate bond market is still underdeveloped and nascent when compared to the banking sector and equity markets as a source of funding. This can be explained by the existence of structural factors related to excess liquidity and bank dominance as a source of funding for the government and non-government fixed income markets. One additional reason is the fact that debt market development reforms are processes that develop gradually over time and the sustained effort required was partially interrupted by the revolution. This section takes into account the most significant achievements in government and non-government fixed income markets accomplished during the two phases of the Financial Sector Reform Program (2004–2008 and 2009–2012) and proposes a series of priorities and specific recommendations to reinforce ongoing reforms.

Money Markets

Well-functioning money markets are essential for the development of both government and non-government fixed income markets. Not only do they enable issuers and investors to manage liquidity more efficiently, but they also lower liquidity risk and the cost of inventory holdings through repo markets. The latter are essential to support lengthening of the yield curve and liquidity, including market-making mechanisms. Money markets are also central to effective monetary policy through the use of indirect instruments. Central Banks have a dual responsibility in developing efficient money markets. The first is effective liquidity management schemes through accurate liquidity forecasting and timely and effective liquidity draining or injection operations. This includes a careful choice of monetary policy instruments that are supportive of money market efficiency.

Liquidity management may prove challenging in economies with chronic excess liquidity due to high sterilization costs, inaccuracy of liquidity forecasts by other government institutions and the need to coordinate closely with the Ministry of Finance’s issuance policy. The second is the development of an operational framework conducive to facilitating money market transactions. This includes efficient clearing and settlement arrangements, price dissemination mechanisms and robust and tax neutral repo frameworks. Egypt’s money markets are relatively shallow as a result of the combined effects of chronic excess liquidity related to past capital inflows, and a still developing money market operational framework. Most transactions take place between the Central Bank and banks in the form of overnight deposits, auctioned short-term non-tradable deposits at the Central Bank to drain liquidity and auctioned short-term repos to inject liquidity² (Table 3.9). The evolution of the CBE’s liquidity management instruments and the operational money market framework as well as suggested improvements is described below.

Table 3.6: Monetary Policy Instruments in Egypt

Instrument	Features	Launch date
Reserve requirement	Currently 10 percent of local currency deposits excluding CDs 3 years and above, unremunerated	Launched in 1957
Overnight interest rate corridor	Standing deposit and lending facility Overnight rates fixed by Monetary Policy Committee	Launched in 2005
Auctioned CBE bills	7, 14 days Tradable	Launched in 2005 until 2008
Auctioned deposits	currently 7 days fixed rate auction at mid-corridor, more tenors previously Non tradable	Launched in 2007
Auctioned repos	7 days T-bills as collateral	Launched in 2011 until 2013

Source: CBE.

Implications of Monetary Policy Operations and Excess Liquidity

In 2004, when Phase I was launched, the CBE was already confronted with a pressing need to sterilize excess liquidity which was aggravated by large capital inflows. Since then, CBE has completed a series of successful reforms aimed at modernizing monetary policy and liquidity management with the ultimate goal of implementing inflation targeting. In 2005, the CBE moved from a quantitative operational target (excess reserves) to a price target (overnight inter-bank rate; launched an interest rate corridor;³ and started issuing CBE instruments as the primary instruments for liquidity management through open market operations). These measures enhanced monetary policy operations facilitating effective liquidity management with the aim of implementing in the future a full-fledged inflation-targeting regime.⁴ In addition, CBE initiated a very ambitious reserve management program initiating an efficient and sophisticated model that has served to strengthen the operational management of its balance sheet. All these measures have contributed to partially fulfilling the pre-conditions to developing a more efficient money market.

The first open market operations launched in 2005 to sterilize excess liquidity were CBE tradable CDs, which could be bought by both domestic and foreign investors. They were replaced in 2007 by non-negotiable CBE auctioned deposits. Tradable CDs were eventually eliminated given the perverse effect they were having on attracting further capital flows. In 2011, after the revolution, the CBE introduced auctioned 7-day repos to address eventual liquidity shortages.

From an operational perspective, the instruments launched by the CBE represent a step in the right direction. They reflect the dynamic approach that a central bank needs to take when designing open market operations while

the market is still developing. However, they have yet to begin addressing on a sustainable basis effective management of structural excess liquidity (a condition necessary to support a well-functioning fixed income market). Although, political uncertainty brought on by the revolution has reduced excess liquidity, it can be expected that once the situation stabilizes capital inflows will resume, and structural excess liquidity will present similar challenges to those existing prior to the revolution.

Management of structural excess liquidity is a complex and delicate task which invariably involves the need to make certain trade-offs between monetary policy and debt market development. Such decisions involve policy decisions relating to legal, institutional and financial matters among others. This is a common situation faced by most EMEs that are exposed to large capital inflows. The most successful experiences are those that have developed schemes supportive of debt market development (e.g. Mexico, Brazil, and South Africa). Decisions to be taken by Egypt to develop a sustainable structural liquidity management scheme should include at a minimum the following issues:

- Coordination between the CBE and the Ministry of Finance regarding issuance policies and choice of instruments.⁵
- Comprehensive analysis of the impact of the chosen scheme on overall debt market development.
- Ensuring consistency between the structural sterilization scheme and monetary policy instruments to manage seasonal liquidity fluctuations, as well as safeguards to enable the CBE to intervene with extraordinary amounts in situations of financial stress.
- Permanent agreement in place regarding the manner in which sterilization costs are shared between the CBE and the Ministry of Finance. Multiple models exist ranging from one institution bearing the full cost to shared cost agreements.

Money Market Instruments and Organization

Transactions in the Egyptian interbank market are rare but can include unsecured lending, T-bills and documented and undocumented Repos. T-bill OTC trading is the most active market with prices being reported on Reuters and settled at CBE on T+0.

Since 2010, the CBE has taken relevant steps to enhance the efficiency of the T-bill market. These include separating sell-buy backs from outright sales in price collection and dissemination, publishing a daily T-bill yield curve; and initiating a project to organize a market-making scheme for T-bills. The latter is essential for the development of the money market but should be consistent with ongoing actions to develop a comparable scheme for T-bonds. Ideally, T-bills and T-bonds should trade in a unified OTC market architecture.

Repos between banks and institutional clients are generally conducted in the form of undocumented sell-buy backs using T-bills and T-bonds as collateral. There are two ongoing initiatives led by the CBE for repos on

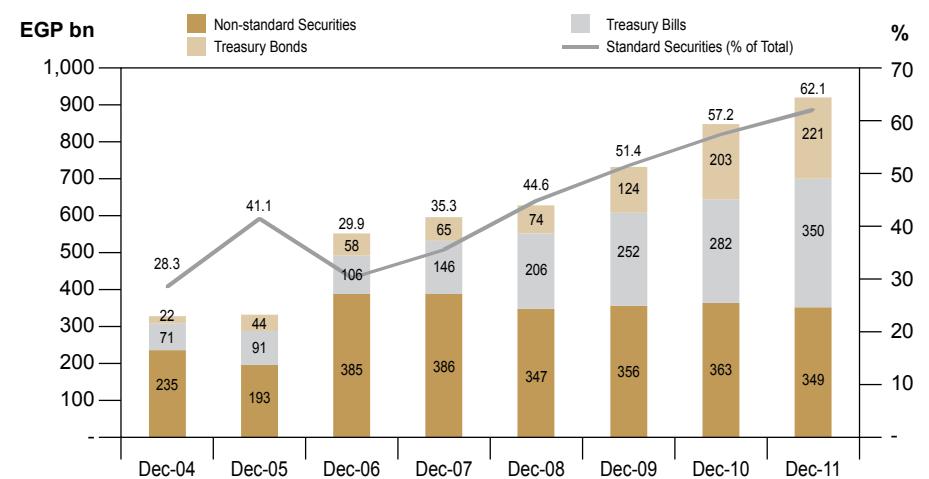
T-bills and by the Ministry of Finance and EFSA for repos on T-bonds. Ideally, a single repo framework should be designed to accommodate both types of collateral. The development of a sound repo⁶ framework including a standard master Repo agreement and clarifying the tax and accounting framework is essential to the further development of the money market.

Primary Markets

Government fixed income markets. Primary Market policies of government debt play a fundamental role in enhancing competition, improving price formation and ensuring a stable and cost-effective funding program. Well-articulated issuance strategies support the development of a benchmark yield curve by providing an adequate set of instruments issued at reliable prices and covering a wide spectrum of maturities. Policies include the careful selection of securities, the design of auction calendars capable of sustainable implementation and the creation of a competitive environment, usually involving PDs.

Egypt has made considerable progress in its primary market policies through a gradual plan of reform initiated in 2004 and reinforced at a second phase in 2009/10. This set of reforms, discussed in detail below, has served to help transform Egypt's debt profile (Figure 3.1). As a result, the share of tradable standardized securities (T-Bills and T-Bonds) began to predominate, reaching 62 percent by September 2011, against 28.3 percent in December 2004. Similarly, average maturity of the debt increased from 0.4 years in 2004 to a peak of 1.73 years in November 2010, and the percentage of debt maturing in less than 12 months (a measure of refinancing risk) dropped from 92 percent in 2004 to levels around 60 percent by the end of 2010.

Figure 3.1: Evolution of the Structure of Domestic Debt (2004–2011)⁷



Source: CBE; EGX.

Debt indicators inevitably worsened after January 2011, in light of increased uncertainty and challenging funding conditions. The average maturity of the debt dropped to 1.3 years by the end of 2011, while T-Bond issuance was interrupted from February 2011 to July 2011.

In spite of drawbacks in the debt profile, the reforms introduced since 2004, particularly those introduced after 2009 as will be explained below, provide solid foundations for a renewed process of debt market development as enabling conditions in the political-economy front stabilize. An agenda of primary market policies should be formulated taking into account lessons learned from reforms already implemented as well as the remaining challenges still to be addressed in two key areas: (i) issuance policy and (ii) PD system.

Issuance policy. Egypt's issuance policy has been focused on the use of tradable, standardized securities and of re-openings of T-Bonds since 2004. Despite progress, a needs assessment carried out by the World Bank in 2007/08 pursuant to a request from the Ministry of Finance identified some key inefficiencies: (i) long-term maturities were being issued before the consolidation of shorter-term liquid benchmarks; (ii) bonds with very close maturities were being issued in the same year, causing debt fragmentation; and (iii) re-openings followed an irregular pattern with considerable time-lags.

A second wave of reforms to tackle existing inefficiencies was implemented in the period 2009/10. Issuance was organized with the goal of improving benchmark building and price discovery in the primary markets. The main elements included the gradual process of consolidation of benchmarks from short to longer-term tenures; and the enhanced organization of auction calendars of government securities' maturity dates.

In 2009, the gradual process of consolidation of benchmarks was initiated with re-openings of 9- and 12-month T-Bills. By reducing the number of lines of these T-Bills and increasing their average sizes by at least two-fold, Ministry of Finance improved liquidity and created better short-term price references to launch longer-term instruments. Together, these two instruments, 9-month and 12-month T-Bills, represented more than 60 percent of T-Bills issued in 2009.

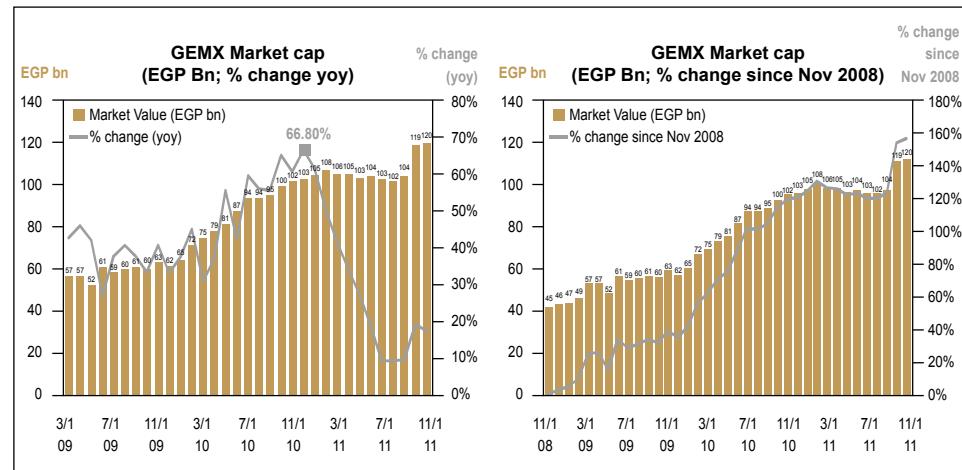
T-Bond issuances that had been interrupted since June 2008 resumed in January of 2009 following an approach that started with shorter maturities (3-year T-Bonds) before advancing to 5-year and longer-term T-Bonds. This approach proved beneficial for price discovery with a potentially significant reduction in funding costs.⁸ However, the T-Bond program still lacked regularity and organization of auction calendars, and maturities that could enhance the size and liquidity of these instruments. Currently, the T-Bond program becomes more regular, and new tenors have been introduced. A thorough reform of quarterly auction calendars in 2010 reinforced the process of gradual benchmark building. The main principles adopted included:

- Standardization of benchmark maturities: Focus on issuances of T-Bills of 3, 6, 9 and 12-months; and T-Bonds of 3, 5, 7 and 10-years.
- Smaller number of lines and larger benchmark amounts: Greater use of reopening and definition of target sizes of benchmark instruments.
- Fixed pattern issuance calendar: T-Bills would be auctioned every week and T-Bonds every other week in a predictable manner.
- Organization of maturity dates of T-Bond benchmarks: T-Bond maturity dates were standardized to avoid bunching of maturities and better manage refinancing risk.

Following this new approach, by the end of 2010 Egypt was able to attain two important achievements: (i) the stock of T-Bonds grew significantly from LE 124 bn in December 2009 to LE 203 bn in December 2010; and (ii) larger size benchmarks at key maturities were created.

A noteworthy consequence of the increase of average benchmark sizes was the impressive growth of Egypt's market capitalization in the GEMX index. Egypt had the second highest increase in market capitalization among the 24 emerging markets included in the index, moving from LE 62 bn in Dec 2009 to LE 103 bn in Dec 2010.⁹ In addition to creating enabling conditions for enhanced liquidity and reforms in the secondary markets, the consolidation of benchmarks also paved the way for improvements in the PD system.

Figure 3.2: Egypt's Market Capitalization in GEMX

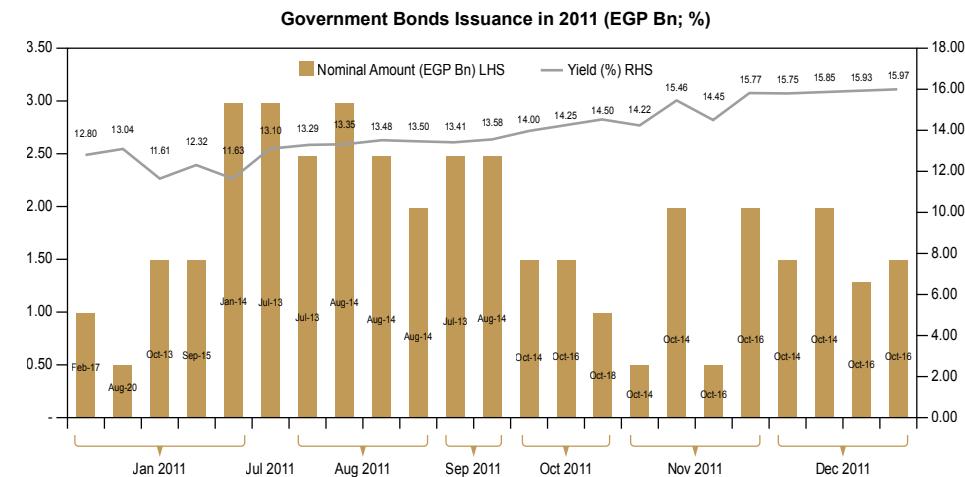


Source: EGX.

The process of consolidation of T-Bond benchmarks suffered a setback after the revolution of 2011. T-Bond issuances were interrupted from February to June and irregular after resuming in July 2011 due to continuing turbulent times (Figure 3.2). The implementation of liability management techniques (such as buybacks and switches) to mitigate refinancing risk of large T-Bond instruments, especially those coming due in 2013, were also delayed.

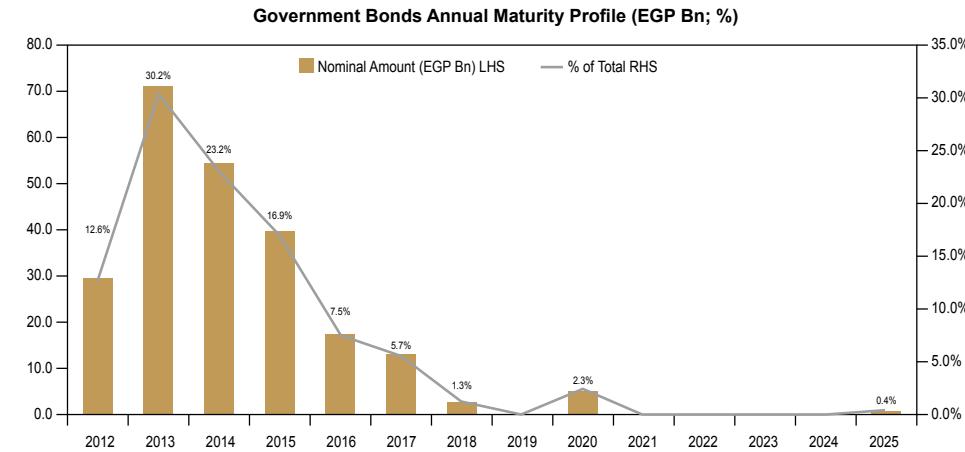
Figure 3.3 shows that as of January 2012, more than 30 percent (LE 72 bn) of the T-Bond stock will mature in 2013. There is significant concentration in July 13, with maturing T-Bonds totaling LE 24 bn in that month alone. Measures to mitigate refinancing risk should rank high on the agenda of the authorities in the near-term.

Figure 3.3: T-Bond Issuances in 2011



Source: CBE; EFSA.

Figure 3.4: T-Bond Annual Maturity Profile (as of Jan 2012)



Source: CBE.

Primary dealers. Egypt's PD system was introduced in 2002 and reinforced in the context of the 2004 reforms. PDs' rights include exclusive participation in primary markets and commissions on customer's winning bids. Obligations consist of minimum volumes in submitted and winning bids by each of the 15 PDs, as well as minimum turnover and provision of two-way market quotes in secondary markets.

As in the issuance program, several areas for improvement were detected during the WB needs assessment of 2008. PDs lacked motivation and commitment to perform, while the Ministry of Finance was only monitoring compliance to primary market obligations. Underperformance in secondary markets was linked to problems in the issuance program discussed above, but also due to: (i) lack of incentives for PDs to compete among themselves; and (ii) hurdles in secondary market architecture, including absence of market making infrastructure (e.g. no electronic trading platform with an auto match function and securities lending facility). The latter is further discussed in the section on secondary markets below.

In parallel to improvements in the issuance program, competition among PDs was strengthened in 2010 via enhanced performance monitoring and the publication of league tables with the top five performers in both the primary and secondary markets. The Ministry of Finance developed a methodology based on quantitative and qualitative performance indicators that according to authorities were well received by PDs, with positive impact on their activity. A comprehensive review of the PD convention was underway just prior to the revolution of 2011. The optimal timing to launch the new convention depends on the pace of reforms in the secondary markets that would create an enabling environment to strengthen PD's obligations and their compliance, especially with respect to bid and ask spreads on electronic trading platforms.

Non-government fixed income markets. Primary market efficiency defined as the ability to tap savings expeditiously with low issuance costs are critical factors for the development of the non-government fixed income market. As opposed to the manner in which government bond markets function, corporations need to have the ability to tap funds opportunistically and with a broad range of instruments depending on market conditions. This includes the capacity to access different types of investor segments involving a more diverse range of placement schemes than contemplated in government bond markets. There are variations in the schemes depending on the country but they can be broadly classified in three types: public offers; exempt public offer regime¹⁰ for qualified institutional buyers (QIs Islamic Bankings) and private placements.¹¹ The role of the securities regulator is essential in three aspects: ensuring that there is a sound regulatory regime in place (issuance, creditor's rights, corporate governance); developing a regulatory framework flexible enough to enable the election of one of these three models; and being able to process funding requests in a timely manner.

Egypt's non-government fixed income industry is nascent and underdeveloped representing only 2 percent of GDP or LE 23.5 billion (US \$4 bn.) as of end 2010. The government bond market dominates at approximately 29 times the size of the corporate bond market compared with the 2.5 equivalent ratio present in many EMEs.¹² Despite an unfavorable structural environment for corporate bonds, recent regulatory reforms are in part responsible for the growth in issuance value by approximately 160 percent between 2008 and end-2010. Issuance has been maintained at a

similar level following the revolution at LE 2.6 billion between January and June 2011. For the purpose of this report, in addition to pure corporate bonds (LE 6.9 billion), securitized bonds (LE 6.4 billion) and public juristic¹³ bonds (LE 10 billion) will also be considered as part of the non-government bond universe, as they provide an overview of existing and potential supply and demand conditions in Egypt for non-government fixed income instruments.

Instruments

Corporate bonds. Pure corporate bond issues are concentrated in six large recurrent high quality firms,¹⁴ four of which are also blue chips in the equity market with 19 percent of the Exchange market capitalization. There are six bond issues outstanding at LE 6.9 billion (30 percent of total) with maturities ranging from 5 to 6 years for fixed coupon bonds to 7-years for the sole floating rate bond (Table 3.11). Average size of issues at around LE 1 bn is reasonably in line with the average size of government bond placements within the LE 0.5–2.5 bn range and building up to issue size of LE 6 bn. Most outstanding bonds have an embedded call option.

An example of corporate bond market dynamics is the issuance by Mobinil in January 2010 of a LE 1.5 billion 5-year bond. It was placed utilizing two modalities: LE 1.4 billion under an Egyptian private placement¹⁵ tranche oversubscribed by 1.5 times and offered to institutions and HNW individuals; and LE 100 million under a public offer tranche offered to retail investors through bank branches and oversubscribed by 11 times. The coupon was 12.25 percent with a 175 basis point spread when compared with equivalent government bonds. After the revolution in January 2011, Mobinil placed a syndicated loan for LE 2 billion, which illustrates the fact that the supply and demand for funds existed but the appropriate environment was still missing for corporate bond issuance to become a reliable and regular funding channel for most corporations.

Public juristic bonds. Issues from public sector and economic authorities, known as public juristic bonds, have recently come to the market since the issuance of the ministerial Decree No. 1 of 2010 authorizing public juristic entities and international financial institutions to issue bonds in the debt market in Egypt. There were four issues outstanding of LE 2.5 billion each (see Table 3.11). All issues belong to a single issuer, the NUCA. They represented the largest size overall in the corporate bond universe. There were two short-term issues with maturities of 13 months and two medium-term issues with maturities of five years. The latter have floating rate coupons referenced to the 6-month T-Bill.

Revenue Bonds: along the lines of municipal bonds, EFSA introduced to the capital market law executive regulations the ability of public authorities to issue revenue bonds for commercially viable projects. To date, this newly introduced instrument has not been used.

Securitized bonds. There are 13 outstanding securitized issues of which two were issued in 2006 after the Ministry of Investment set the regulatory

framework by the issuance of the ministerial Decree No. 46 of 2004 that added a new chapter to the executive regulations of the Capital Market Law regarding securitization and its amendment by the ministerial Decree 139 of 2006. To date there have been only four issuers, yet they have been able to tap the market on a relatively regular basis with maturities ranging from 1 to 10 years. For example, July 2010 was a peak month with Contact Cars for Securitization and Al-Tawfeek for Financial Leasing tapping the market with three different issues each at maturities of 1, 3 and 5 years. Issues generally have a fixed coupon, except when they extend beyond 5-year maturities, and most of them have a call option. As in the corporate bond market the primary market is generally split between Egyptian private placements¹⁶ taking around 90 percent of the issue and public offerings restricted to retail investors taking around 10 percent of issuance.

Table 3.7: Overview of Corporate Bonds in Egypt as of December 2010 (LE)

Issuer	Size	Maturity	Call Date	Maturity Date	Type of Coupon
Corporate Bonds					
Ezz Steel (2nd issue)	990,000,000	6 years	Jun-10	Dec-14	Fixed
International Co. for Leasing	200,000,000	5 years	Jun-11	Sep-14	Fixed
Egyptian Co Mobile Services	1,500,000,000	5 years	Jan-13	Jan-15	Fixed
GB Auto	1,000,000,000	5 years	Jan-12	Dec-14	Fixed
Orascom	1,650,000,00	5 years	Jul-12	Sep-15	Fixed
Golden Pyramids Plaza	1,626,238,500	7 years	Dec-09	Jun-14	Floating
Subtotal Corporate	6,966,238,500				
Securitized Bonds					
Subtotal Securitized (13 issues)	6,442,237,119	1-10 Years	Only for 9 Issues		4 floating, 9 fixed
Public Juristic Bonds					
New Urban Communities Authority	2,500,000,000	13 months	n.a.	Apr-11	Fixed
New Urban Communities Authority	2,500,000,000	13 months	n.a.	Jun-11	Fixed
New Urban Communities Authority	2,500,000,000	5 years	n.a.	Mar-15	Floating
New Urban Communities Authority	2,500,000,000	5 years	n.a.	Jun-15	Floating
Subtotal Public Juristic	10,000,000,000				
Total	23,408,475,619				

Source: Own elaboration with data from EGX, Yearbook.

Table 3.8: Structure on Securitized Issues as of December 2010

Issuer	Value outstanding	Percent	Number of issues
Contact	874,196,602	14	7
Al Tawfeek Securitization Company	874,062,500	7	3
Egyptian Arab Land Bank	925,012,500	14	2
Al Tamer Securitization Company	4,168,965,517	65	1
Total	6,442,237,119	100	13

Source: Own elaboration with data from EGX, Yearbook.

Commercial Paper. Short term paper for working capital is almost non-existent, even for the larger companies, although the 13 month issues by the New Urban Communities Authorities and by two securitization companies may be classified as commercial paper (see Table 3.8). They are treated under the same rules as ordinary bonds in terms of the time it takes to authorize them (e.g. 2–3 months. See details in next subsection), which has deterred their broader use. In May 2011, EFSA issued a decision to expedite the approval process for the so called short-term bonds. Although this is a step in the right direction, the decision still limits pre-approval to one year and the shortest tenor to 13 months with a call option six months after issuance. Approval is also merit based. For example, issuers need to comply with 1:1 current assets to current liability ratio. Regulations to support the development of a commercial paper market should be strongly encouraged as a first step in developing a more active corporate bond market. This would benefit the cash management needs of issuers and investors under the current uncertain market environment as well as in the long run. It would also enable a segment of the fast growing MMMF industry to diversify assets and offer better returns.

Issuance Regulatory Framework

Since 2004, the government through the Ministry of Investment and EFSA has been taking steps to provide a more supportive environment for corporate bond issues through regulatory changes. Some of these reforms may be behind the 140 percent growth in outstanding issues between 2009 and 2010 (see Table 3.12). In addition to the Securitization regulatory framework setup, a set of relevant reforms was passed in 2008 and 2010 that included elimination of the requirement for private businesses to submit an auditor's certified forecast of the company's financial prospects contained in audited financial statements for the period of the bond's maturity by the ministerial Decree No. I of 2010; introduction of a shelf registration option but limited to one year after filing and with two weeks prior notice required to sell a portion of the shelf offering amount by the Ministerial Decree 64 of 2010. These two restrictions weaken the value of shelf-registration as a one-year grace period may not be long enough and shorter periods may be needed between the funding decision and the ability to tap the market, particularly

for commercial paper. It is worthy of mention that EFSA is considering to propose a regulatory amendment extending the maturity to two years instead of one; authorization for public sector and economic authorities (Public Juristic) to issue bonds to meet their financing needs and finance infrastructure projects by the Ministerial Decree No. 1 of 2010. Authorization for International Financial Institutions such as the African Development Bank, the World Bank, the International Finance Corporation,...etc. to issue bonds in the domestic markets after taking the CBE's and EFSA's approval by the Ministerial Decree No. 1 of 2010. This authorization was incorporated in the Law 123 of 2008 that amended some articles of the Capital Market Law 95 of 1992. In spite of the above-mentioned changes, there remain several major constraints that make the issuance process prohibitively expensive, uncertain and slow. All of these features are particularly detrimental for the development of a vibrant bond market.¹⁷ Key issues that would need to be addressed as part of a sequenced plan include the following:

- The Capital Market Law establishes that a company seeking to issue a bond or commercial paper requires the approval of its General Assembly, including the yield and tenure of the instrument. Securing bank loans requires no such approval. The primary market remains a merit-based rather than a disclosure-based regime. For example, only issues with an investment grade credit rating (BBB-) or above would receive EFSA's approval. If during the life of the bond the rating falls below investment grade, the outstanding bond balance (including principle and interest) must be fully redeemed. This stringent obligation limits the access to high quality firms that generally already have access to other funding sources.
- There is no clear differentiation between a private and a public placement in terms of differentiated disclosure requirements or the availability of an expedited issuance process for the former. These are features commonly found in most other markets. The difference between the two is the placement methodology and the targeted investors. A private placement is organized following a book-building process involving only institutional investors, whereas public offerings are targeted at retail investors and allocated on a pro-rata basis.
- Market participants perceive the offering preparation process as expensive, slow and with an unpredictable approval timeline and outcome. The latter ranges from 3–5 months, according to investment bankers interviewed, which compares unfavorably with the 25-day average registration or approval time present in many EMEs.¹⁸

Structural Obstacles

The Role of Banks. There is varied experience across countries with respect to the constructive or unconstructive role of banks as sponsors of non-government fixed income markets. As sponsors, their primary focus may be on bond origination to fund their corporate clients, as this will free

resources on their balance sheet. Additionally, they can provide capital for underwriting as well as financial expertise to support origination. On the other hand, banks may perceive the bond market as competing for good quality client borrowers. In this regard, banks may feel compelled to provide very competitive lending conditions to prevent their targeted corporations from getting direct funding from fixed income markets.

In the case of Egypt, low access to credit (48.5 percent loan to deposit ratio as of end-2010) would make a strong case for the development of a fixed income market in order to improve corporations' access to funding. However, the dominance of banks in the financial sector¹⁹ leaves little space for NBFIs to develop in a meaningful way, either on the origination or on the savings side.

A notable anomaly in the pricing of financial assets in Egypt is that interest charged on bank loans is generally lower than what the same issuer could obtain through the issuance of fixed income instruments. This places fixed income instruments at a distinct disadvantage that is exacerbated when origination costs are added. Interviewed banks explain this apparent paradox as a result of banks competing for a limited number of creditworthy companies. Banks are able to offer very competitive rates given the low cost of their deposit base and the fact that there is structural excess liquidity in the financial sector overall. The only incentive a bank would have to support the issuance of fixed income bonds by its client corporations would be when the compulsory 25 percent quota on its lending portfolio to a single company has been fulfilled (e.g. this condition was behind Mobicel's diminished issuance activities). The bank would then become an active partner in the bond issuance transaction and, in many cases; it would buy a large proportion of the issue and hold it to maturity.

It is still too early to assess, but the recent ban on corporations investing in bank CDs may trigger structural changes in financial disintermediation in Egypt. Banks have already started to sponsor fixed income mutual funds to capture former CD investors (corporations, insurance companies and pension funds). This shift would imply a reduction of banks' liability bases, which can be expected to trigger their active involvement in origination transactions in fixed income instruments for their regular corporate clients.

Since 2009, the government has initiated a reform plan to improve the enabling environment for NBFIs as a means to promote the incipient financial disintermediation process in Egypt. These reforms, as well as recommendations to reinforce them are explained in other sections of this document.

The role of government debt markets. Government debt as a risk-free asset provides a reference price against which non-government fixed income instruments can be priced. A liquid yield curve in government debt including long-term maturities is therefore an essential condition precedent to the development of non-government fixed income markets. Additionally, the latter can leverage on the market infrastructure (trading, clearing and settlement) developed for government bond markets.

The Ministry of Finance has conducted several reform initiatives since 2004 to develop more liquid government debt markets. Phase II (2009–2012) of the reform program established a systematic issuance plan for medium and long term benchmarks up to 10 years. This was complemented with a series of planned reforms in secondary market architecture, clearing and settlement and a Repo framework. By December 2010, liquidity in the secondary market had started to develop and foreign investors were buying medium and long-term debt in sizeable volumes with holdings reaching a peak of 16 percent of outstanding debt in October 2010.²⁰ As of May 2014, foreigners hold LE 300.5 million in T-Bills.

Political and financial uncertainty following the revolution in 2011 brought about a suspension of the government's implementation of its strategy as foreign capital fled the country and domestic investors shifted to short-term government paper. However, the Ministry of Finance maintained most of its pre revolution accomplishments in terms of regularity of auctions and issuance policy transparency, which consolidated T-Bills as price references for non-government financial assets. Once the Ministry of Finance is able to resume its strategy to lengthen the government yield curve, it can be expected to become over time a reliable price reference for the non-government fixed income market.

There has been some debate in the market over the potential crowding out effect on the corporate bond market of increased government issuance. While growing fiscal deficits may produce some negative consequences, it is important to evaluate them against a broader context. The capital markets in Egypt have historically been relatively open and under normal conditions, such as those existing before January 2011, and was able to attract foreign investors to hold as much as 16 percent of the government debt, which should still leave sufficient space to channel savings to corporate debt. The latter also has the advantage of being tax exempt.

One factor that would seem to have a more significant negative impact on the issuance of corporate bonds is the high reported inflation that results in high yields on both government and corporate bonds. Additionally, spreads on corporate debt are even higher when compared to bank loans. This can be explained by the fact that excess liquidity conditions and the existence of only a few creditworthy corporations prompt banks to offer very low interest loans.

Enabling Environment²¹

Credit rating agencies. Fixed income issues in Egypt require a credit rating prior to issuance and updated on an annual basis after issuance. The minimum accepted rating is investment grade.

Taxation framework. The taxation framework is very favorable as corporate bonds are tax-exempt whereas government securities have a 20 percent withholding tax. This is compared to other financial assets that are also tax exempt such as mutual funds, saving and time deposits, capital gains and dividends on stocks.

Secondary Markets

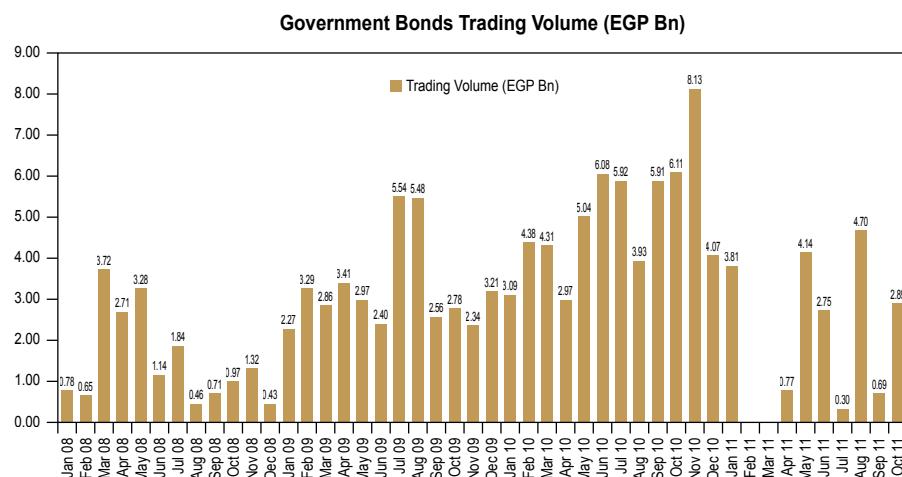
Government Fixed Income Markets. Deep and liquid secondary markets of public debt help countries implement their funding strategies at lower cost and risk. They also promote efficient price discovery and the dissemination of a risk-free yield curve that supports the development of other fixed-income products, such as corporate bonds. Well-functioning secondary markets are a function of a country's market architecture, investor's incentives to trade and enabling conditions provided by the several building blocks covered in this report: money markets; primary markets; investor base; and clearing and settlement infrastructure. Egypt's secondary markets are illiquid and concentrated in the short-term. Monthly value of T-Bond trades was following a positive trend prior to the 2011 revolution, increasing from an average of LE 1.5 bn. in 2008 to LE 5.7 bn. in the second semester of 2010. Value of T-Bond monthly trades reduced to levels close to LE 2 bn. and became more volatile during the 10 months that followed the January 2011 revolution (including some periods of no trades due to temporary shutdowns of the stock exchange).

Growing liquidity of T-Bonds in 2010 was being fueled by the pro-active primary market strategy of the gradual building of T-Bond benchmarks, described previously. On the primary government fixed income markets. Despite these developments, the average volume of T-Bond transactions as of December 2010 remained only a small fraction, approximately 10 percent, of the volume of T-Bill monthly transactions. For example, monthly turnover of T-Bills was approximately 20 percent in the last months of 2010, compared to 2 percent for T-Bonds during the same period.

A significant agenda of reforms to enhance secondary market liquidity, especially of long-term securities, was in the process of implementation when the revolution arose. The agenda combined reforms in all of the building blocks for bond market development, as described in other sections of this report, and specific measures to (i) enhance the efficiency of Egypt's secondary market architecture, including the removal of critical bottlenecks; and (ii) building an enabling infrastructure with appropriate incentives for improved price dissemination and trading.

Egypt's market architecture is segmented between T-Bills and T-Bonds by reporting, trading and settlement arrangements.²² Other critical bottlenecks include:

- A “de facto” monopoly of PDs in T-Bond secondary market trades - PDs are the only ones entitled to meet the mandatory reporting requirements to EGX; and
- Pre-deposit of T-Bonds before trades are matched and the inability to sell a T-Bond until it is settled on T+ 1 MCDR; that in practice prevents intraday trading and short selling, with severe adverse implications for secondary market liquidity and market making.

Figure 3.5: Government Bonds Trading Volume, Jan 08 – Oct 11

Source: CBE.

Improved market architecture should include measures to harmonize procedures for clearing and settlement of T-Bills and T-Bonds, even if conducted by two different institutions, CBE and MCDR (as discussed in more detail in section 5 on Clearing and Settlement). It should also include the removal of impediments to broader access of a variety of investors to the secondary markets of T-Bonds. Non-PD institutions should be allowed to trade among themselves without the obligation of having to trade (or register trades) via PDs.

An overhaul in the infrastructure for trading and in incentives for price dissemination is needed to complement the suggested changes in market architecture. A roadmap of reforms in this regard includes:

- Designation of an official electronic trading platform and the creation of a securities lending facility for PDs: these two platforms would provide the foundations for greater price transparency of T-Bills and T-Bonds. The electronic trading platform should ideally include a B2B segment as well as allow B2C trades. The securities lending facility, managed by Ministry of Finance and dedicated to PDs would be a powerful tool to mitigate resistance of the PDs to comply with quoting obligations.
- Introduction of a new PDs code of duties, including quoting obligations: enhanced infrastructure for trading will provide the pre-conditions for Ministry of Finance to monitor and enforce quoting obligations of PDs. Procedures for firm bid and ask spreads for key benchmark securities should be introduced and followed by PDs, observing minimal amounts, maximum spreads and pre-defined trading periods. A broader revision of the PDs code of duties should be conducted to ensure a balanced set of incentives and obligations that would enhance their performance.

- Improved price dissemination and transparency will also depend on strengthening mechanisms to collect pre-trade prices (e.g. aggregate measures derived from quotes in electronic trading platforms), and post-trade reporting obligations. Altogether these measures will not only enhance the conditions for the creation of a reliable risk-free yield curve, but will also allow wider enforcement of mark-to-market valuations by the securities regulator for investors' portfolios in accordance with the requirements of the accounting regime.

Non-government fixed income markets. Secondary markets in corporate bonds are generally thin even in Advanced Economies (AEs) with large corporate bond markets. This is the result of the nature of corporate bond funding: it is opportunistic; does not always use standard instruments; and issues are generally too small to be liquid. Thus, corporate bond markets are generally a universe of small fragmented issues with higher yields but low liquidity when compared to government bond markets. Low liquidity is reinforced by the dominant role of institutional investors with buy-and-hold investment strategies as long as high yields can be obtained. However, the ability to trade options both OTC and through electronic trading platforms is still a relevant feature in corporate bond markets. EMEs generally tend to have even thinner secondary markets caused by a smaller size both overall and at the individual issue level. Also, their generally weaker infrastructure for price dissemination, trading and clearing and settlement contribute to anemic secondary markets.

Despite the fact that 2010 represented a peak year in Egypt (Figure 3.7), the secondary market for corporate bonds remained particularly thin at approximately USD 100 million or less than a 1.4 percent turnover ratio as of end December 2010. All trades take place on the EGX as the Capital Market Law extends the tax exemption to listed corporate bonds only. Hence, all corporations issuing bonds in the local market opt for listing the bonds issuance with the EGX and corporate bonds may be traded through the main trading system at EGX that is open for four hours daily.

Low secondary market volumes can be attributed to the small size of the market, the fact that some issues are held by very few investors (banks and State Owned Enterprises), and the requirement of trading through the EGX facilities. Although the structural reasons (e.g. market size, investor base) are significant factors contributing to the scant secondary market, it might also be relevant for the authorities to consider providing greater flexibility in utilizing various secondary market alternatives, such as the availability of a pure OTC market. Under this scheme, EGX could continue to bear price dissemination responsibilities and the attendant revenue that might be generated therefrom.

Investor base. A large and diversified investor base is important for ensuring high liquidity and stable demand in the government fixed income markets. Development of contractual savings institutions such as pension funds, insurance companies as well as mutual funds, is an extremely important

component since it is these entities that serve to contribute to the creation of a natural market for medium and longer-term government debt. Foreign investors have also been major drivers in lengthening the yield curve and supporting secondary market liquidity across most EMEs. A heterogeneous investor base with different time horizons, risk preferences, and trading strategies ensures active trading and consequent high liquidity and, enables the government to execute its funding strategy under a wide range of market conditions. Efforts should be made to ensure equitable treatment of investors in accessing government debt markets.

In the case of non-government fixed income markets, a stable and broad institutional investor base is one of the pillars of a vibrant market as banks and retail investors are unlikely to be relevant investors. Corporate bonds compete with bank lending and require a degree of sophistication generally absent among retail investors. Low liquidity is also a deterrent. Corporate bonds are ideal assets for pension funds and insurance companies to match against their long-term liabilities. In this sense, most EMEs with bank dominated financial sectors face a structural obstacle to developing corporate bond markets on the demand side. Generally, those EMEs that have a more diversified institutional investor base, even if it is at an early stage of development, have proven most successful in developing deep and liquid corporate bond markets (e.g. Malaysia, Korea, Brazil, South Africa)

In Egypt, the poor development of institutional investors and the fact that those that do exist are concentrated, mainly in SOE's, represents one of the structural reasons underlying thin trading in the government bond market and the small size of the corporate bond market. NBFIs assets amounted to approximately 8 percent of GDP compared to roughly 106 percent for banks as of December 2010. Concentration is high within all segments and SOE's, particularly in the insurance area, have the largest asset size. In addition, banks dominance as fixed income investors (35 percent of their assets) has been a major obstacle for the growth of NBFIs. However, there are several promising changes currently underway related to banks' interest in sponsoring mutual funds that could leverage ongoing efforts to support government and non-government fixed income markets both on the supply and the demand side.

Banks. The 39 commercial banks operating in Egypt are the main investors in government securities with holdings of approximately 55 percent of total T-Bonds as of end-2010, representing 35 percent of their total assets (Table 3.9). This is a result of banks' dominance in the financial sector, excess liquidity, a high liquidity ratio, (20 percent of deposits that can be fully met by holding government securities) and the low level of credit to the private sector, which amounts to only around 48 percent of banks' deposits. Banks also represent the main investors in non-government fixed income instruments. Nevertheless, given the smaller size of this market, it still represents only 1.9 percent of their securities portfolios versus 79 percent for government securities (Table 3.9). Despite the high government debt

holdings of banks and the fact that 15 of the banks are also PDs, volumes in the secondary market are extremely low (Table 3.13). As mentioned in the sections on money markets and government fixed income markets, structural changes on several fronts would be needed to invigorate the secondary market. These include more effective management of excess liquidity, reform of the secondary market architecture and PD rules, changes in the eligibility of T-Bonds for the liquidity ratio and a robust repo framework.

Table 3.9: Structure of Banks' Securities Portfolios Expressed as a Percentage

	2009	2010
T-bills	58.1	43
T-bonds	24.9	35.6
Corporate Bonds	2.2	1.9
Equities	10	8.2
Foreign Securities	4.8	11.3
Total	100	100

Source: CBE Annual Report.

Inadequate accounting rules may also serve as a disincentive to trading. Accounting standards for Egyptian banks are very similar to IFRS. However, the enforcement of the accounting rules for financial instruments is unclear. Informal comments made by interviewed market participants suggest that the differences between "trading", "available for sale" and "held-to-maturity" portfolios are merely notional. Moreover, T-Bills are not marked to market irrespective of the portfolio to which they belong.

Table 3.10: Distribution of T-Bond Holders as of March 31, 2008

Type of investor	LE million	Percent
Banks	40.742	55.43
government and Social Insurance Fund	14.840	20.19
National Investment Bank	7.819	10.64
Insurance companies	3.397	4.62
Foreign Investors	2.848	3.87
Holding companies	2.061	2.80
Others	0.666	0.91
Insurance Funds	0.361	0.49
Funds & portfolio management companies	0.757	1.03
Individuals	0.100	0.01
Total	73.500	100.0

Source: Ministry of Finance.

Mutual funds are the main institutional investor and MMMFs represent 92 percent of AUM (Table 3.14). All MMMFs are sponsored by banks and started to gain prominence in 2005 when the CBE was offering high yields through the deposit corridor facility that banks were intermediating to their

corporate and HNW clients through those MMMFs. The nature of MMMFs was distorted as they held a large proportion of their assets in bank deposits (e.g. 40 percent as of end-2010). But after the revolution, volumes of T-bill issuance at high yields increased bringing MMMFs' holdings of bank deposits down to 8 percent of AUM. The high growth rates of MMMFs since 2005 illustrate the potential for dis-intermediating savings in Egypt, provided that banks have the right incentives to support such a strategy. As of December 2010 there were 79 investment funds compared to only 49 in December 2008.

As of May 2014 Money market funds represent 88.5% from total funds. Fixed income and equity funds currently represent around 8.5% of total mutual funds, not much changed from 8% stated above.

Table 3.11: Evolution of Mutual Funds *(LE Million)*

	Dec-09	Percent	Dec-10	Percent	May-11	Percent
Money Market Funds	50,130	89.7	51,345	91.2	57,337	88.6
Other Funds	5740	10.3	4,925	8.8	7,390	11.4
Total	55,1870	100.0	56,270	100.0	64,729	100.0

Source: Own elaboration with data from CBE.

Table 3.12: Holdings of Money Market Mutual Funds *(LE Million)*

	Dec-10	Percent	May-11
T-Bonds	1,209	2.4	919.483
Corporate Bonds	1,164	2.3	121.006
T-Bills	28,038	54.6	50,692.96
Deposits	20,346	39.6	4,664.474
Mutual Funds	558	1.1	
Other	30	0.1	939.432
Total	51,345	100.0	57,337

Source: Own elaboration with data from CBE.

As of end-2010 several new fixed income funds focusing on investing in corporate bonds were about to be launched but were postponed with the onset of the revolution. Banks new found interest in sponsoring fixed income mutual funds resulted from a CBE regulation prohibiting corporations, including pension funds and insurance companies, from investing in bank CDs. Fixed income mutual funds would enable banks to retain their former CD corporate investors while offering higher returns than the existing MMMFs. The NBE took up the initiative by launching a LE 200 million fixed income mutual fund in September 2011. As the market stabilizes, it can be expected that other banks will follow a similar strategy. It is worthy of mention that the growth of MMMFs would not have been possible unless for the Ministerial Decree No. 209 of 2007 issued by the Minister of Investment that set the regulatory framework for MMMFs. This Decree was further amended by the Decree

No. 126 of 2008 to reduce the average maturity of the MMMFs investments while setting a maximum maturity for the MMMF investment of thirteen months. During 2009 and 2010, EFSA initiated a review of select mutual fund regulations aimed mainly at addressing conflicts of interest. Recently, EFSA issued a series of Capital Market Law Executive Regulations including a code of conduct, the separation of directors for bank-sponsored funds and related party investments,²³ and the appointment of Independent Fund Administration Companies to protect investors by performing critical back office functions.

In 2014 the regulation for Mutual Funds was overhauled by EFSA, introducing numerous international best practices and activating real estate investment funds. Specific rules for fixed income and money market funds were stipulated, in addition to introducing for the first time exchange traded index based funds (ETFs). EFSA also set an end of August 2014 deadline for all funds to appoint a fund administration services company to value the certificates and maintain certificate holders registry. Additional duties were assigned for the fund administration services companies handling real estate investment funds (with regards to ownership titles, property contracts and property valuation reports).

Despite that the current regulatory framework governing mutual funds in general equally allows banks and insurance companies to sponsor and promote funds without establishing a separate fund company, it was banks that took advantage of such regulation and extensively promoted MMMFs. If insurance companies follow banks footsteps, money market mutual funds could become the base for the development of a broader family of mutual funds in longer-term instruments. In the short term, MMMFs could also generate demand for commercial paper and become active participants in the repo and secondary markets.

It is worth noting that EFSA issued in early 2014—for the first time—regulation addressing the requirements and financial adequacy conditions related to approving the issuance of funds by insurance companies.

Policies supporting mutual funds would need to combine regulatory upgrades to facilitate access to independent asset managers, as well as actions to increase the supply of instruments and their secondary market liquidity in both government and non-government fixed income markets. This is in line with several initiatives that the government had initiated prior to the revolution (see sections above on primary and secondary government fixed income markets).

Insurance companies. The life insurance sector is small with AUM of LE 38 billion as of June 2013. The insurance sector has undergone a series of structural reforms. While these reforms are serving to encourage the sector to become profitable and operate on a fully commercial basis, it is a slow process that will not make insurance companies a relevant investor in the short term. Most of the sector's assets are invested in bank deposits or government debt and are not currently a relevant source of demand for non-government fixed income instruments.

Table 3.13: Assets Under Management

Institutional investor	AUM	(LE Billion) Percent
Mutual funds	65.7	53
Insurance (Life reserves)	23.1	18
Pension funds	36.1	29
Total	124.9	100

Source: Data for Insurance and pension funds is as of June 2010, and for mutual funds it is as of December 2010.

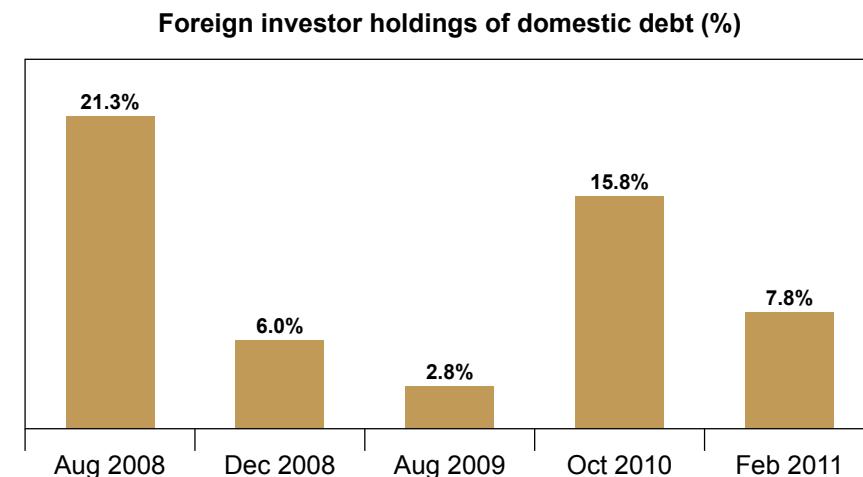
Pension funds are small contributors to the development of the fixed income market with AUM around LE 39.4 billion or 2.3 percent of GDP as at June 2013. They are not always professionally managed, and a large proportion of the private ones operate with actuarial deficits.²⁴ Currently they are not relevant contributors to the non-government fixed income market as approximately 75.5 percent of assets are invested in bank deposits or government debt.

There are a series of ongoing or planned reforms that are essential for the sector to develop on more solid ground; however, it cannot be expected to become an important investor in the short term.²⁵

Foreign Investors

The evolution of foreign investor holdings in Egypt's government fixed income instruments shows the potential that can be achieved in attracting foreign capital when the political situation stabilizes. Before Egypt initiated a systematic strategy to lengthen the yield curve in 2009, foreign investors were mainly interested in T-bills, given the low liquidity in T-bonds. Non-resident holdings in T-bills increased from 10 percent in 2006 to 50 percent in March 2008 whereas investments in T-bonds were almost non-existent. After the achievements of the T-bond issuance strategy in 2009, non-residents investors were starting to purchase T-bonds for the first time after having been exposed to T-bills exclusively.

Overall foreign holdings of government debt have experienced large swings depending on international perceptions of EMEs during the financial crisis and, later, with increased risk perceptions after the revolution. In August 2008 a peak was reached with non-residents holding 21.3 percent of tradable domestic debt (DD), which dropped to 6 percent in December 2008 and to a low of 2.8 percent a year later in December 2009. After that non-residents regained confidence reaching another peak holding of 16 percent in October 2010, which dropped to 7.8 percent in February 2011 after the revolution (Figure 3.6).

Figure 3.6: Evolution of Foreign Investor Holdings of Domestic Debt in Percentage

Source: Ministry of Finance.

The sale of T-Bills to foreigners has been a relevant line of business for some banks. They receive either the Ministry of Finance commission for primary market placements to clients or they charge a spread of around 50–60 basis points over primary market prices if they sell securities from their portfolio. Once the political situation stabilizes, if Ministry of Finance resumes its strategy to lengthen the yield curve a more important presence of non-residents in the medium and long term debt segment can be expected. In this context, reform in upgrading the secondary market architecture, enhanced price transparency and more robust clearing and settlement infrastructure would be essential to accommodate and reduce the volatility of foreign investors' demand.

Clearing and Settlement Infrastructure

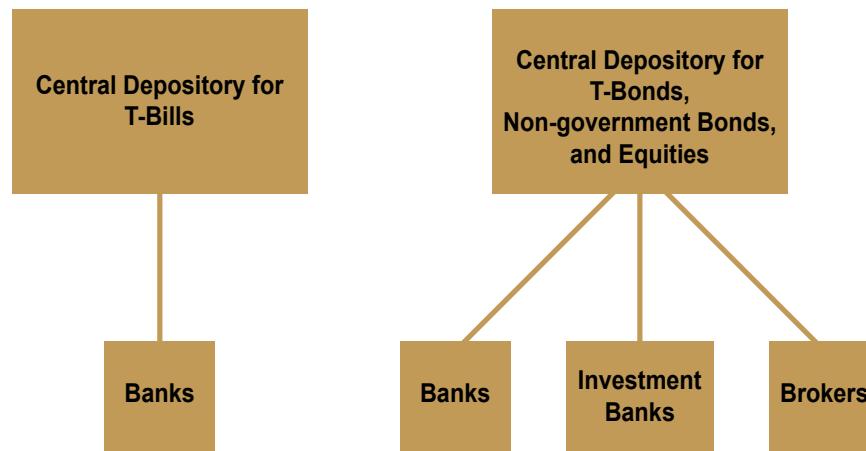
The clearing and settlement infrastructure should effectively compromise between the business interests of different market participants and support planned market development policies. Access should be granted on equivalent terms to banks and NBFIs to ensure a level playing field in the securities markets. Systems should be cost effective, efficient and have the capacity to manage risk and limit exposure to systemic risk. Given its relevance for the financial sector, it is essential that the institutional structure is neutral and with a strong supervision and oversight role of the public sector. Supervisory responsibilities are normally conducted by the securities regulators, whereas oversight, more related to systemic risk and policies, is generally the responsibility of the Central Bank. Ownership and governance structures can follow different models depending on the country ranging from public sector to private sector ownership or hybrid models.

Institutional Organization

In Egypt clearing and settlement arrangements are split by law between two CSDs, both operating fully dematerialized regimes: CBE's bookkeeping-entry system for T-bills and MCDR for T-bonds, non-government fixed income instruments and equities. MCDR is a self-regulatory organization (SRO) supervised by EFSA and owned by the EGX (5 percent), banks (50 percent) and securities intermediaries (45 percent). Only banks can access the CBE's platform, whereas all financial intermediaries (banks, investment banks and brokers) may have direct accounts at MCDR.

There are two models that represent the most widespread infrastructure arrangements across both EMEs and AEs. The first one is split between a single CSD for all government securities, generally operated by the Central Bank, and a private CSD for non-government securities under strong oversight from the Central Bank or the securities regulator. The second model is a single CSD for all securities that in some cases is partially owned by the public sector.²⁶

Figure 3.7: Central Depository: Existing Model for T-Bills and T-Bonds

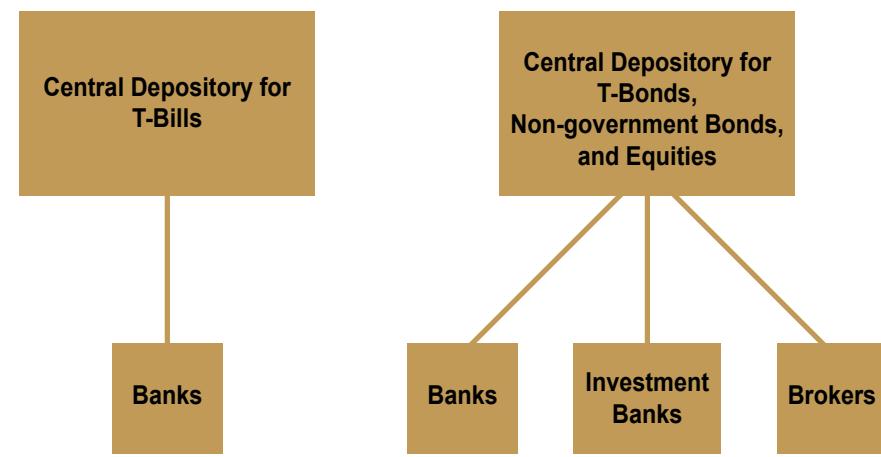


There are substantial gains in economies of scale under the single CSD model but there are also policy reasons supporting the dual model approach, particularly in the early stages of government debt market development. A CSD for a wholesale government debt market requires a strategic vision and financial and operational resources that may not be available in the private sector in the early stages of market development. In addition, central banks and Ministry of Finances are generally better placed to understand the policy challenges to develop efficient government fixed income markets. The lack of the right clearing infrastructure may undermine implementation of those policies that are critical for the financial sector overall. As an example, the dual model split between government and non-government securities was followed in most European countries until the adoption of the Euro. In the case of Egypt, with government

fixed income instruments still at a developing stage, the involvement of the CBE and the Ministry of Finance in the design of services and operations of clearing and settlement of government debt is essential to support planned policies. Given the current CSD structure two models are proposed that are variations of the dual CSD structure.

Under the first proposed model, the current institutional segmentation between the CBE for T-bills and the MCDR for T-bonds and non-government securities is maintained. However, settlement services and procedures for T-bills and T-bonds would need to be harmonized and upgraded (see suggestions below) so that the infrastructure does not segment the T-bill and T-bond market. In addition, it is recommended that the CBE holds a sub-custody account for T-bonds at MCDR so that it can process settlement instructions from OTC markets.

Figure 3.8: Proposed Model 1: T-Bills and T-Bonds under CBE

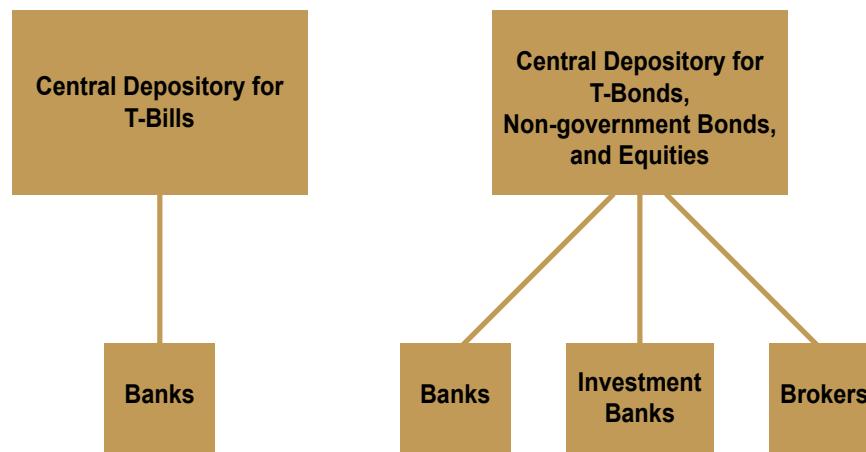


Under the second proposed model, government fixed income instruments are consolidated under a single CSD owned and operated by the CBE, whereas non-government securities continue to be registered and settled by MCDR. This model better reflects the desired unified plan for all government fixed income securities but may involve more complex institutional changes than model.

A Common element under both models is that direct accounts in the CSD are not restricted to banks. This is an important feature to support competition and a level playing field in the fixed income market. If only banks can access the government debt CSD they will be in a position to prevent investment banks and intermediaries from competing and providing trading services to their market segments. It is important that they have direct access to securities accounts even if they use a settlement bank for the cash leg of the transaction. In both models it is proposed to provide direct access to CSD securities accounts to both investment banks and brokers.

Services and Operations

Figure 3.9: Proposed Model 2: Connectivity between CBE and MCDR



Although the CBE bookkeeping system for T-bills settles on T and presents a low degree of automation, there are plans to develop a state-of-the-art central depository in line with the existing RTGS system operating since 2008. The intraday liquidity facilities developed for the RTGS system would require a fully automated central securities depository (CSD). Currently the system is not fully compliant with the delivery versus payment (DVP) principle but risk is limited as only banks with reserve accounts are members of the CSD and they cannot access their securities accounts on-line.

MCDR facilities for T-Bonds settle on T+1 and present a higher degree of automation than at the CBE's system. However, there are several problems in the settlement arrangement that would need to be addressed in order to support a liquid and efficient government fixed income market:

- T-bonds are blocked in the seller's account before trading, which prevents intraday trading or short-selling which is a condition precedent to introducing a market-making program. There are plans to solve this conundrum in the future by implementing a securities lending facility that would address the risk of non-delivery.
- The cash leg of T-bonds is settled on a multilateral net basis with equities and corporate bonds. Going forward settlement cycles of those instruments should be segmented as they bear different types of risk.
- Settlement of T-bonds can only be conducted with instructions from the EGX PD trading system and is limited to a single settlement cycle on T+1. When planning the development of a true OTC government fixed income market (see details in section on government fixed income secondary markets), it will be important to enable processing of OTC generated settlement instructions, as well as introduce more

flexible settlement cycles, including the option to settle on T as is the case for T-bills.

- Repos cannot be reported and settled as distinct operations, so they are processed as two separate outright purchases. The second leg of the repo is submitted and processed on settlement due date, thus leaving an unreported settlement exposure between the two parties of the repo. As the repo framework is developed, the clearing and settlement platforms should be enhanced to support standard repo settlement services: e.g. reporting of both repo legs on trade date, automatic settlement of the second leg, rollover and early settlement facilities and collateral management.
- The DVP principle is not fully complied with, but there is an implicit guarantee that the CBE will always settle the cash-leg by providing a lending facility to the settlement bank if it has insufficient funds. This arrangement is expected to eventually evolve into a standard DVP model 2.²⁷ This would imply a major change for the MCDR in terms of its responsibility for managing the settlement risk of the cash leg. It is not clear at this stage whether this would be addressed by the un-winding of the net in order to subtract a defaulting trade or through the creation of a guarantee fund.
- Settlement for non-government fixed income instruments and equities generally takes place on T+2, although authorized brokers may do intraday settlement of eligible actively traded securities which are included on a list and selected based on liquidity criteria. Risk of non-delivery is managed by blocking securities before trading, whereas non-payment risk is addressed through a guarantee fund. There are plans to implement a securities lending facility to address non-deliveries and eventually eliminate the pre-trade blocking of securities. Non-listed physical securities can also be settled following a T+4 cycle that is bilateral and outside the formal settlement mechanism.

CONCLUDING REMARKS

Capital markets in Egypt have gone through important reforms during the past decade in two phases (2004–2008 and 2009–2012) with differing results. Government debt markets achieved positive progress while non-government fixed income markets, in spite of commendable changes, are still facing a challenging agenda to become a relevant funding channel to private business. This is the right sequence to develop capital markets. Focus on government debt markets, as seen in other countries, is the first step to increasing financial sector efficiency overall and to creating the first building block for robust capital markets. Efficient government debt markets lower funding costs of public deficits, support more effective monetary policy, provide price references for private bonds and equity valuations, contribute to developing risk management tools for financial institutions, and support sustainable integration with global financial markets.

Equity and non-government fixed income markets are an alternative financing channel to banks that can broaden access to capital and lower costs to the private sector, SOEs and local governments.

Reforms in Egypt's government debt markets included the standardization of issued debt, the development of predictable benchmarks through competitive auctions, and the extension of the yield curve up to 10 years. A solid design of the secondary market and its supporting clearing and settlement infrastructure was also addressed. In the non-government fixed income market, several legal reforms were enacted including simplified requirements for registration, and the broadening of instruments such as securitized vehicles, international financial institutions (IFIs), and public juristic bonds. Equity markets increased their size mainly through privatizations and benefited from an active program in EGX to increase efficiency in the primary and secondary market. Attention was also placed in expanding access to smaller companies through the Nilex board. On the demand side, a nascent mutual fund industry was supported starting with money market mutual funds, followed by fixed income funds. Finally, the merger of all regulatory bodies under EFSA was an important step to better articulate supervision and development policies. All these changes were slowed down or put on hold after the revolution. While no reversals have been seen so far, it would be essential to resume planned reforms to continue the momentum achieved prior to the revolution.

Capital markets in Egypt are confronted by challenges of both structural and institutional natures. Structural issues include the need to a return to political and macroeconomic stability, which would enable issuers and investors to plan longer-term investment strategies. A more stable environment would still need to address broader financial sector reforms, including the impact of a dominant banking sector that has been detrimental to capital market development.

From an institutional perspective, the most important step would be to resume government debt market reforms, as this will create an enabling environment for non-government fixed income and equity market development. The two latter markets would require the development of an EFSA led reform plan in coordination with other government agencies (CBE and Ministry of Finance) and the private sector. On non-government fixed income markets, a new regulatory framework should be designed to increase issuance efficiency, including a less costly institutionally oriented market segment, as employed in other markets. On the equity market, besides resumption of EGX efforts to increase secondary market efficiency, the State could play an important role in increasing the free float of its listed companies, and eventually listing suitable candidates for privatization (e.g. state-owned insurers). It would be essential to clarify the status of past privatizations in terms of protecting bona fide investors from rescinding concluded transactions. Additionally, greater attention should be placed in reinforcing venture capital and private equity business that could use the exchange as a refinancing outlet. Finally, creating a supportive regulatory framework for the development of non-bank related mutual funds would support both government and non-government securities markets. Reforms in other NBFIs, as discussed in the next chapter would also be necessary to support a greater diversity of issuers and investors.

ENDNOTES

- 1 This background paper was elaborated by Catiana García-Kilroy and Anderson Caputo Silva. The authors would like to thank Patrick Conroy for reviewing the document and providing valuable comments, and Olga Akcadag and Indhu Raghavan for their excellent research support. The views expressed in this document are those of the authors and do not necessarily represent the views of the World Bank.
- 2 Auctioned repos with T-Bills as collateral were introduced in April 2011 to address eventual liquidity shortages caused by financial stress during the revolution.
- 3 It can be defined as two standing facilities: the overnight lending and the overnight deposit facility with their respective interest rates established by the Monetary Policy Committee.
- 4 See more details in background paper Herrera S. (February 2011): Macroeconomic Stability and Financial Sector Development.
- 5 Effective sterilization of excess liquidity requires issuance of long-term liabilities, which may compete with T-bonds. Several countries have implemented overfunding schemes through which Ministry of Finance sterilizes on behalf of the Central Bank with its own instruments.
- 6 The term Repo as used in this document is generic and refers to either documented repurchase agreements or documented sell-buy backs.
- 7 Standard securities are tradable T-bills and T-bonds placed under competitive auctions, while non-standard securities reflect non-tradable Government debt placed under non-market schemes.
- 8 Greater price discovery and reduced cost was shown in the first re-opening of the 3-year bond launched in January 2009. Dispersion of winning bids (spread between maximum and minimum winning bid yields) dropped from 0.45 percent to 0.16 percent, while the average yield reduced by approximately 130 bps. This strategy also facilitated the launch of a 5-year bond with low dispersion of winning bids 0.18 percent, a significant evidence of price discovery.
- 9 This index includes 15 benchmark bonds.
- 10 This is a hybrid scheme reflecting features of both public and private offering regimes. See more details in IOSCO Development of Corporate Bond Markets in the Emerging Markets, November 2011.
- 11 The different features of corporate bond markets when compared to Government bond markets include the smaller size and the unpredictability of their funding needs. Therefore, their inability to create market benchmarks, which characterize the more standardized and predictable issuance policies employed by Governments.
- 12 See IOSCO 2011.
- 13 Public juristic entities are defined as public sector and economic authorities.
- 14 Orascom Construction, Mobicel, Ezz Steel, GB Auto, Golden Pyramids and International Co Leasing.
- 15 Private placements in Egypt require filing with EFSA and the delivery of a conforming prospectus. They also need to be listed and traded in the Exchange market as any other publicly offered bond issue. The main difference with public offers is that they are only offered to institutions through a book-building process instead of a public offering with a pro-rata allocation process.
- 16 See footnote 14 above on private placements.
- 17 Cost of issuance is around 3 percent of issued volume according to OECD, 2010, while mature markets such as the US and Japan present cost of issuance between 1 and 2.5 percent.
- 18 See more details in IOSCO Development of Corporate Bond Markets in the Emerging Markets, November 2011 p14.
- 19 Bank assets amount to 106 percent of GDP whereas NBFIs amount to only 8 percent.
- 20 See details in background note on Government debt markets.
- 21 For details on corporate governance, accounting and creditor's rights protections see background note by Jonathan Katz: non-bank financial services regulation in Egypt.
- 22 The T-Bill market is OTC and settles in the CBE bookkeeping entry system. T-Bonds are mainly negotiated OTC with trades reported to the EGX system and settled by MCDRMCDR.
- 23 See more details in DPL III Aide Memoire.
- 24 See more details in MENA Flagship, World Bank, 2010.
- 25 See more details in Insurance and Pensions background note.
- 26 For example, in Spain the Central Bank transferred the Government debt CSD to the private CSD in exchange for a 40 percent holding in the private CSD.
- 27 Transfer instructions for securities are settled with finality on a trade-by trade basis, with fund transfer instructions settling on a net basis with finality only at the end of the funds processing cycle.

4. NON-BANK FINANCIAL INSTITUTIONS

Background

The non-bank sector in Egypt was characterized by underdeveloped bond, insurance, and mortgage markets, thin trading in equities, weak corporate governance, and poor financial infrastructure. Egypt's financial system was, and still is, mainly bank-based, with banks constituting over 95 percent of the financial system's assets—accordingly the contribution to growth by the non-bank sector has to date been de minimis. Overall, Egypt's non-bank sector was very small and underdeveloped before the launch of the reform programs.

INSURANCE AND PENSIONS

The insurance sector can play a critical role in financial and economic development. By introducing risk pooling and mitigating the impact of large losses, the sector reduces the amount of capital that would otherwise be needed to cover such losses, encouraging additional investment, output, innovation, and competition. By introducing risk-based pricing for insurance protection, the sector can change the behavior of economic agents, contributing to the prevention of accidents, improved health outcomes, and higher efficiency gains. As financial intermediaries with long investment horizons, life insurance companies and pension funds can contribute to the provision of long-term finance and effective risk management. Insurers can also improve the efficiency of other segments of the financial system, such as banking and bond markets, by enhancing the value of collateral through property

insurance and reducing losses. The insurance and contractual savings sector also performs an increasingly important role in helping governments create fiscal space for infrastructure investment by enabling a more efficient and equitable targeting of social insurance expenditures. These services include the provision of supplementary health benefits, supplementary retirement incomes, natural disasters funding and the direct provision of risk management services to the working poor through micro-insurance.

Insurance and Pensions Prior to 2004

Restructuring the state owned insurance sector and improved supervisory capacity were the cornerstones of the reforms launched in 2004. The insurance sector was facing major challenges, the National Insurance Company was heavily insolvent and Al Chark for Insurance was on the verge of being unable to meet its obligations to policyholders and, in fact, was unable to accurately identify its liabilities. Egypt Re, the state owned re-insurance company was found to be solvent but suffering from poorly priced business placed by the state owned direct insurers and was not able to operate on a fully commercial basis. Only Misr, the largest SOI, appeared to be relatively healthy and to have adequate management and systems.

The mandatory MTPL insurance (MTPL or ‘ACT’ insurance) business was highly unprofitable and underpriced. The private sector insurers had been avoiding this class and the state-owned insurers, which wrote virtually all MTPL, were accumulating large losses. Increasingly, these losses were being disguised as understated claims provisions in their balance sheets. In addition, some group life pension insurance business sold by the state insurers was providing unsustainable guaranteed rates of return and that certain life insurance policyholder liabilities were being valued incorrectly, leading to an understatement of policy mathematical reserves. In consequence, the reform program needed to put MTPL onto a sound footing and strengthen the technical capacity of the supervisor. There was also a need to strengthen the supporting infrastructure, including developing local actuarial skills and capacity, and identifying management for the state-owned insurers capable of operating in the new environment supported by an appropriate governance structure.

The private pension sector was also experiencing unprofessional management and a number of plans appeared to be heavily underfunded. Actions taken to date have been largely of a diagnostic nature, although a draft law has been produced to enable the supervisor to effectively do its job and to require the appointment of professional fund managers but has not yet been presented to and ratified by the legislative bodies due to the non-existence of a legislative body in Egypt since January 2011. As a result of the reforms state-owned insurers were able to weather the credit crisis of 2007/8. The state-owned insurers are also now better placed to compete actively in the market place without resorting to mutually destructive price competition. In addition, private sector insurers have entered the MTPL market, which in the past was the main source of SOI balance sheet deterioration after increasing

its prices. Supporting infrastructure is now in place including a strengthened actuarial profession and a more professional and market focused supervisor.

Reform Since 2004

These reforms focused on financial and strategic diagnoses of the government-owned institutions, restructuring them as necessary and developing the necessary supporting infrastructure and institutions. As the program unfolded, it became evident that social pressures were growing and that the general public was not benefiting in the short term from the reform program. Thus, a second generation of reforms became necessary. Beginning in 2009, these reforms have focused primarily on improving the reach of the financial sector and on better integrating the insurance and private pension sectors with social insurance reform.

Phase I (2004–2008) largely focused on building the reform scaffolding which included carrying out an owner’s due diligence and financial diagnosis of the state-owned insurers and an independent valuation of MTPL outstanding claims provisions in the state-owned insurers and ensure transfer of the relevant technology to the Egyptian actuarial profession (so that provisions could be maintained at adequate levels in the future and actuarially adequate premium rates established). Reforms also included the setting up of an overriding governance structure for the four state-owned insurers, and the development of a supervisory development plan (SDP) for Egyptian Insurance Supervisory Authority (EISA). After relevant legal requirements were satisfied in mid-2006, the four state-owned insurers were placed under a holding company (the Insurance Holding Company or IHC), which became operational in October 2006.

Despite these reforms, the insurance sector was still facing major problems. There was a deficit of approximately LE3.6 billion in 2007 arising from MTPL (‘ACT’ insurance) outstanding claims provision shortfalls and overvalued property.¹ In addition, there was a significant deficit in National’s life mathematical reserves, partly reflecting mispriced group life retirement products developed for the ‘Classified Sectors’. The situation was exacerbated by an incorrect application of methodologies for determining life insurance mathematical reserves (in effect the application of a net premium methodology with some gross premium assumptions — effectively putting some product funding on a partial PAYGO basis). Consequently, it became clear that in their present states none of the state-owned insurers could be privatized or even partially privatized through an IPO. National was heavily insolvent and Al Chark was on the verge of insolvency and losing money. Egypt Re., while well capitalized, was becoming a dumping ground for unprofitable business written by the state-owned insurers under pressure from significant mutual price competition and was not servicing its capital base.

In December 2007, Al Chark and Egypt Re. were merged into Misr, the strongest of the state-owned insurers and the only one with adequate information systems.² A multiyear program to recapitalize the balance

sheets of Misr and National was also produced and approved. A real estate management company was established by IHC to take over most of the SOI property portfolio enabling the insurers to concentrate more on their core businesses. The company's initial task was to divest properties that did not meet the IHC group's strategic objectives.

Table 4.1: Performance Ratio of the Insurance Sector (2004-2011)
(percent unless otherwise specified)

	2005/6	2006/7	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13
Non-life direct premiums LE million	2,804	3,274	4,170	4,750	5,174	5,655	6,089	6,954
Life direct premiums LE million	2,146	2,946	3,514	3068	3608	4,000	4,518	5,267
Non-life penetration	0.45	0.44	0.47	0.45	0.43	0.42		
Life penetration	0.35	0.40	0.39	0.37	0.36	0.32		
GDP deflator rate	7.4	12.6	12.2	11.2	10.1	10.5		
SOI share of non-life market	89.7	76.6	66.8	59.5	57.4	55.0	54.0	45.9
SOI share of life market	70.3	56.4	50.9	46.8	46.8	47.6	36.1	35.5
AUM LE billion	18.7	21.3	29.0	28.9	31.7	35.3	39.6	38.0
Percent of GDP	3.0	2.9	3.2	2.8	2.6	2.6		
Net combined ratio - non life	155.9	149.9	152.9	110.7	124.9	114.5	107.4	110.6
Investment return - whole sector	11.8	10.9	15.3	7.2	8.3	7.8	8.3	8.1
Net expense rate - non life sector	34.9	32.8	30.6	27.1	30.3	32.1	34.7	38.0
Net expense rate - life sector	24.2	19.8	16.7	21.0	23.8	22.7	25.8	26.2
Estimated unadjusted solvency ratio to total sector	572.3	470.2	810.2	442.3	390.2	268.1		

Note: Penetration is gross premium income expressed as a percentage of GDP.

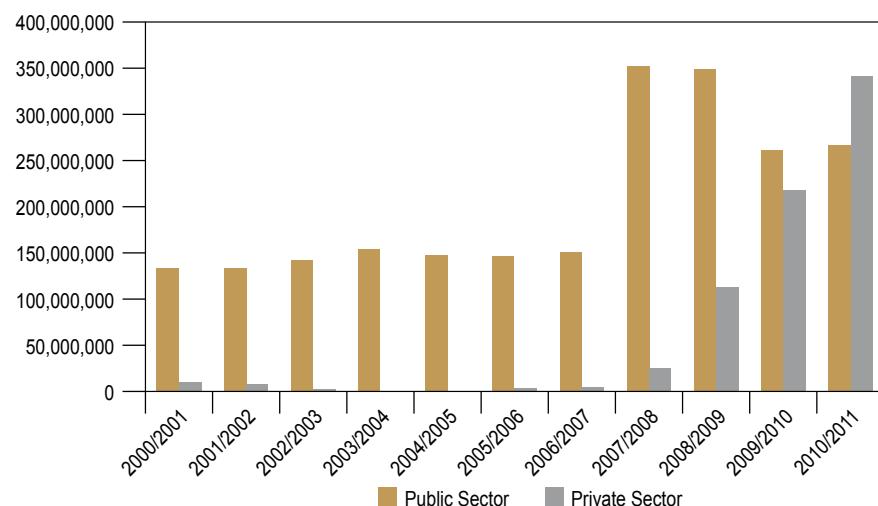
Source: EISA/ EFSA annual reports, IMF country data, SOI annual reports.

There are more than 600 private pension funds (although 25 accounted for more than half of assets under management) with most not being effectively supervised. Actuarial reviews were only required every 5 years (increased from 3 years because of a lack of actuarial capacity) and a lack of

investment skills saw more than 90 percent of funds going into bank deposits and government paper (despite an almost universal DB structure which requires longer term investments for proper matching). In at least one case, assets were being used to fund the employer's activities. It was also evident that many funds were likely to be seriously underfunded.

Phase I (2004–2008) of the reform plan led to an improvement in the performance of the insurance sector in terms of real aggregate balance sheet strength and an increasing private presence. While combined ratios³ during phase I have been high this largely reflects the gradual strengthening of outstanding claims provisions in the state-owned insurers (offset in part because expense rates dropped slightly over this period). The private sector accounted for 45 percent of non-life premium income in 2010/11 following its more aggressive entry into the motor insurance market (Table 4.1).

Figure 4.1: Private Sector Re-entry to the MTPL Market



Source: Misr Insurance Holding Company.

The estimated industry solvency ratio⁴ of 268.1 percent at end 2010/2011 would be reduced once adjusted for aged receivables, other non-admissible assets and remaining understatements of policyholder liabilities in the state-owned insurers. The solvency ratios during the reform period were initially overstated as they reflected the gross understatement of policyholder liabilities in the state-owned insurers. However, the industry as a whole appears to be adequately capitalized.

Non-life penetration reduced in the period to June 2010. This reflects greater price competition in certain industrial and commercial lines combined with a period of rapid economic growth (increasing the denominator faster than the numerator in the ratio). Consumer classes, including MTPL, health and individual life have shown real positive growth rates. However, increased access to insurance for the less privileged sections of the community will

need to be addressed in any ongoing future generation reform program. Private sector insurers account for more than half of the MTPL market, representing a significant positive deliverable under the reform program. Anecdotal evidence indicated that several smaller insurers might now be viable as a result.

The performance of the private pension sector has been, if anything, retrograde and key reforms, especially the passage of the draft Private Pension Law still need to be addressed. While investment returns are stable due to approximately 95 percent of pension fund assets being placed in bank deposits or government paper, they barely cover inflation. This reflects the part time, non-professional and overly conservative nature of the management of most of the funds. The reported expense rates also seem excessive. In sum, there is considerable scope to improve both the governance and the management of most private pension funds.

Table 4.2: Private Pension Funds (2004-2011)

	2003/4	2005/6	2007/8	2009/10	2010/11
AUM LE billion percent	14.2	18.6	23.9	29.8	32.9
GDP	2.9	3.0	2.7	2.5	2.4
Investment Return percent	9.8	9.6	9.8	9.2	8.9
Expense rate* percent	2.8	4.9	3.7	7.3	4.8

*Before provisions.

Source: EISA/EFSA annual reports.

The performance of the state-owned insurers (Misr Insurance and Misr Life) during is difficult to gauge from published data. This is because it includes the costs (including reserve strengthening) of the restructuring, recognition of capital gains and losses, and the impacts of major transfers of risk and assets portfolios and of staff.⁵ In addition Misr Insurance paid nearly LE 500 million in dividends in the 2 years prior to the revolution. In November 2011, the General Assembly of Misr Insurance agreed to transfer LE 350 million of general reserves to capital, leaving the company with LE 2 billion of capital. The state-owned insurers have effectively operated as specialist non-life (Misr Insurance) and life (Misr Life) insurers since June 30, 2008 and a revenue account ratio analysis can be carried out over that period. Balance sheet strength can also be assessed based on the restated June 30, 2011 accounts (Tables 4.3 and 4.4).

Table 4.3: Misr Insurance Performance Ratios

	2009	2010	2011	2012
Non-life Total MTPL Other				
Gross written premium LE million	2,816	349	2,467	2,971
Claims ratio	262	2,709	3,108	267
Expense ratio	2,84	3,701	245	3456
Operating profit margin	85.2	343.0	66.9	
Total MTPL Other Total MTPL Other				
Source: IHC.				

Table 4.4: Misr Life Performance Ratios

Life	2011	2012	2013
Net premium LE mill.	1,441	1570	1770
Acquisition cost ratio	14.1	18.2	18.8
Admin. Cost ratio	14.1	14.5	13.8
Yield on math. reserves	4.4		

Source: IHC.

Misr Insurance has reduced market share accounts in part for a high ratio of MTPL technical provisions to earned premium as its technical provisions reflect uncapped business written many years into the past when the state-owned insurers had virtually the whole of the MTPL market.

The key ratios highlight the current balance sheet strength of the two remaining state-owned insurers. The solvency positions of both insurers are strong and insurance liability provisions and reserves have been significantly strengthened. Misr Insurance shows adequate profitability. However, Misr Life's aggregate expense rate remained high at the end of 2008/9 for a mature life insurer, mainly reflecting the Al Chark excesses (Table 4.5).

Table 4.5: State-Owned Insurer General and Administrative Expense Ratios*

	2010/11	2011/2012	2012/13
Life activities	13.5	14.5	13.8
Non-life activities	10.8	8.8	9.6

* As a percentage of gross premium revenues.

Source: Misr Insurance Holding Company.

The June 2011 financial reports showed a worrying trend. In the 2010/11, Misr Life had an overall expense rate of 28 percent compared to a private sector expense rate of 20 percent: as late as 2009, it had a better expense rate as the private sector life insurers. At June 30, 2011, Misr Insurance had 4,105 staff and Misr Life had 5,105 staff (an overall SOI staff reduction of 20 percent since June 2005). Generous salary and agency remuneration increases have been reflected in significantly increased expense rates at a time when revenue sources are under pressure from increased competition and reduced investment returns (Table 4.6). Some indication of the current level of staffing relative to benchmark can be found from international comparatives, after adjusting for PPP income levels (Table 4.6).

**Table 4.6: Adjusted Premium per Insurance Employee
Normalized Egyptian PPP GDP/ Capita-2009 (LE1000s)**

Country	Egypt (state-owned insurers)	Germany	Spain	France	Poland	Turkey	UK
Adjusted premium per staff	55.8	122.8	191.5	224.1	126.7	135.6	175.3

Source: CEA Statistics No 42, November 2010, Axa Reports.

The Egyptian state-owned insurers appear to have approximately 2.5 times the staff counts normalized to PPP adjusted premium as the least efficient European countries. More accurate benchmarks could be obtained by examining domestic private sector insurer staffing levels and separating direct sales staff from other staff, but this would be unlikely to change the conclusion. A related issue is the legal right of SOI staff to 10 percent of profits. Such expectations can create pressures on management to overstate profits, usually by understating policy liabilities.

A detailed examination of Misr Insurance's profit sources shows that it is effectively acting as a conduit of funds from government-owned enterprises in order to subsidize motor vehicle owners and fund the excess staffing levels discussed above. As long as Misr Insurance is able to maintain a preference in the placement of government business, it can stabilize returns through reinsurance and exchange commission income. This hidden cross subsidy from key productive sectors of the economy is inefficient and not sustainable in the long term: strategies to deal with MTPL underpricing and overstaffing of the state-owned insurers will need to be developed.⁶ In the case of Misr Life the overstaffing issue is potentially of existential importance as its expense rate is now well above industry norms.

A short/medium term threat to Misr Life's balance sheet is the impact of high supplementary salary increases on group life pension contracts written for the public section of the insurance sector (including some EFSA staff). While these contracts were in approximate balance based on current

salary levels at the time of writing, deficits of up to LE600 million have been projected if current levels of supplementary salary increases are assumed to increase at current rates.

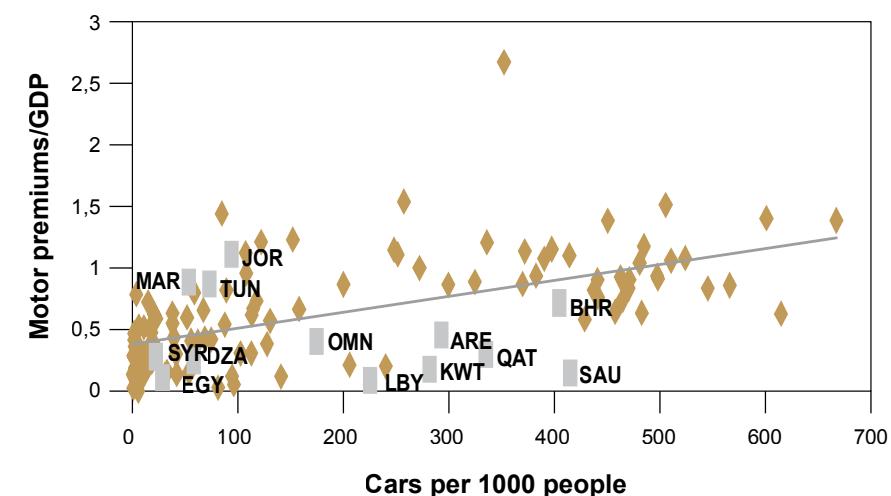
A governance challenge specific to the state-owned insurers is the issue of staff indirectly holding agencies through family members. Decree 245 of 2008 states that the staff of insurers, except those working in sales and marketing, may not hold insurance agencies. Amongst other objectives, this rule is intended to protect Misr Insurance against conflicts of interest when insurance risks are priced. However, SOI staffs, including managers, continue to hold agencies through family members and the Decree should be extended to cover immediate family members of ineligible staff (including all staff whose job description does not include directly selling new business).

Sectoral Structure and Performance

Insurance Sector

If structural, cultural and other economic variables are introduced Egypt's insurance penetration is better than expected for life and about equal to expectation for non-life, despite its being an underperformer relative to income level. Key variables holding back sectoral development include the lack of development of credit at the small business and household level, inflation rates (for life insurance), government domination of the non-life insurance sector, and cultural effects (i.e. a lack of clarity as to the acceptability of certain forms of insurance under Islam). Positive explanatory variables affecting life penetration are population density and the emergence of a middle class with discretionary income.

Figure 4.2: MTPL Premium Penetration Versus Vehicle Density



Source: World Bank Database.

A highly predictive variable for Property & Casualty (P&C) penetration is the size of the national car fleet. On this measure Egypt is well behind expected premium levels. The most obvious reason for this state of affairs is the ongoing inadequate premiums being charged to cover certain MTPL risks (although the shortfall has recently been reduced due to corrective action on the part of the previous government). However, there is also scope to investigate levels of car owner compliance with the mandatory purchase of MTPL insurance, and whether vehicles are properly classified when MTPL coverage is purchased.

An important line of business that has not been modeled is health insurance. This is one of the fastest growing classes of insurance in emerging markets, and the Middle East in particular, as governments attempt to create fiscal space.⁷ Egypt lags behind its regional peers in terms of health insurance penetration, possibly reflecting its current high level of coverage through social transfer arrangements and a large rural population. An additional risk factor associated with health insurance is the lack of a regulatory framework governing the operations of health insurers. Prior to January 2011, the Ministry of Investment and EFSA drafted a legislation to regulate this industry; however, it is not yet a priority on the reform agenda by the government,

A distribution channel that has yet to be fully exploited is bancassurance. The three life insurers (including CIL, the largest by new business) gain most of their business through this channel. There had been a freeze on any new bancassurance agreements being approved by the central bank. This freeze was justified as the applicable rules needed to be strengthened and there was evidence of banks mis-selling through unlicensed staff. There is as yet no internationally accepted standard model of bancassurance and country specific regulation tends to be ad hoc. In May 2013, CBE reauthorized bancassurance with new set of regulations that included hedging the risk borne from the insurance company, complete separation between the activities of the insurance company and the bank, in addition to transparency. EFSA has also allowed postassurance in the second quarter of 2014.

The low retention ratios reported for the Egyptian insurance sector indicate that significant underwriting is taking place in foreign reinsurance offices or parent companies. While low retentions are justified for very large risks such as those in the oil industry (called ‘peak risks’ in the industry), it is difficult to understand why classes such as fire (retention 26.1 percent), accident (retention 63.7 percent) and health (retention 61.5 percent) are being reinsured to such a large extent given the more than adequate capital employed in the sector (see Annex 5 for retention ratios by class of business). One possibility is that some insurers are ‘fronting’ and their proprietors are happy to accept the more reliable but potentially lower income available from reinsurance exchange commission. A negative outcome from such a business model is that local underwriting skills are not being developed and there is little incentive to develop the non-life insurance market.

Supplementary Pension Sector

There are two types of standalone supplementary pension arrangements in Egypt, one of which currently is subject to full EFSA oversight. The first is entitled Private Pension Funds (PPFs) and covers approximately 3 million employees. Most PPFs are occupational plans (usually for public sector employees) and they have historically been set up on a DB basis, although more recently formed plans have adopted a Defined Contribution (DC) approach. As at the end of June 2010, there were 632 such plans of which 25 operate on a DC basis. As mentioned above the funding status of the DB plans is gradually being determined under a stepped program instituted under the first generation reforms (Table 4.8). Funding levels appear to have improved since the 1st generation supervisory reforms were introduced. Remedial action continues to be taken to the extent possible under the existing inadequate law.

Table 4.7: Private Pension Funding Levels (May 2012)

Funding Ratios	Number of Funds	Percentage
Less than 60 percent	23	5.4
60-80 percent	42	9.9
80-90 percent	59	13.9
90-100 percent	65	15.3
100-125 percent	122	28.8
More than 125 percent	113	26.7
Total	424	100.0

Source: EFSA.

The second type of retirement savings arrangement, is termed a syndicate plan, and is now subject to partial EFSA oversight. These also tend to be designed around DB principles, and are established to cover the large memberships of various professional and vocational bodies, such as accountants, tour guides and engineers. The 3-syndicate funds reviewed to date (out of 10) appear to be reasonably well funded. However media reports dating back at least three years (news.egypt.com) refer to certain syndicate funds experiencing severe cash flow shortages—despite paying minimal pension benefits—and implying that they have zero funding ratios (i.e. are now on a PAYGO basis). Aside from these standalone arrangements market intelligence indicates that a significant proportion of pension arrangements are now managed through life insurance groups and individual policies. A number of private pension funds have wound up and have been transferred to insurance companies.

Key Challenges Confronting the Contractual Savings Sector

MTPL (‘ACT’) Insurance. The main technical challenges continue to be maintaining the stability of the MTPL insurance non-life portfolio in Misr Insurance. Although Misr Insurance has significantly strengthened its own

technical reserves, it inherited an enormous technical reserve shortfall when it took over National Insurance's 'Act' insurance claims portfolio in 2009. In addition, claims provisions for business written before claims were capped (under Law 72 of 2007) continue to prove to be inadequate as the claims are run off (Table 4.9). This reflects National's former dominant role in the MTPL business and the dependence of a segment of the legal profession on representing accident victims and their need to generate income from the old claims portfolio during its run off period. On the other hand, the business written since the claims cap was instituted and premiums were increased is providing an adequate overall return to underwriters, although some categories of vehicle continue to be highly unprofitable.

Table 4.8: MTPL Loss Ratios* (2007-2013) (percent)

Accounting Year	2007	2008	2009	2010	2011	2012	2013
State owned Insurers	846.8	635.2	261.1	452.3	377.9	343.0	228.1
Private insurers	267.1	131.2	28.5	59.2	66.7	37.3	40.9

*Claims ratio is claims cost over corresponding earned premium.

Source: Misr Insurance Holding Company.

Accounted loss ratios tend to underestimate real claims ratios in growing portfolios and the private sector experience will almost certainly deteriorate with time, but not to the levels being experienced by Misr Insurance. An alternative approach which helps to identify the impact of the old system business is to examine Misr Insurances post 2007 experience by underwriting year (Table 4.10).

Table 4.9: State-Owned Insurer Claims Ratios by Underwriting

FY business written	2008/9	2009/10	2010/11	2011/12
Claims ratio developed to date percent	65	178	92	83

Source: Misr Insurance Holding Company.

The differential (DIFF) experience of the post 2007 business between public and private insurers reflects the fact that under the current regime private insurers are able to select the best risks while Misr Insurance continues to have to also accept inadequately rated and hence loss making commercial vehicle (including taxis) business. As noted above Misr can continue to cross subsidize motor insurance from excessively priced government sourced business but in a competitive market and given current fiscal pressures this will become increasingly more problematic over time and is undesirable from a public policy perspective.

The standard approach to the incentive problem described above (i.e. the worst risks being effectively diverted to government owned insurers) is to establish an 'assigned risks pool' for loss making commercial business and to allocate this to all non-life insurers according to their market shares. The concern in Egypt is that this will upset the development of the private sector

non-life insurers. In addition there is at present no credible data set on which to base such policy decisions. Ideally, the correct premium rates should be charged based on detailed actuarial analysis however, social groups (e.g. taxi drivers and privately owned light transport) this may not be possible in the current environment. Thus in the short term the best approach may be to establish a separately managed pool for certain classes of commercial vehicles and for the insurance sector and government to jointly subsidize this pool on a transparent basis.

If EFSA is to be able to justify future increases in MTPL premium rates (particularly for socially sensitive groups) it will need an excellent database feeding into a modern actuarial premium setting practice. For this reason it is essential that a central data repository is established by the Insurance Federation to gather policy and claims data by vehicle and driver. This information could have a range of uses including helping to assess the general level of required outstanding claims provisions (i.e. through actuarial examination of claims run off patterns) and hence enable the authorities to establish pure risk premium rates. It would also enable the authorities to clearly identify the highest risk vehicles (typically taxis, motor cycles and commercial transport) and begin to require appropriate risk management measures such as driver training. Finally, it would enable the relevant bodies to identify car owners who are either not buying compulsory insurance or who are misclassifying their vehicles to reduce premiums. A system to achieve this has been developed successfully in Turkey and currently Saudi Arabia is developing its own system.

SOI expense rates. While it is desirable that market level compensation is paid to all SOI staff, in order to attract high quality recruits, this will not be possible until Misr Insurance and Misr Life also attain competitive efficiency (i.e. premium per staff) levels. A generous retrenchment structure and natural attrition, combined with modern performance review systems are three methods of dealing with this. Both state-owned insurers have developed medium term attrition plans based on the relatively high average age of their staffs. In the interim only essential recruitment for specified skills enhancement should be allowed.

Private pensions. A Private Pension law has been drafted and was submitted to the Cabinet of Ministers in November, 2010 and since the revolution, and the dissolution of Parliament, the law has been pending. This law is not controversial and is essential if EFSA is to be able to do its job properly, ensure that private pension funds are professionally managed and to clarify relevant tax incentives.

Of more concern is the status of the syndicate funds. Any resolution of this subset of funds is likely to require a considerable diagnostic effort, a major restructuring program, and possible government financial contributions.

Insurance and private pension supervision. Unfortunately, following the unexpected departure of the first Chairman of EFSA, and a freeze on senior appointments imposed by the interim government, progress towards the planned functionally based structure of EFSA has stalled. Recently applied salary caps

have also significantly reduced the incomes of senior EFSA staff (reflecting low civil service minimum salaries) and key individuals have already departed for better paying jobs in the private sector. The new management of EFSA is currently undertaking a thorough review of the insurance law, its executive regulation and the private pension executive regulation. Advisory committees including experts and market participants are working on drafts to be followed by public consultations in the second half of 2014 as indicated by EFSA.

In the interim the insurance and pension, SDP has been partly implemented. However, there is a need to further develop the capacity of EFSA to risk rate institutions and to introduce an enforcement and sanctions regime commensurate with these ratings. Ideally, the supervisor should be able to produce a detailed risk matrix for each insurer and pension fund incorporating both hard numerical analysis (including IRIS and solvency ratios) and the current qualitative inputs.

Group Life Contracts in Misr Life. As noted above the new management team in Misr Life (formerly National Insurance) has inherited a group life pension portfolio that is difficult to fund when salaries are rapidly increasing. A particularly generous component of this business covers employees of the state-owned insurers, insurance supervisory staff and staff of the Insurance Federation. This component places no cap on salary increases allowed for determining ultimate benefits, while most other group life pension plans do impose such caps. If current generous salary increases are maintained the liability valuation actuary will be required to change his assumptions and this could severely damage the recently repaired Misr Life (formerly National Insurance) balance sheet. The best solution would be to put public sector insurance staff group life arrangements onto the same basis as other group life arrangements. The legal steps required to achieve this should be explored.

Opportunities Going Forward

A basic question that needs to be asked is whether the new government post-revolution is prepared to allow the state-owned insurers to be run on a fully commercial basis given the employment imperative. The financial sector can support efforts to create fiscal space and through its intermediation and risk management roles, it can encourage and support economic development. However if it is used directly to provide employment it is likely to perform poorly in these roles, and inefficient subsidies consequently become necessary.

**Table 4.10: Household Savings through Financial Institutions in Egypt
(LE billion)**

	June 2008	June 2009	June 2010	June 2011
Time and Savings Deposits	330.1	388.3	448.3	447.5
Life insurance math. reserves	12.7	14.2	16.4	17.8
Private pension AUM	23.9	26.7	29.0	30.1
Total	366.7	429.2	493.7	498.6
Percent of GDP	40.9	41.2	40.9	40.8

Source: CBE, EFSA.

A related issue is the level of household savings in Egypt intermediated through banks. Combining the assets of the private pension funds and life insurers with household term and savings deposits produces a sum equal to 41 percent of GDP (Table 4.11). However, the institutional investors only capture a small fraction of household savings. This situation has hardly changed in recent decades and indicates that the general public has yet to gain a familiarity with and trust in, the insurance sector as a medium for long term savings. Until recently, the sales that have occurred in the life insurance sector have had a significant single premium investment linked component.

If institutional investors were to successfully begin dis-intermediating significant savings from the banking sector, it appears likely that they would be obliged to place funds with the government in order to support domestic borrowing needs. Given that, at the time of writing, all but one outstanding government bond issue matures in 2016 or earlier, the scope for the provision of the long-term guarantees that underpin traditional life products will remain quite limited. Thus, the future of the life insurance sector is in part linked to government macro management. This in turn will be influenced by the social transfer arrangements implemented going forward, and in particular the success of the new government in targeting those most in need and creating fiscal space by requiring the better off to make their own supplementary arrangements.

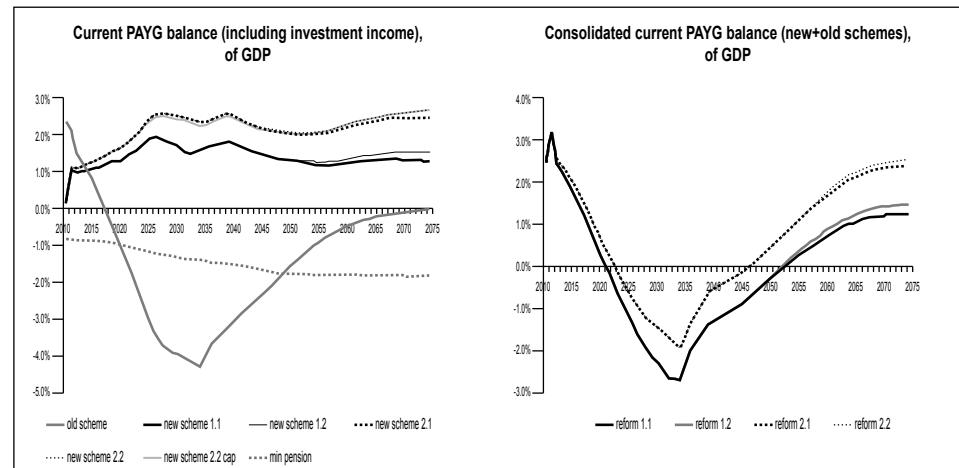
Pensions. The Law 135 of 2010 introduced a fundamental restructuring of pension and related social insurance benefits in Egypt. This reform became necessary because the existing model was inequitable, had limited coverage (despite a constitutional guarantee) and was becoming fiscally unsustainable (Figure 5.3). In addition, the high employer contribution of 26 percent (in part on full remuneration) was pushing firms into the informal sector or encouraging them to underestimate salaries.

Key features of the new system include significantly reduced contribution rates (offset by the removal of salary caps for both contribution and benefit purposes), a guaranteed basic demogrant (i.e. retirement income) and individual defined contribution accounts with guaranteed minimum returns (to be supplemented by a central solidarity fund). A central board will determine investment policy with between a third and 45 percent of funds potentially going to investments other than government securities.⁸ The extent to which these funds will be invested through private fund managers is not clear, although a significant private sector involvement is preferable as it would ensure a disinterested approach and reduce the potential for later fiscal strains arising from poor returns related to politically directed investments.⁹

The impact of this reform on private institutional investors is likely to be negative unless certain further amendments are made. Advisers have already suggested that private pension funds will not be necessary for new employees (younger employees may also switch to the new system). If this advice is followed, existing private pension funds will become closed funds and are likely to experience increased funding problems in the absence of new entrants. Life

insurers may benefit in the short term as DB funds are wound up, converted to DC arrangements and transferred to professional management (as required by the proposed private pension law). However, in the longer term the role of institutional investors in Egypt is likely to be severely curtailed (the central fund excepted). One possible approach, which could help to create fiscal space given the economic challenges Egypt will be facing, is to re-impose caps on contributions and benefits, but to do so in a way that would introduce greater progressivity in the pension system (i.e. more transfers from the well off to the poor). This would leave scope for those with higher incomes to seek supplementary retirement income from insurers and private pension funds.

Figure 4.3: Fiscal Balance - Old and New Public Pension Systems



Source: Maait.

Note: Reforms 1 and 2 assume different allocations between invested assets and transfers to government. Reforms 1.1 and 1.2 (and 2.1 and 2.2) assume different earning rates on invested assets.

Health insurance. A major restructuring of health services funding and provision is being tested through a series of pilot programs for similar reasons to those underlying the pension reforms. Rationalization of a fragmented and inefficient system and the wide use of political patronage to gain access to better quality facilities (often with PTES (Program for Treatment at the Expense of the State) funding) are additional specific issues needing attention.¹⁰ Overriding these concerns is the fact that despite the constitutional guarantee, approximately 72 percent of all health expenditure in Egypt is out of pocket (OOP).¹¹ The future of this reform program, which includes greater decentralization of authority under the MOH system, and the enrolment of rural families in a primary care system remain unclear.¹²

This reform is likely to be less of a threat to private sector insurers given the political and operational challenges entailed, and the necessary lead times in raising the quality of government health care provision to the public at large.¹³ Surveys demonstrate that even a majority of the working poor are

prepared to pay the additional cost of accessing private primary care and hospital facilities.¹⁴ Public hospital utilization is barely 40 percent. Reasons for avoiding the government facilities that are available free of charge include long waiting times (which many cannot afford), poor equipment, crowding and the need to sometimes pay baksheesh. In addition, some costs such as lab fees and drugs, are not free. For these reasons, other initiatives that will help to transfer some of the load to private sector providers (and again possibly increase fiscal space), and increase coverage (such as expanding the coverage of micro-insurance) should be supported.

Micro-insurance. Approximately 41 percent of Egypt's population is classified as living under the national poverty line with the majority of the poor largely confined to the informal economy, and concentrated in Upper Egypt. Thus a significant proportion of the population has no or limited access to financial services. In practice, this group has also had little access to social insurance mechanisms.

Surveys indicate that microfinance already accounts for the major part of the financing of small informal sector entrepreneurs in Egypt, although '95 percent of the demand for microcredit remains unmet' (Planet Finance). The micro insurance initiative in Egypt is currently focused on protecting micro loans and to date has been confined to joint efforts between Allianz insurance and two local NGOs, and Misr Life and Principal Bank for Development and Agricultural Credit (PBDAC). Thus, it is mainly protecting the lenders rather than households. Workshops in numerous countries, including Egypt, show that the working poor would be enthusiastic purchasers of micro insurance if the product were delivered through trusted institutions and were designed to meet the target market's specific payment and claims management needs. Once Misr Life is put onto a sounder footing its management could possibly consider setting up a specialist micro-Takaful window to meet the needs of the conservative population currently not served.

Takaful. Eight Takaful insurers have entered the Egyptian market, the first in 2007 and the balance since 2008 (three were family (life) and five were non-life). These are commercial enterprises, although their business model is to provide a facility for those consumers who prefer a cooperative model more consistent with Shari'a principles. While it is still too early to determine the ultimate success of these new insurers (although at least one has already withdrawn), experience in other contiguous markets indicates that non-life Takaful insurers tend to compete for existing business¹⁵ while life ('family') has more potential to increase overall insurance penetration.

Reinsurance. Egypt Re., the state owned reinsurer was merged into Misr Insurance as part of the restructuring of the state-owned insurers. This was largely because its existence was enabling direct insurers to underprice risk and pass it on, effectively to the State, and because that way its net assets could be better employed in supporting the direct insurers' capital needs. More than 50 percent of its business came from domestic insurers and it was earning inadequate returns on the public funds invested in its

balance sheet. As part of Misr Insurance, the business can be run down efficiently, yet in practice, other insurers have little incentive to make facultative¹⁶ placements with a competitor. Given the long history and reinsurance placement skills of the Egyptian insurance sector (especially following the SOI restructuring) it seems unlikely that Egypt (in common with many developed countries) needs a national reinsurer. However if there is a desire to establish a second local reinsurer (Africa Re's Takaful subsidiary was recently established in Cairo) it should have strong regional focus and be privately funded.

MORTGAGE MARKET

Mortgage Market Development

Egypt's Mortgage Market grew rapidly during the period 2006 to 2010, although it still remains small relative to the overall economy and the overall size of the financial system. Much of the initial growth was led by the banks and the Mortgage Finance Companies (MFCs) followed. Although recently data for banks have been difficult to obtain it would appear that during 2010 and into 2011, very little mortgage lending was done by banks.

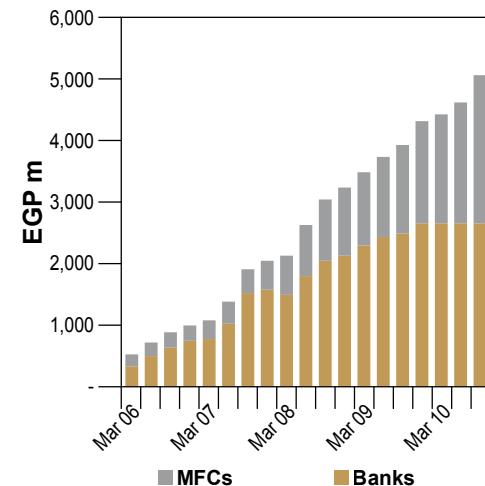
Future growth of the sector is likely to depend at least in part on (i) further lending by MFCs, assuming they are able to fund their expansion (ii) growth in the government's lending programs, possibly under the National Housing Plan subsidized loans program which is being phased out or more likely, under the Mortgage Finance Fund affordable mortgage finance program (iii) an improvement in property registration nationwide.

Egypt's Mortgage Market

Egypt's mortgage market is a relatively recent development for the financial sector. Egypt has made significant progress in launching a mortgage finance system, reforming the land and property registration system, formulating a more conducive property tax law and a Unified Building Code, implementing a new Rental Law, and expanding the variety of affordable housing typologies offered under social housing programs.

Just after the Egypt's revolution in 2011. The Peruvian economist Hernando the Soto published an essay¹⁷ in the Wall Street Journal discussing the relationship between property rights and the causes of the revolution. He succinctly summarized one of the drivers of discontent with the Mubarak regime as: "More than 90 percent of Egyptians hold their property without legal title. No wonder they can't build wealth and have lost hope." So although much has been achieved, much also remains to be done in scaling up Egypt's mortgage market and bringing mortgage finance within the reach of lower income groups. This chapter should be seen within the context of the broader financial sector development, but also merits stand-alone consideration as a roadmap of recommendations for future development of the mortgage sector.

Figure 4.4: Mortgage Debt Outstanding



Source: Egyptian Financial Supervisory Authority, IFS Database.

Figure 4.5: Mortgage Debt Outstanding

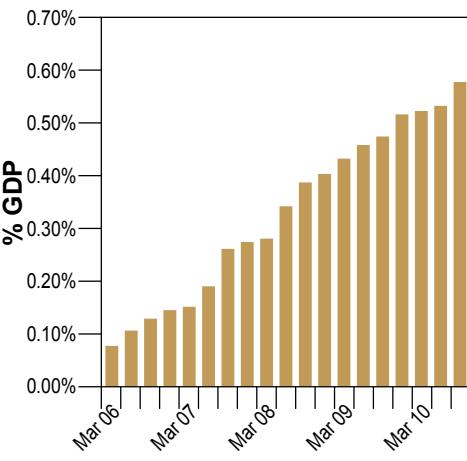
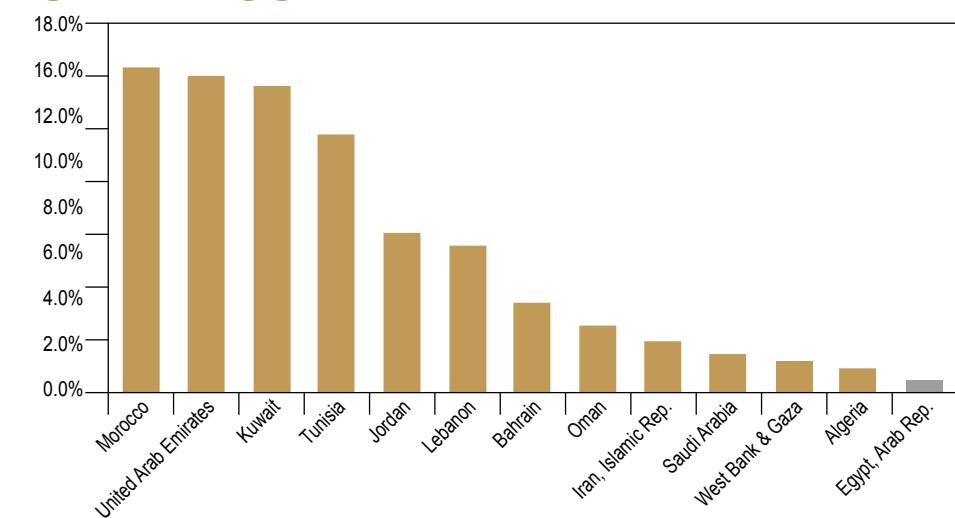


Figure 4.6: Mortgage debt-to-GDP



Source: World Bank mortgage database collated from Central Banks and other national sources.

Despite the rapid growth in Egypt's mortgage market, it still lags behind many neighboring economies.

A recent paper by the World Bank covering housing finance in the MENA region, attempted to estimate the expected size of a mortgage market based on certain key variables such as overall level of wealth as measured by GDP. The charts below show the significant opportunity that exists in Egypt to further expand the mortgage market. In the exercise, MENA region

housing and mortgage markets were modeled to measure the gap between the current and potential depth of housing finance markets. Housing loans/GDP and housing loans/total loans were regressed against several variables, including income per capita, population size and density, and inflation. For both regressions, the model shows that for most MENA countries, mortgage finance is below expected levels. This discrepancy indicates the potential for mortgage finance to grow in these countries as well as the potential to progress toward attaining international reference levels, without significant new demographic or economic developments. The area below the diagonal line represents an under-performing market. So Egypt with just 0.6 per cent of mortgage debt to GDP has an expected market of closer to 2 per cent of GDP or at least 3 times larger than currently.

Housing Loan Product Penetration

The chart below provides a unique perspective on the Egyptian home loan market using the Global Findex Financial Inclusion Survey. The data show clearly the low levels of penetration for home loans with formal financial institutions among the adult population. In all areas, Egypt has a lower level than the average across the MENA region. Based on a survey of over 1,000 adults carried out in 2011, just 2 per cent of the population reported having a loan used to purchase a home or apartment. The most surprising output of this survey may be that the group, which reported the highest penetration level, was the poorest quintile of the income distribution. This may reflect the fact that loans for purchasing new properties are not extended by financial institutions but by developers and would not be included in these results and secondly that the National Housing Program (NHP) has helped some home buyers at the bottom of the income distribution with 10.5 per cent subsidized loans granted through the state owned banks. However, the overall level of penetration remains low even by developing economy standards.

Path of Mortgage Market Reform 2001–2009¹⁸

The government introduced a number of reforms to promote mortgage and mortgage finance starting in 2001. Most notably was the introduction of a legal framework that paved the way for mortgage finance, the establishment of a regulatory authority, the setting up of a fund to support low and middle-income housing, and the creation of specialized mortgage finance companies. Moreover, the mortgage foreclosure regime was modernized, the property registration system was improved and fees reduced, and the private credit bureau became fully operational. In July 2009, a new law was issued to create a supervisory authority for NBFIs.

One of the central goals of Egypt's previous Financial Sector Reform Program was to create a vibrant mortgage lending market. A number of major reforms were undertaken to achieve this. The building blocks for mortgage finance which were put into place include:

- **Enactment of the Real Estate Finance Law 148 of 2001**—the basis for all the reforms, which established the institutions to regulate the mortgage sector, creating the Guarantee and Subsidy Fund (GSF), and prescribing the rules for the types of loan products which banks and mortgage finance companies are permitted to offer borrowers.
- **Creation of the Mortgage Finance Authority (MFA)**, whose functions were incorporated into the remit of the Egyptian Financial Supervisory Authority (EFSA) in July 2009—a key step in creating a secure and strong regulatory environment to protect the interests of lenders and consumers. The importance of strong regulation has been underlined during the current crisis.
- **Establishment of a mortgage liquidity facility**—the Egyptian Mortgage Refinance Company (EMRC) in June 2006, that enhances mortgage lenders access to term re-financing which is crucial for the establishment of long-term lending and better management of financial risks.
- **Enforcement of foreclosure**—the ability to enforce collateral rights is essential to lenders if they are to properly value the collateral in a secured loan. The first cases of foreclosure went through the courts in 2008, establishing the necessary legal precedents to give comfort to mortgage lender.
- **Streamline property registration**—this process has been significantly improved, through a nationwide mapping and titling program. In addition, the time it takes to register a mortgage and the fees charged have been significantly reduced. The government continued to make an effort to address property-registration issues to facilitate the development of primary markets.
- **Enhancement of consumer protection and financial education**—minimum disclosure requirements pertaining to loan information and consumer education programs are being conducted by the EFSA. These programs are designed to familiarize Egyptian consumers with new financial products and to ensure that they are aware of the terms and conditions of the product when securing a loan.
- **Set-up the first private credit bureau**—I-Score was established to provide timely and accurate information on credit worthiness, which will serve to improve the underwriting process and lower the credit risk for lenders.

These building blocks have helped in gradually developing the mortgage sector in Egypt, attracting foreign capital into the sector and creating steady growth of mortgage loans in both number and geographic spread around the country. Nine non-bank MFCs were created, and others are currently being formed, but they still only account for a small share of lending due to inadequate availability of long-term funds and delays in registering property titles in the new urban communities.

Islamic Housing Finance

During the 1970s, a number of schemes were marketed under the banner of Islamic Finance. However, some of these turned out to be investment frauds that resulted in many small savers and investors losing their money. This left ordinary Egyptians with a distrust for products marketed as being Islamic Finance. Subsequently, Egypt's leading cleric, Sheikh Mohammed Sayed Tantawi, the Grand Imam of Al Azhar Mosque and University - which has been a leading center of Islamic studies for centuries - issued a fatwa indicating that simple bank interest would be permitted as long as it was not excessive. Thus, Islamic finance in Egypt bears a greater similarity to conventional finance but with a usury safeguard.

Based on the fatwa, therefore almost all mortgages in Egypt are technically compliant with Islamic Shari'a law although they are not structured in a way that is usually understood as being in accordance with the principles of Islamic finance. There is a widely quoted figure from a 2009 McKinsey report that indicated that a mere 3 per cent of Egypt's banking assets are in the form of Islamic Finance. The accuracy of this figure is suspect given that in fact regular financial products in Egypt bearing moderate interest can be considered as being Shari'a compliant as a result of the fatwa.

This has been accepted by most Egyptians and Egyptian financial institutions and has not appeared to cause any problems. One of the downsides of this ruling, however, is that it has meant that the more traditional Islamic finance products for housing have not taken root. Given that Egypt is almost the birthplace of Islamic Finance with a pilot project in the village of Mit-Gahmr in 1963, it seems unfortunate that more progress in this area has not been achieved.

Having a financial system that includes housing finance in the form of Musharakah (profit sharing structure), Ijara and diminishing Ijara (housing leasing structure) or Mudarabah (also profit sharing but with greater risk for the lender) alongside traditional interest bearing products could be considered. Additionally funding for these loans could tap into a different class of investors using Sukuk bond issuances. Given the growth in this sector across the MENA region, Egypt could consider developing some of these products even with its unique Egyptian fatwa, even in the absence of it being necessary under its Shari'a law.

Mortgage Finance as a Driver of Growth

Currently, one central theme of global development policy is job creation. One of the benefits of promoting housing as a policy objective is both the tangible improvement in living conditions but also the potential jobs created. Many of the jobs will be low skilled and are therefore very accessible. This section of the chapter considers a theoretical framework of benefits arising from housing finance and then seeks to put this into the Egyptian context by looking at the potential expansion in housing and housing finance and the benefits for the Egyptian economy.

Economic benefits of housing finance. The section below provides some theoretical background on the importance of housing finance as a driver of growth and some of the other externalities that result from investing in housing.

Deepening financial access. There is a broad array of literature regarding the impact of deepening financial access on poverty levels.¹⁹ Gaining access to finance can be a way out of the perpetual cycle of poverty that is prevalent at the bottom of the income pyramid. This 'poverty trap' is well illustrated in the book 'Portfolios of the Poor: How the World's poor Live on \$2 a day' which provided a detailed chronicle of the financial lives of households in India, Bangladesh and South Africa. It advanced the proposition that without credit those at the lowest levels of income will face significant difficulties in order to climb out of poverty. Credit allows for unexpected events to be dealt with without causing a slide back down the income distribution pyramid.

Improving property rights provides the means of expanding access to finance through the use of secured lending. This arrangement reduces the risk for lenders and improves repayment discipline. Providing collateral against a loan can be especially important in environments where credit history, formal payment records and credit bureaus are either scarce or non-existent. Enhanced access to finance enables households to smooth consumption patterns, manage unexpected costs as well as invest in education, health or directly in a business. In addition to benefits accruing directly to households, there are also broader benefits for the economy as a whole. A recent IMF paper (Singh 2011), looking specifically at the issue of financial deepening in sub-Saharan Africa, found that there was causality between financial deepening and poverty reduction as well as income inequality reduction. It also concluded that stronger property rights reinforce the effects of private credit expansion on poverty reduction.

Unlocking 'dead' capital, the classic exposition of the power of property in enhancing access to finance is De Soto (2003), *The Mystery of Capital*. He sets out convincing arguments about the vast sums that are locked in property. Improving property rights and allowing this property to be used as collateral for loans, could unlock an expansion of investment at the bottom of the income pyramid. In practice, some of these arguments may have been somewhat exaggerated, just as the sub-prime crisis demonstrated that lending solely based on collateral is not a prudent approach. Secondly, De Soto implied that poor households were all budding entrepreneurs capable of making informed business and investment decisions. As with the rest of the income distribution, this is not always the case and many households will tend to be risk averse, preferring not to risk losing the little property they do own by putting it up as collateral.

Driver of construction, Duebel (2007) postulates that housing finance is a direct driver of construction output. However, he also suggests that this relationship only holds true in cases where the construction sector is able to freely expand, and this is dependent on access to serviced urban

land and also to developer financing. Mexico and Malaysia are both good examples of countries that have seen their housing production rise as a result of expanding the housing finance system.

Housing multiplier effect. This is a central argument in favor of housing investment. The premise is that every unit spent on housing will generate a multiple amount of benefit for the economy, as it creates jobs through horizontal and vertical supply chains. This includes jobs in areas such as raw material production, mining, cement production, timber and aggregates. In addition, there are also impacts on local economies where the construction jobs are created, and in the service industries linked to housing, such as mortgage lending, real estate agents, retailers of home goods such as furniture or white goods. Although the multiplier argument is used routinely, there is no clear methodology or agreement on how to calculate the multiplier effect. There are several country studies that have looked at this effect; unfortunately, very few have looked at this issue in relation to emerging markets however:

United States - The multiplier effect accounts for the fact that income earned in other sectors of the economy as a result of a home sale is then re-circulated into the economy. The National Association of Realtor's macroeconomic modeling suggests that the multiplier is between 1.34 and 1.62 in the first year or two after an increase in spending. This means that each dollar increase in direct housing activity will increase the overall GDP by \$1.34 to \$1.62.

Argentina-A 2006 study found that the multiplier effect, just on the production side of raw materials and direct inputs for housing had a 1.6 multiplier effect. Further indirect employment effects are also present in related industries. (See Duebel 2009)

Australia - The total multiplier for output and employment in the construction industry is estimated by the Australian Bureau of Statistics to be 2.866. Therefore, for every \$1 million increase in construction output, there is an increase in output elsewhere in the economy of \$2.9 million. (Source: Housing Industry Association)

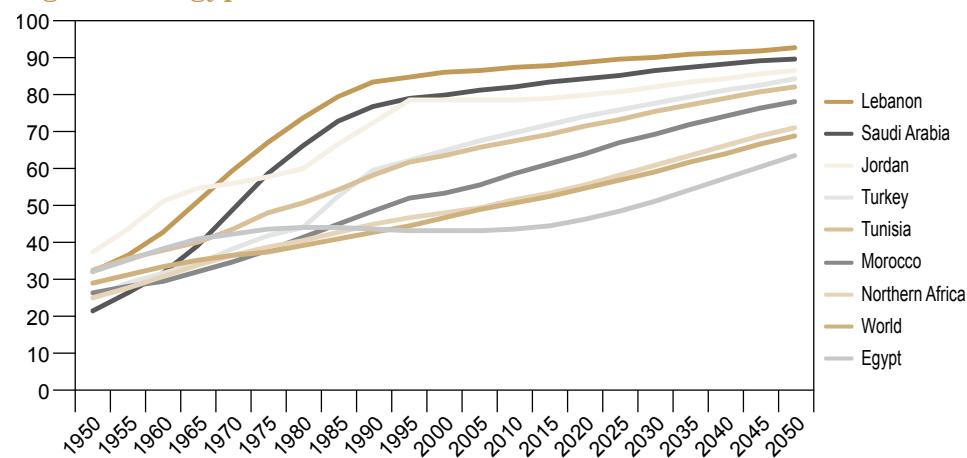
Scotland-Some of the most detailed work has been done looking at multiplier effects for Scotland (Whitehead 2010). The results show that the gross value added to the economy through different multiplier effects and channels, is in excess of all other industries. It is roughly a two-fold multiplier effect, so for every GBP 1 spent on housing, GBP 2 are generated for the economy.

Philippines - The National Economic and Development Authority of the government of the Philippines found that for every 1 peso spent on housing activities, an additional 16.61 pesos were contributed to the gross domestic product. One commentator concluded: "More housing investments and construction mean increases in job generation and sales for allied industries of the shelter sector." (2006)

Social Benefits of Housing Finance

Numerous benefits can be ascribed to improving access to housing finance and thereby housing. Homeownership has long been promoted as a way of giving individuals a stake in society and a stake in the economy. By having a stake, which can increase in value, it provides an incentive for the homeowner to look after the property and to maintain the neighborhood in which the house is situated. This theoretically results in lower crime levels and improved quality of life. Other social benefits that have been observed arising from homeownership are lower fertility rates. This is a less intuitive benefit, but if the house is fully owned, parents in emerging markets where there is no pension system, no longer have to rely on their children in their old age for somewhere to live. Lastly, further benefits include improved health, through better and safer construction, and improved sanitation.

Figure 4.7: Egypt and Peers Urbanization rates 1950–2050



Source: UN Populations Division, World Urbanization Prospects 2009 Revision.

The above provides some compelling arguments in favor of housing, the list is not exhaustive and the exact magnitude of the economic benefits will be dependent on the environment in which the changes are made. A financial system that benefits from a developed capital market and an efficient land allocation system will clearly be in a much better position to expand its housing demand and housing output and reap the benefits of housing expansion throughout its economy.

Housing and Land

The demand for housing in Egypt is growing both in terms of numbers and also the quality and size of units required.

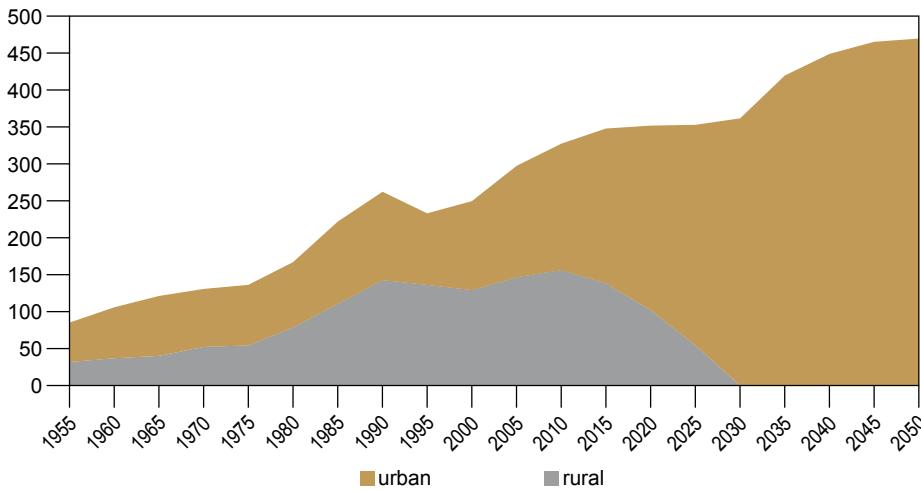
Egypt has a population of 84 million people. The population is currently growing at a rate of 1.9 per cent annually with the urban population growing considerably faster at a rate of 3.1 per cent annually. Around 60 per cent of the population is below 30 years old.

The typical household size is approximately 4 people in urban areas and 5 people in rural areas. This is significantly fewer than 20 years ago when it was 5 and 6 people respectively. There is a strong trend of decreasing household size, which further adds to the housing demand burden.²⁰

The chart below shows the rapid rate of urbanization in the region over the past half century. It is also worth noting that although Egypt is close to the 50 per cent of the global average for urbanization, it is among the least urbanized in the region. In fact, urbanization has stalled over the past 40 years where it shows no change from the 43 per cent level recorded back in the 1970s. This contrasts with countries such as Lebanon, which are rapidly moving towards becoming fully urbanized societies with urban living accounting for close to 90 per cent of the population.

One of the big drivers for housing demand in Egypt is the marriage rate. It is currently at around 600,000 marriages per annum. It is at this point that newlyweds receive gifts from their family in the form of cash or land and look to set up home in a new house.

Figure 4.8: Egypt Housing Demand (Household Formation Rate) – 000s



Source: UN Populations Division, World Urbanization Prospects 2009 Revision, Author calculations.

The annual demand for new housing can be estimated at around 328,000 units annually. This is based on the household formation rate, together with changes in demand due to rural urban migration taken from UN Populations Division data projections. The split is 172,000 urban units and 157,000 rural units. By 2030, it is estimated that rural demand will disappear completely as the level of urban migration outstrips any natural rural population growth rate.

Other estimates put the demand at a higher level, with the annual housing demand attaining a level as high as 450,000 units.²¹ This may include housing needs related to the improvement of current stock and the depreciation of current stock some of which may need to be replaced.

Housing Supply

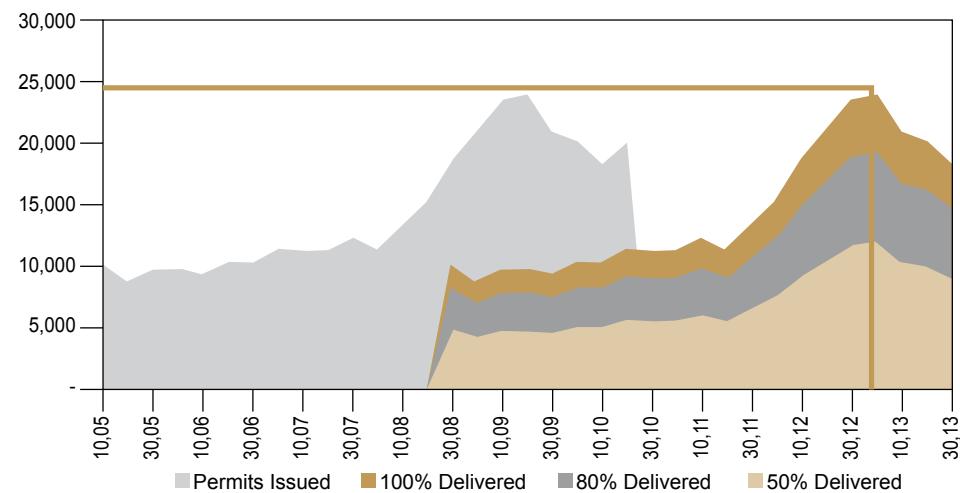
Prior to the revolution the supply of new housing was growing rapidly with building permits reaching an all-time high. It was becoming evident that the top end of the market was reaching the saturation point, which had prompted some developers to start moving down-market. Orascom Construction Industries (OCI) for instance had started large scale projects for the construction of affordable housing. The lower margins available on these projects were compensated for by much higher volumes.

The chart below shows the rapid rise in the issuance of construction permits in Cairo. It has been estimated, given the time interval between the issuance of a permit and the delivery of a building that as many as 150,000 residential buildings would be delivered over the coming 3 years. Given that one building can represent multiple units the actual amount of construction taking place is being underestimated.

Government Housing Programs

To help improve access to formal home ownership by low and middle income households, the government has in the past provided a range of subsidies, through a plethora of special programs. Since the 1950s, social housing programs have focused on delivering finished and relatively high standard housing units, mainly in the New Urban Communities and satellite cities, and at the fringe of existing cities. These government programs are overseen by different authorities; however, the housing models and payment conditions are substantially similar and have changed little over time. Many of these public housing schemes continue to involve large government subsidies. Overall, they have exacted a heavy toll on public finances, making such efforts unsustainable, while satisfying a relatively small portion of the demand and failing to reach the targeted income groups.

Figure 4.9: Housing Supply in Greater Cairo



Source: Alembic HC, Sector Report, November 2010, Egypt Real Estate.

The range of government housing production over the past several decades has ranged from 15,000 to 35,000 units annually, but has significantly increased under the current NHP. NHP has affirmatively committed to producing a total of 500,000 subsidized units of newly constructed houses between 2005 and 2011, an average of 85,000 subsidized units annually, for rental, leasing and ownership. The armed forces and Ministry of Interior have built additional public housing for their personnel. The largest portion of subsidized housing has traditionally been produced by government entities such as local government and governorates, housing cooperatives, in new urban communities under the NUCA, and smaller projects by government housing companies including the joint projects agency, the housing fund, the housing bank, and 'Tameer' agencies. Under the NHP, private developers have, for the first time played a substantial role and have committed to allocate approximately 95,000 units of the planned 500,000 units to be brought to the market and for which it will assume the market risk. An additional 100,000 units will have been produced by individuals under the "Ibni Beitak" or site and service component of the NHP where individuals were offered 150m² plots with a subsidy to build their own property.

Affordable Mortgage Finance Program

The Affordable Mortgage Finance Program, which is supported by USD 300 million World Bank loan, is intended to expand the residential mortgage market and increase access to mortgage loans for low and middle-income households in order to improve housing affordability. Its focus is on those households falling within the 75th to 45th percentile of the urban income distribution band with the ultimate goal of gradually making the bulk of these subsidies available to the lower income range of the band. It will encompass new and existing housing and new and older urban areas to offer a wider range of housing options and prices. Lower income households, that fall below the 45th percentile and who would not otherwise have access to mortgage credit, will benefit from low-cost rental housing programs and "infrastructure only" programs planned for the same period.

Linking the program to mortgage credit will leverage substantial private sector resources for housing and free up government resources for lower income housing. The program will leverage financial market and household resources for housing, and alleviate pressure on the government to substantially subsidize much of the housing supply for middle-income households. The new program will decrease the total and per unit housing subsidy burden. It also intends to improve the targeting and efficiency of subsidies by linking subsidies to affordable mortgage loans that beneficiaries are required to take out with a participating lender of their choice. Households are required to pay a down payment. Typically, the subsidy will be paid out over the initial years of the loan in the form of a contribution to monthly mortgage payments on a maximum affordable loan. The program of mortgage subsidies is administered through the Mortgage Finance Fund, formerly the GSF. It is anticipated that as many as 65,000 loans annually would be done under the program.

Cancellation of land sales. The ongoing political environment continues to create uncertainty regarding the potential for more cancellations of certain land deals that were entered into between the previous government and developers. The current government has indicted its willingness to protect investors but no concrete solution has yet been put forward as to how or when this will be accomplished. Analysts believe that cancellations will become more numerous (estimated cancellations for 2011 are 10–15 percent of contracts) which would have serious repercussions on the cash flow of some developers, particularly those who are reliant on this form of funding.²²

Housing Supply Constraints

The majority of Egypt's housing stock is still constrained by very high vacancy rates, rent control, and informality. Almost 3.7 million urban housing units are unused, either vacant or closed. The scale of vacant urban housing units, much more serious than in other emerging markets, is a unique and puzzling phenomenon of the Egyptian housing market. One explanation is that the sustained rapid appreciation in property values over the past 25 years and the lack of alternative investment mechanisms until quite recently meant that housing and real estate have consistently served as an inflation-proof savings and investment tool, without need of the rental yield.²³ The idea of renting was even less attractive due to the imposition of rent control until 1996. Even now, the continued perception of uncertainty about the enforceability of the new rental law makes many owners hesitant to put their unoccupied units up for rent. Poor targeting of government subsidized units, and unattractive locations of subsidized units in New Urban Communities, have further exacerbated the problem.

An estimated 42 percent of the housing stock is frozen under rent control. Since the passage of Law 4 of 1996, which allowed newly built units to be placed on the rental market with the exception of existing rent-controlled units which were grandfathered for the duration of the then existing rental agreement, the rental market is showing signs of increased dynamism. However, the TAPRII Greater Cairo Housing Demand Survey found that 42 percent of the total urban housing units in Greater Cairo remain locked under the rent control regime due to the grandfathering provision, and that this situation does not appear to be benefiting the poor. Excluding such a large proportion of units from the rental market greatly constrains residential mobility, significantly reduces the inventory of rentable property, and distorts the overall housing market.

Some 45 percent of new urban housing is produced by the informal sector. During the period (1996–2006), the urban housing stock is conservatively thought to have grown by an annual average of 2.8 percent or 263,838 units.²⁴ Of these, 55.6 percent were formal and 45.4 percent informal (built without government authorization and registration). Constrained by onerous building and zoning standards, as well as a bureaucratic and costly permit issuance process, many small developers operate within the informal

sector to meet the growing housing demand of lower income households. While informal housing provides a low cost housing solution, it undermines planned provision of infrastructure and does not allow households to use mortgage finance, which hampers their affordability.

While these distortions are not entirely additive (e.g. an informally built unit may be kept vacant), it could be conservatively estimated that 50–75 percent of the urban housing market in Egypt suffers from such market constraints. These combined market weaknesses directly affect adversely the housing affordability, the potential for success of the recently initiated mortgage system, labor mobility (economic growth), and the government's ability to address the shelter needs of poor households.

Developer Financing Model

One of the recent successes in Egypt's housing market has been the growth in private housing development. Many of the companies set up to develop the New Urban Communities have seen rapid expansion thanks to large land banks and a comparative rise in demand from a wealthier middle class. However, this expansion in housing has occurred despite the mortgage system rather than as a result of it. Some estimates put the number of mortgages as low as 1 in a hundred new properties.

The developer installment loan-financing model is a response by the developer to the lack of formal financing provided by the financial sector. The schemes are more akin to a leasing arrangement than a typical mortgage loan, with much greater protection for the seller, which in this example is the developer. Because the property is only transferred to the purchaser upon receipt of the final payment, the developer is in an advantageous position should any problems arise with respect to making payments. There is no need to foreclose on the property as the developer is still the owner. Also in this model, there is potential for no equity to have been built up as the transfer is dependent on the final payment being made. Any default could mean losing all previous payments, unlike a mortgage where a portion of the principal would have been paid down.

In practice developers in Egypt, have contracts, which provide consumers with a good degree of protection, and there is recognition of some principal down payment, and even interest paid on deposit balances. However, this may not be the case with all developers, as this type of financing is entirely unregulated and varies greatly. The buyer will typically put a deposit down on the property ahead of its construction and gradually make payments in line with progress on the property and then continue making payments for several years after delivery. Developers are able to offer loans for as long as 7 years now. The process does include many safeguards and is transparent. However, it is not regulated by any government or industry body and could be open to abuse by less scrupulous developers. Equally, the consumer could fall victim to the financial collapse of the developer and never receive the final transfer of the property at the end of the installment period.

Property Registration Rate

Conversion of the land and property registration arrangement in urban areas from the Sejel Shakhsee (person-based deed registration) system to the Sejel Ainee (title registration) system through effort coordinated/overseen by the Ministry of State for Administrative Development and involved cooperation between the Ministry of Justice's Real Estate Publicity Department (REPD) and the Ministry of Irrigation and Water Resources' Egyptian Survey Authority (ESA).

Historically mortgage finance has been constrained by a deficient property registration system. Few titles have been registered in the past, in large part due to the high cost and time-consuming registration process. This has led to the growth of informal housing, slower economic growth, weakened social protections, and reduced collection of fiscal revenues. Except for mortgage credit applications, in Egypt the registration of property is not mandatory for a legally enforceable real estate transaction. In recent years, the cost of deed or title registration has been lowered and is no longer tied to the property value but charged at a maximum flat fee of LE 2,000. In addition, a special agreement has been made between the Ministry of Administrative Developemnt and the Ministry of Investment to fast track the registration of new housing in priority zones under the NUCA. However, registration of existing units in older urban areas will continue to be time-consuming, particularly for multifamily housing units. The registration of the large stock of informal housing on agricultural land is to be resolved by requiring approval of the current building and planning standards of the area, which will be greatly facilitated by the new Building Law 119 of 2008. Only then, can individual units be registered.

Obstacles to Further Development of Egypt's Mortgage Market

Egypt's mortgage market has made great strides over the past decade putting in place much of the necessary infrastructure to facilitate growth and expand access to lower income groups. However, despite policy work that has already been carried out and the creation of new entities such as the EMRC, the mortgage market accounts for less than 0.5 percent of GDP. This chapter will explore some of the reasons underlying the mortgage market's underdevelopment and considers the steps that might be taken to meet current needs by expanding housing investment.

Property registration. The inadequacies of the current registration process remains the fundamental obstacle to achieving a secured lending system based on property. The time it takes to register property and the related uncertainties that exist during the registration process, create a major impediment to the development of mortgage lending. This was identified long ago and multiple efforts by Ministry of Administrative Developemnt, USAID and the World Bank have yet to produce a system which is reliable and where delays are minimized.

Developer financing of buyers. The vast majority of newly built properties in Egypt are purchased either for cash or pursuant to an installment loan system provided by the real estate developer. This system presents numerous problems:

- A potential conflict of interest arises in circumstances where a developer also provides financing to the end user. The sale may be tied to the financial product being offered, and this in turn may result in the consumer obtain an inferior deal.
- Some installment products can be quite profitable for real estate developers and may act as an incentive to delay the subdivision of their plots into individual titles thereby making mortgages impossible to secure until the whole development is complete.
- Installment loans weaken the borrower's position in situations where they obtain no ownership interest in the property until the final payment on the installment loan is accepted. As such, until the final payment is accepted there is the theoretical possibility that should the borrower default, they will also forfeit any rights in the property and lose all payments previously made regardless of how much has already been paid. In practice, the contracts, which are signed with the larger developers, actually include provisions to address to ensure that the consumer is reasonably protected, but this may not be the case with all developers.
- The position of the consumer is also weaker in cases where the developer becomes bankrupt and creditors may take a different view of borrowers in default. Another situation relates to the current land declamations by government in cases of deemed fraudulent sales. A purchaser of a property on an installment sale would certainly be subject to much less legal protection than in cases where they have full title to their property.
- Installment schemes often involve down payments for off-plan sales. Banks were forbidden from providing financing to consumers for pre-sales, which induced developers to provide their own alternative. These pre-sales form a significant part of the developers' project finance. The obvious danger in this arrangement is that these schemes are wholly unregulated and as has occurred in many countries, the failure of a developer can result in many property buyers losing their deposits. Frequently the deposit represents a buyer's life savings and once lost, with it goes any hope of becoming homeowner.
- Another problem with installment loan schemes is the lack of sustainability. There is a limit to how much funding the developers are able to raise. The loans also cannot be easily securitized or funded through a secondary mortgage market mechanism. They are clearly a second best alternative and a potentially risky one also.

Funding of mortgages. This has been an ongoing issue which the creation of EMRC was intended to address. To date EMRC has succeeded in refinancing a significant portion of existing loans, but has also not yet been able to create a bridge between the capital markets and the housing market. The World Bank loan that provided the initial funding for EMRC, together with

shareholder equity, has thus far proven sufficient to meet most of the needs of a market with such limited growth. High interest rates have also made it difficult for EMRC to raise funds through bond issuance at rates that it could pass on to banks at a competitive level. A sustainable economic and reliable source of funding is needed for the long-term development of the market.

Dysfunctional retail deposits market. A major impediment to the development of an economic funding solution for MFCs and banks is the serious flaws that exist in the Egyptian deposit market. Deposits are largely price inelastic, which means that even during periods of soaring inflation, or rising interest rates, depositors do not shift their deposits including times where they are receiving negative real rates of interest. This is in part due to a lack of competition among financial institutions, large public sector deposits that do not necessarily behave in an economically rational manner and a regulatory framework, which allows deposits to fund a large part of lending. Within such an environment, it is difficult for EMRC or indeed other capital market funding mechanisms to compete with much less expensive deposit based funding.

Inefficiencies in the housing market. Typically healthy mortgage markets go hand in hand with thriving and liquid housing markets. A key feature of such a market would be an active resale market, not just a market for new properties. This has yet to fully develop in Egypt for a variety of reasons including: The substantial stock of vacant properties that are held as investments given the absence of other investment opportunities; the lack of organized primary or secondary property markets; the lack of proper incentives in the rental market which could make it more attractive and safer to rent out properties for property owners; and the lack of regulatory oversight or strategic direction for the sector.

During the initial phase of Egypt's mortgage market development, a key role was performed by the MFA and the Ministry of Investment. Both have now been disbanded leaving no comparable 'champions' to promote the further development of the mortgage market. EFSA has undergone significant structural modifications as well as numerous personnel changes which have adversely affected its ability to fully deliver on its mandate. In addition, there is a significant shortage of experienced staff possessing the requisite skill sets to effectively carry out routine supervision duties for the mortgage sector. EFSA is not charged with the same strategic market development role that MFA had under the auspices of the Ministry of Investment.

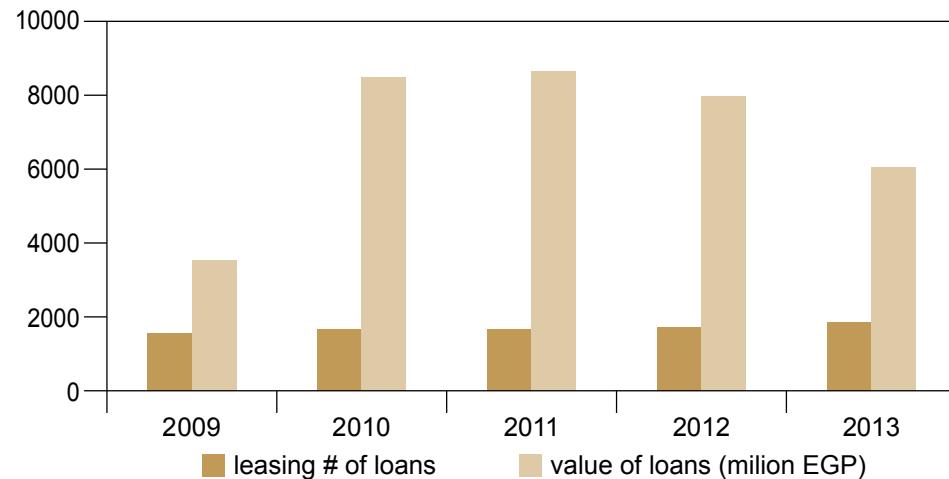
FINANCIAL LEASING AND FACTORING

Introduction: Why Leasing?

Financial leasing can play a key role in the development of financial markets. While on the one hand, the industry complements the banking sector by increasing the range of products and services provided to potential

clients, on the other it increases the competitiveness of the financial sector as a whole by competing with banks and forcing them to improve efficiency and responsiveness to clients. Leasing also plays an important role in enhancing access to finance for younger and smaller enterprises that often face sometimes insurmountable challenges in obtaining credit from banks. By retaining ownership of the leased assets, the lessors have the ability to recover their investment in case of default with greater ease, which in turn lowers the overall risk and makes smaller enterprises more viable clients. As such, for SMEs that do not have a lengthy credit history or a significant enough asset base for use as collateral, leasing can play a critical role in bridging the SME finance gap and bringing small businesses into the formal financial sector. As opposed to other financial instruments, leasing, being an asset-base financing option, also has the added advantage of being an inherently Shari'a friendly product, which makes it an attractive financial option for enterprises in Egypt with an appetite for Islamic finance.²⁵

Figure 4.10: Growth of the Leasing Industry



Source: EFSA.

The Egyptian Leasing Industry

The Egyptian leasing industry was established by Law 95 of 1995 and later amended by Law 16 of 2001. Among the most important features of the amendments was an increase in the minimum capital requirement for leasing companies as well as major changes in the manner in which leasing transactions are taxed.

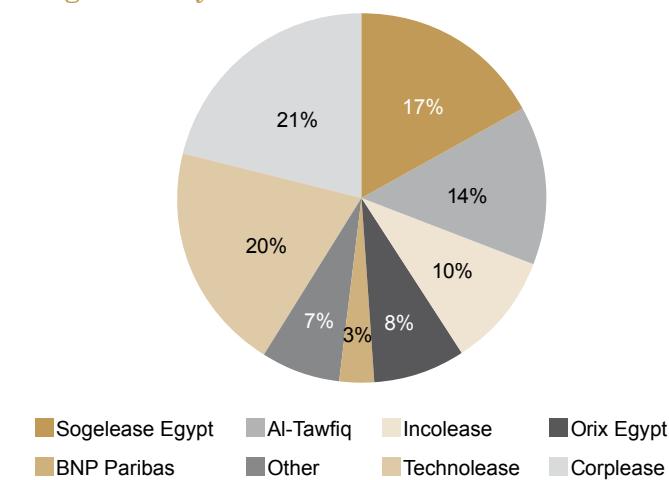
The laws and amendments governing leasing in Egypt allow for the commercial leasing of all types of assets including cars—which under the initial law had not been permitted—as well as the leasing of land attached to productive activities. A Ministerial Decree issued in 2005 opened yet another business line allowing leasing companies to lease buses for touristic

purposes, a practice which had previously been restricted by the Ministry of Tourism to companies with a tourism license.²⁶ To date, only Financial Leasing is permitted under the current law.

Despite the industry's relative cumulative growth and the favorable developments in the market, leasing remains relatively small and underutilized in Egypt. The most recent EFSA Annual Report on the industry estimates the size of the market at LE 6 billion, which is less than one percent of GDP.²⁷ The most recent enterprise survey data available for Egypt shows that the enterprises sampled lease or rent only 18 percent of their land and 17 percent of their buildings.²⁸

Although in the past five years the number of leasing contracts has remained relatively constant, the total value of contracts has tripled in size (Figure 4.11). This is largely due to a growth rate of almost 140 percent between 2009 and 2010. The most recent figures for the year 2011 show a significantly lower growth rate of only 2.3 percent, which is most likely due to the post-revolution economic uncertainty.

Figure 4.11: Leasing Company Market Share for Q4 of 2011- Growth of the Leasing Industry



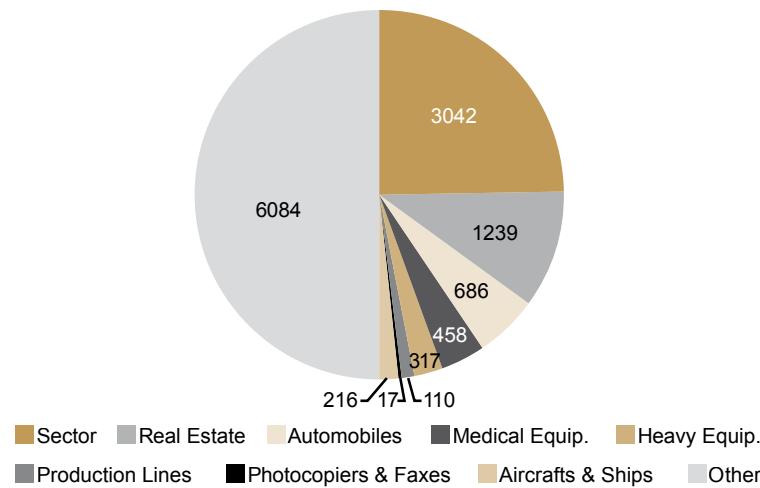
Source: Ministry of Investment.

Although there are currently 208 leasing companies registered with EFSA, only 24 of them registered leasing contracts in 2011.²⁹ Of these 24 companies, approximately nine have been active in the market and make up most of the industry's market share. These companies are for the most part, owned by banks or bank-affiliates. While figures from the most recent quarter show that Corplease and Sogilease were among the most active and had a market share of 21 percent, and 17 percent respectively for the final quarter of 2011, cumulatively, Incolease is the largest player in the market with approximately a 30 percent market share.³⁰

In terms of activities and sectors financed by the leasing industry, buildings and real estate, aircraft, and boats/ships, and automobiles, are the sectors most often financed with 40 percent, 18 percent and 12 percent of all leasing contracts for 2011 respectively (Figure 4.12).³¹

Aircraft leasing has tremendous growth potential in Egypt. The MENA region is currently witnessing one of the highest growth trends of this sector especially in the booming area of commercial low-cost carriers (LLCs).³² Airlines are increasingly making use of leasing as a financing tool instead of having to rely on more conventional finance sources.

Figure 4.12: Value of Leasing Contracts



Source: EFSA.

Recent Development in the Leasing Industry

Three key developments have recently taken place that have positively affected the institutional and regulatory environment in which the leasing industry as a whole operates—the first and most significant is the change in regulator. When the leasing industry was first created, the companies established reported to the General Authority for Free Zones and Investment (GAFI), which acted as its administrator.

Today, leasing is regulated by EFSA, the consolidated regulatory body for the non-bank financial sector established in 2009 by Law 10 of 2009. While no significant changes from the previous regulatory regime have taken place, leasing companies have witnessed an improvement in the streamlining of the registration process. In this regard, the registration of all leasing contracts has now been computerized and the approval of contracts can be completed online.³³ Based on the formal reporting required of leasing companies, EFSA has also begun producing quarterly reports which contain industry data including value of total leased assets, number of leasing contracts, leasing

assets by type or activity, number of active leasing companies and leasing companies' market share. It also produces an annual report that features the aggregate data for the year as a whole. While all this work represents a positive first step for EFSA, there is still potential for it to play a much larger role collecting information, promoting the industry and proposing changes to the leasing law necessary to support the industry's growth.

Box 4.1: The Egyptian Leasing Association

The Egyptian Leasing Association (ELA) is a not-for-profit professional trade association established in 2011 with the main objective of being the voice, promoter and advocate of the leasing industry in Egypt. The ELA was founded by the majority of active leasing companies in Egypt including Adilease, Al Tawfeek, Corplease, Orix, Piraeus Leasing, Soglease, Inclease as well as a number of individual leasing experts.

Among the association's strategic objectives are (i) creating awareness and educating investors/lessees and other stakeholders about leasing and ijarah and their benefits; (ii) creating a physical space where players can discuss impediments that are faced by leasing companies and ways to overcome them; (iii) developing training courses to enhance the technical expertise of leasing professionals; (iv) proving networking and business opportunities; (v) fostering ethical standards, best practices and corporate governance in the leasing industry; and (vi) being a source of information about the leasing and ijarah industry through periodic online newsletters and publications on the industry.

ELA offers its members several benefits which include an enhanced corporate profile through local and international networking among leasing practitioners worldwide, a forum for interaction with stakeholders, policymakers and regulators, advisory services to member of policy compliance and market intelligence and the dissemination of vital information on leasing trends and developments in the industry.

ELA has been meeting regularly with EFSA to discuss a number of constraints facing the industry and a short policy paper has been issued that not only describes these constraints but also suggests a number of legal amendments that will, in both the short and long term, be of tremendous support to the growth of the industry.

In March 2008, the first private credit bureau, I-Score, became operational. I-Score has a database of approximately two million borrowers, which includes both individuals and SMEs, collected from several sources including the public credit registry, banks and NBFI. Credit reports are updated on a monthly basis and provide comprehensive and reliable information services including the manner of payment, the length of outstanding loans, the history of loan balances and repayments.³⁴ While, the establishment of I-Score has helped the financial sector as a whole by

improving access to creditworthiness information, the establishment of a unified movable collateral registry as part of I-Score will be particularly beneficial to the leasing industry by reducing risk in contract leasing and increasing confidence of lessors in contracts and SMEs.

The third major development for the leasing industry in Egypt was the establishment of a professional leasing association for the industry. The Egyptian Leasing Association (ELA) was established in 2011 to act as a voice for the industry and includes all the major players in the market (see Box 1). Not only does the existence of an association allow the leasing industry to have greater visibility in the market and attract a greater number of clients, but it also allows for the industry to be a united advocacy group with the lobbying power to bring about necessary legal, regulatory and institutional changes for the industry.

Constraints to the Growth of the Leasing Industry and Recommendations

There remain several constraints facing the leasing industry that have inhibiting its growth and its ability to achieve its full potential. Of these inhibiting factors perhaps the most crucial is the scarcity of long-term funding. Leasing companies tend to rely on their sponsor bank for funding. This is a problem for a variety of reasons: (i) although most are, not all leasing companies, are owned by banks or bank-affiliates and as such will not have the same access to bank funding; (ii) even when the long-term funding from banks is made available it is prohibitively expensive; and (iii) banks are the main source of competition to leasing companies and increased borrowing will lead to increases in the companies' leverage. Moreover, the relatively limited development of capital markets does not support the issuance of bonds to provide long-term funding. Despite this, it is worth noting that in 2009 and 2010, two leasing companies issued bonds that provided them with much greater flexibility in utilizing their funding and a better matching of finance tools. Bond issuances in 2009 amounted to LE 2 million in 2009 and LE 6 million. There were also securitization deals worth approximately LE 538 million.³⁵ While this was an important step for these companies in an effort to enter the debt market, these amounts are still quite limited when compared to the size of the industry as a whole and the need and demand for long-term financing. In order for the leasing industry to access the amount of long term funding needed to grow exponentially, the bond and asset-backed securities markets need to be further developed in order to extend the average maturity of leasing contracts and better serve potential and existing clients.

Another main challenge facing the leasing industry is the difficulty of repossessing assets associated with the inadequate enforcement of ownership rights and the delays in the collection of overdue payments. Due to the difficulties of repossession and the poorly developed secondary market, leasing companies are often forced to resort to negotiations with customers and rescheduling of leases. Cumbersome repossession procedures also increase the credit and liquidity risks for lessors, which ultimately leads to

higher default rates and an increase in the cost of doing business. A stronger judicial system, which is able to enforce foreclosures and ensure the efficient and effective repossession of assets in case of default, is key to developing a supportive regulatory environment for leasing. While the establishment and development of economic courts is a step in the right direction, greater capacity building of these courts and the training of judges—especially in leasing concepts—is necessary for greater overall effectiveness.

The growth of the industry is also constrained by legal obstacles that create unfair disadvantages to leasing and create unnecessary barriers to the expansion of the sector. There is a great deal of confusion in the tax and accounting treatment of leasing as well as a general inconsistency with international standards. The existing fiscal legislation treats financial leasing as a type of rent, not a form of financing, and hence, does not create a level playing field between leasing and other forms of credit. The definition of leasing in the law must be adjusted to contain a clearer, more precise definition that differentiates this type of financial transaction from all others including property hire or rent to prevent abuses of tax benefits and double taxation.

In order to increase the industry's client base, it would also be of great benefit for the law to be amended to allow for leasing for non-commercial purposes. The leasing industry in Egypt is also in need of a sounder institutional environment to operate within, particularly through the establishment and development of more effective registry procedures. The absence of a registry for leased assets increases the risk to the lessor and hinders the expansion of the market. The law in Egypt currently imposes requirements to register individual leasing contracts instead of the asset themselves. This is not only a cumbersome procedure for the lessor, but it also inhibits the development of a secondary market for moveable assets. It is vitally important for the industry that I-Score move forward with the establishment of its moveable assets registry.

Finally, one of the reasons the industry is not achieving its true potential is the lack of understanding of the sector and the limited information and data available on it. There is a lack of experience, skills and understanding of the sector by current practitioners and potential lessors as well as a general lack of awareness on the part of government officials including agencies responsible for asset registration, courts, and the tax authority. Both EFSA and the Egyptian Leasing Association have an important role to play in creating both a greater understanding as well as greater visibility for the industry. While the quarterly reports issued by EFSA are helpful and a positive step forward, the data available remains to be limited with only a few specific indicators being tracked on a regular basis and on an aggregate and cumulative level. Producing reports and disseminating information on the sector should be one of the Egyptian Leasing Association's main objectives.³⁶

Although the industry has not grown as much as it has the potential to, especially in the past year, the circumstances surrounding the transition period in Egypt can be extremely advantageous to the industry. Due to the

government's increased domestic borrowing to reduce the fiscal deficit and the associated crowding out of the private sector, it will become increasingly difficult for banks to extend loans, especially to start-ups and SMEs. These exceptional circumstances provide an opportunity for this vital and vibrant industry to play an important role and serve a sector that is the backbone of the Egyptian economy and a major source of employment.

Factoring: as of end of 2013, there are 6 factoring companies licensed by EFSA. Total financing provided throughout that year reached EGP 3 billion, outstanding balances at end of December 2013 were EGP 0.9 billion.

CONCLUDING REMARKS

NBFIs services have made relevant progress after Phase I (2004–2008) and Phase II (2009–2012) of the Financial Sector Reform Program, but are still well below their potential in Egypt's economy. As experienced in other countries they are essential for financial deepening, access and competition. Particularly insurance, pensions and efficient mortgage markets are important to channel savings to productive investments, as well as to build the social safety net required in Egypt. Leasing services are also critical to facilitate access to finance to new and small firms.

Reforms conducted over the last eight years include a reduced presence of the State and the development of institutional and regulatory frameworks supportive of a greater presence of the private sector, particularly, in the insurance, housing and leasing sectors. The consolidation of the different regulatory bodies into the EFSA was a landmark with promising prospects both for enhanced regulation and for a well-articulated development plan across all capital markets and NBFIs services. Several institutional and legal reforms supportive of growth across all sectors were also initiated. A sample of these reforms include the re-structuring of loss making state-owned insurers the creation of mortgage finance companies, reforming the land and property registration system, a unified building code, enforcement of foreclosure regulations and the constitution of a first private credit bureau. The latter benefited also the leasing activity. Most of the momentum achieved with these reforms came to a halt with the revolution, but no clear regression has been experienced so far.

Main challenges ahead may be divided between structural and institutional obstacles. From a structural point of view, besides the need of a stable macroeconomic framework, one of the main obstacles is the dominance of the banking sector and the low level of development of capital markets. Instruments available to insurance and pension funds with long-term investment horizons are limited to government debt and bank deposits. On the funding side, mortgage and leasing financing is relatively short term not exceeding 5–7 and 7–10 years, respectively. In addition, each sector has specific structural constraints such as a shallow secondary housing and rental market, or a still too large workforce in the public sector in the case of pensions.

From an institutional perspective, there are three main types of constraints applicable to all segments: (i) large pockets of unregulated businesses such as housing finance by developers, health insurance and private pension fund schemes; (ii) regulatory or institutional gaps such as the lack of a moveable property registry or the inefficient application of existing regulations (e.g. land and property registration); and (iii) insufficient institutional support for EFSA to enforce existing regulations and lead effectively initiated reforms. In this context, a stronger support to EFSA to develop the required strategic plans within each sector would be essential to resume, and re-design, to the extent needed, reform plans initiated before the revolution.

ENDNOTES

- 1 The state-owned insurers held most of the controlled rent properties in Cairo. However some strategic shareholdings and commercial properties were heavily undervalued in the SOI's books.
- 2 The relative managerial performance can be seen on the 2004/5 expense rates. Misr was less than 20 percent while the other two direct insurers were both over 30 percent. Despite being smaller than Misr, Al Chark had more staff.
- 3 The combined ratio is the sum of the claims ratio and the expense ratio.
- 4 Actual solvency divided by required solvency.
- 5 Total MTPL technical provision strengthening for Misr Insurance over the 2006/2011 period amounted to LE2.3 billion of which 700 million was added in 2009/11. Misr Life strengthened life mathematical reserves by LE 200 million in 2010/11 of which 50 percent was funded by IHC and 50 percent from general reserves.
- 6 The major ongoing sources of profit for Misr Insurance have been the transport (mainly marine and aviation) and industrial sectors (engineering and oil and gas).
- 7 The IMF defines Fiscal Space as 'room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy.'
- 8 Required to fund the run off of the previous system's obligations.
- 9 The actual allocation will be determined under the Executive Regulations in order to ensure flexibility.
- 10 Hospital bed occupancy rates are on average only 40 percent nationally.
- 11 Approximately 50 percent of the population is uninsured.
- 12 The Ministry of Health would effectively become a buyer of rather than an operator of health services.
- 13 The military and senior officials have preferential access to a separate system.
- 14 There are already approximately as many private primary and secondary health care providers as there are 'free' facilities under the Ministry of Health. A large number of primary care facilities (mainly school clinics) are also provided to formal sector workers through the government Health Insurance Organization (HIO).
- 15 For example the largest and original Takaful non-life insurer has been prepared to underwrite tobacco risks.
- 16 Facultative reinsurance sessions are made on an ad hoc basis and priced at the time of placement.
- 17 Hernando de Soto, Op-ed: Egypt's Economic Apartheid, The Wall Street Journal, 3 February 2011.
- 18 Drawn from Affordable Mortgage Finance Program Project Appraisal Document (2009) and Affordable Mortgage Finance in Egypt: Challenges and Prospects by Sahar Nasr, 2010.
- 19 Beck and Honohan (2004).
- 20 Source: StatCompiler website which summarizes household surveys from around the world, www.measuredhs.com
- 21 Source of data and estimates - Talaat Mustafa Group investor presentation June 2011.
- 22 Source Deutsche Bank, Egypt Real Estate, 9 August 2011.
- 23 Despite some slowdown in the early 2000s, this trend has continued unabated and has very recently reached new heights, fuelled by major inflows of foreign investment in real estate in Egypt from regional investors.
- 24 The preliminary results of the 2006 census made available by CAPMAS do not allow for a precise calculation of the number of housing units. As such, the total number of housing units in urban areas was inferred as the sum of "apartment units" (shakka) and "one/more independent rooms" (hogra mostakela). This figure is counter-balanced by the exclusion of single family housing and the failure to account for housing units converted into offices.
- 25 Al-Sugheyer and Sultanov. Leasing in the Middle East and Northern African (MENA) Region: A Preliminary Assessment, 2010.
- 26 World Bank, Access to Finance and Economic Growth in Egypt, (2008).
- 27 GDP for FY 2011 is 1.3 trillion as per the Central Bank of Egypt Monthly Bulletin. Leasing is approximately 0.6 percent of GDP.
- 28 Egypt Enterprise Survey Data, 2008. From the leasing data available, it is assumed that the larger bulk of this percentage is made up of rented as opposed to leased land and buildings.
- 29 EFSA Annual Report, 2011. Many companies will establish a subsidiary company to conduct a single leasing contract to take advantage of the tax benefit for a specific transaction.
- 30 Egyptian Leasing Association Estimate.
- 31 EFSA Annual Report, (2011).
- 32 Rashad, Shahinaz. "Egypt Market Review" Euromoney World Leasing Yearbook. (2011).
- 33 Ibid.
- 34 Project Appraisal Document for the Second Financial Sector Development Policy Loan, 2008.

35 Rashad, Shahinaz. "Egypt Market Review" Euromoney World Leasing Yearbook. (2011).

36 It is worth noting that IFC is currently undertaking a Market Assessment Study of the leasing industry (focusing on tax and accounting aspects, regulatory framework and lessors' current operations) which should identify the impediments facing the development of the leasing industry and the most critical areas that need to be addressed (either on tax/accounting/regulatory or capacity building/awareness fronts). A comprehensive report including findings and recommendations will be developed and a policy paper with recommendations will be presented to EFSA.

5. FINANCIAL SECTOR INTEGRITY AND ECONOMIC GROWTH

Introduction

The development of financial intermediation plays an important role in a market economy supporting the optimal allocation of resources, contemporaneously and inter-temporally, and thereby determining potential output and its broad-based growth. Confidence in contracts and soundness of institutions and market processes that define financial intermediation are of course key to its development. Furthermore, the broader the range of financial products and their access to them, the greater the contribution of financial intermediation to economic growth is. Soundness and access are in fact interdependent factors in the growth maximizing development of financial intermediation. Moreover, a strong regulatory and supervisory framework for their full achievement must underpin both.

This perspective forms the basis for the assessment in this Chapter of the progress with financial intermediation in Egypt, looking successively at bank and non-bank financial intermediation. A main objective is to identify gaps and weaknesses in the current regulatory and supervisory framework that constrain its development, and to propose remedial actions. The Chapter highlights the fact that despite significant progress with reforms during the past decade, gaps and weaknesses remain. Largely as a result, confidence and soundness is still wanting, while the scope of financial services and access to finance is still limited in certain areas, in particular housing, SMEs, and the corporate securities market. Changes in the legal and regulatory framework, and measures to further strengthen the CBE and EFSA's ability to effectively implement supervision in an expanding and diversifying financial system are proposed.

BANKING SUPERVISION

Egypt's financial sector, and its banking system in particular, has undergone profound changes since the early 2000s, yet continues to lag other countries and regions in a number of indicators measuring its citizens' access to financial services. As a result of the implementation of an ambitious financial sector reform program, the banking sector has emerged as more efficient and transparent, financially sounder, and better equipped to manage the risks inherent to its activities. It has also expanded into many business lines that were poorly developed a decade ago, in particular consumer lending and asset management.

A main purpose of this Section is to look at the interface between access to finance and the regulatory and supervisory environment as broadly understood, with a view to improving this environment to facilitate greater access. Development of the financial infrastructure is a major enabler in this regard, and gaps in this infrastructure may severely impede access. While soundness mostly motivates banking regulations, their existence and effectiveness may also broaden access to finance by clearly codifying the conditions under which such access is indeed possible on a financially sound basis. At the same time, some regulations may unintentionally and unnecessarily impede access as well. In this context, the paper highlights gaps and weaknesses in the banking infrastructure and regulatory environment that continue to make access to finance difficult in certain cases, and proposes measures that may remedy them.

There is clearly a potential tension between broader access to finance and financial soundness. Expanding access to finance means dealing with initially less familiar customers lacking a track record of financial dealings, and thus taking more risk. Nevertheless, as long as the latter is properly priced, and carefully managed, soundness need not be affected; and improving the information on and governance of these customers will help limiting that greater risk as well. Furthermore, because expanding access can also lead to greater portfolio diversification and a reduction in the concentration of risks, it can ultimately also contribute to the overall financial stability of a bank. In any case, a strong risk-based banking supervision is a critical prerequisite for expansion and diversification of bank financial intermediation.

Sub-section A offers a macro-view of Egypt's banking system, highlighting the structure of its assets and liabilities, and how it has been shaped by various factors, especially, the large contribution of the banking sector to financing of the government, but also gaps and weaknesses in the financial regulatory framework and infrastructure.

Sub-section B reviews the progress and challenges with the implementation of the broader regulatory framework for financial and banking transactions, centering on (1) reliable financial reporting and auditing; (2) well designed and enforceable secured transaction rules; (3) progress toward improving corporate governance and financial disclosure; (4) the availability of reliable credit information; and (5) entry and exit rules that promote competition.

With respect to (1), there is a need to include in the banks' quarterly reporting requirements information on the structure and concentration of the bank's shareholders, and on the loan concentrations reflecting the largest borrowers, given the relevance of this information to the incentives for enhancing access to finance. Furthermore, the increased significance of brokerage, mortgage finance, and financial leasing subsidiaries and affiliates, has required all listed banks to move to quarterly reporting of their consolidated operations as well.

With respect to (2), many of the weaknesses in the legal framework and its enforcement, such as the lack of real estate title registration, are entrenched and long standing, and call for greater flexibility and novel approaches, such as a "register-able" property mortgage finance based on an "interim" real estate title registration which could form the base for mortgage collateral and its registry. Another significant gap with secured transactions to be addressed is the lack of a legal and regulatory framework for the use and registration of a broad range of movable property collateral. Furthermore, the existing bankruptcy procedures continue to focus exclusively on liquidation, and need amending.

With respect to (3), good corporate governance and financial disclosure enhances market discipline and efficiency, and promotes an incentives structure that encourages diversified lending. In this regard, CBE's regulation states that the majority of a bank's Board members and its Chairman must be Non-Executive Directors. There is a requirement to have separate Risk Management and Audit committees by law. There is greater conformity between CBE and EGX governance and disclosure requirements, which encourage banks to list. In addition, the CBE should develop incentives that influence banks to seek an international credit rating, for instance by making it a condition for banks to undertake certain types of borrowing. Despite significant progress in recent years, more efforts should be exerted for the effectiveness of good corporate governance at the state-owned banks. The fragmentation of the ownership function and the continued dominance of management at these banks need to be further addressed. Generally, there is still significant room for improvements in the amount, quality, and frequency of public disclosure of financial information by banks.

With respect to (4), Egypt has made significant progress with regard to the availability of reliable credit information, a key requirement for facilitating greater access to finance. The obligation to obtain an I-Score report before a bank can extend credit has been extended to other financial institutions as well. Furthermore, one priority should be to ensure that the fees of the credit bureau do not discourage microfinance institutions from becoming members of I-Score and using its credit information, and some form of fee subsidy could be considered. Two priorities, with possible involvement of I-Score, are the creation of a central registry for movable collateral; and the creation of a SME rating agency, with possible government support to mitigate the deterrent effect of rating fees.

With regard to (5), greater competition should incentivize the banks to broaden their lending activities. In addition, the conditions for approval of new branches should give greater weight to the prospects for increasing access to finance in the location being considered, for instance, by making the local density of SMEs an important variable in the decision. Going forward, ending the moratorium on new banks and promoting the market oriented behavior of state-owned banks, including through further privatizations, are priorities, as is the introduction of a full-fledged banking resolution regime. A uniform, limited, and funded deposit insurance scheme would not work due to negative religious connotation..

Section C reports on the state of implementation of risk-based banking supervision, and deals with the challenges of supervision for enhanced access to finance. The latter necessitates that banks be able and willing to “move up the ladder” in terms of individual risk-taking, and risk-based supervision must accompany this development of financial intermediation. Specifically, the section first assesses the general progress with prudential regulations, on-site inspection, off-site monitoring, loans classification and provisioning, capital adequacy, and sound liquidity management. Then it focuses on the interplay between prudential regulations and key concerns relating to access to finance, namely (1) encouraging diversification in bank lending; (2) supporting housing finance; and (3) facilitating SME financing.

Generally, there is a need to further develop the capacities to assess market and operational risks, which will gain significance with the full implementation of Basel II. the capacity to perform examinations of banking groups on a solo and consolidated basis is being addressed, specifically by strengthening and formalizing the exchange of information between the CBE and EFSAs. The stress-testing of banks will have to consider broader scenarios than downgrade of borrowers’ credit risk, to include interest rate and liquidity risks, especially as exposures broaden and Basel II comes into effect. The minimum 5 percent provisioning requirement for “watch loans” should not be treated as a “general” provisioning, but as a “specific” provisioning, impacting on the CAR. The Macro-Prudential Unit may want to broaden, in its analysis, the scope of potential structural imbalances and shocks that can affect financial stability. In addition, the CBE is disclosing regularly the NPLs ratio of banks (i.e. NPLs over total loans). Finally, there assesses the implications of both Basel II and Basel III for capital adequacy of each individual bank, and at the aggregate.

With regard to point (1) above, in the interplay between financial regulations and access to finance, limits to bank exposure to a single client and to the parties related to the bank itself already encourage diversification and competition. By international standards, there is room for further tightening of the limits introduced in 2006. Large exposures to single clients should also be disclosed in quarterly financial statements, to enhance the significance attached to these in the assessment of a bank’s soundness and overall performance. Generally, there is a need to establish a stronger

linkage between management of these exposures and progress with access to finance. For instance, approval of new branches could, in part, depend on the bank’s performance regarding large exposures. Furthermore, the system of loan classification, collateral, and provisioning must be reviewed from the perspective of access to finance given that it affects banks’ credit decisions.

With regard to (2), the difficulties with real estate title registration and associated costs and uncertainties have been a major concern for banks and an impediment to lending. A flexible solution has been offered by the decree no 100 by the ministry of housing to facilitate this while not undermining prudential principles is a main pre-requisite for enhancing access to and growth of housing finance. As mentioned earlier, standardized mortgage procedures under a “register-able” property regime; “interim” title and mortgage registration mechanisms as well as title or “quasi-title” insurance facilities; and review of the rules banning bank housing loans in the case of informal and under construction properties, are all policy reforms that could prudentially facilitate broader access. The authorities should also undertake a comprehensive comparative analysis of the differentiated regulatory and supervisory environments for real estate mortgages between housing finance companies and banks, with a view to eliminating distortion-induced inefficiencies, and incentives to engage in regulatory arbitrage. Furthermore, the greater availability of mortgage credit guarantees or insurance should encourage banks to offer more housing finance. Moreover, the issuance of covered bonds backed by mortgages or other assets would be a good substitute for mortgage securitization as a way to expand long-term funding sources for housing finance. In this context, the current strict rules for public offerings of bonds should be reviewed.

With regard to (3), there is strong evidence that the development of SME financing has been hampered by the lack of comprehensive banking regulations specifically tailored to such lending. Three overarching factors must be examined: First, the broad regulatory infrastructure must be conducive to SME lending. This calls for minimum accounting standards manageable for SMEs, credit bureaus specializing in SME assessment, efficient legal enforcement of creditor and borrower rights in the case of transactions with SMEs, and specialized SME credit rating agencies. Second, prudential regulations cannot, even unintentionally, be biased against the smaller enterprises. This calls for the banks to be allowed to take on exposures to SMEs based on a much broader choice of possible collaterals. As already mentioned, this would require a new legal framework for movable collateral, supported by a centralized registry for all types of collateral. Third, the banks must be provided an appropriate incentive structure that encourages them to move into higher reward/risk lending opportunities. This can only be achieved through greater competition, based on market-oriented corporate governance. Further commercialization and the reduced dominance of state-owned banks is likely to be a key factor in this regard, which would also be facilitated by further privatization. Furthermore, credit guarantees/ insurance should play a more important role in mitigating

the credit risk assumed by banks when they take exposures, especially longer term, to more risky borrowers such as SMEs. In this context, the experience elsewhere with private sector-led Financial Guarantor Funds should be studied to see whether they could be replicated in Egypt. Local chambers of commerce/business and professional associations could be especially well-equipped to create such an entity. Finally, specific regulations governing the securitization of SME loan portfolios should be issued, with a view to enhancing the amount of financial resources going to the sector.

Key Macro-Issues in Access to Finance

Salient features of banking in Egypt. At about 40 percent of GDP, bank lending to the business and household sectors is much lower than these sectors' contribution to the deposit base of the banking system. The difference largely reflects the significance of the banks' holding of securities, especially government Treasury Bills (TBs), as a result of the banks' contribution to the financing of sustained and large government deficits. That level of bank lending to the business and household sector places Egypt below the average for many comparator countries and regions.¹ In contrast, the household sector accounts for an unusually large share of deposits (3/4); the banking system has continued to be the principal recipient of household savings.^{2 3}

Thus, the financing of government by the banking system has been a significant source of "crowding-out" of the private sector's access to finance. Furthermore, the number of bank borrowers in Egypt by 1,000 adults (only about 85) is well below many comparator countries and regions (200 on average in the MENA region, and 350 on average in emerging Asia), also evidencing the limited access to finance. Among those with access to bank credit, there is still a significant concentration of loans, despite improving trends in recent years. The attractiveness of TBs for banks reflects enticing risk-adjusted yield spreads between government securities and other assets, as well as the automatic eligibility of these securities for meeting the 20 percent statutory domestic liquidity ratio, as per CBE regulations. However, this statutory ratio has not been a constraint in recent years. In short, despite the size of its banking system, there is no contradiction in stating that Egypt suffers from financial repression in terms of its ability to meet the needs of its productive business and household sectors.

The banks are often diversifying their financial activities through financial subsidiaries and affiliates. In turn, these may rely on bank loans rather than the financial market for their funding. Subsidiaries and affiliates include brokerage firms, housing finance companies, leasing finance companies, and asset management companies. A number of banks are still holding equity investments in non-financial companies that represent a large share of these companies' capital. The low equity/assets ratio in conjunction with the regulation that total investments (other than TBs and the trading book) cannot exceed 100 percent of capital⁴ severely restricts the allowable level of investments in the banking book within total bank assets (to, basically, less than 7 percent in view of the prevailing equity/assets ratio).

A positive development in recent years has been the near halving in the share of bank financing of the SOEs, to no more than 7 percent of total lending and discounts, and, in contrast, the more than doubling in the share of loans to the household sector, to almost 20 percent of total lending and discounts. This is higher than in China and Russia, though still less than half the ratio typically observed among AEs and even some emerging economies such as India. It appears to be the result of changes in the incentives structure among banks that have encouraged greater portfolio diversification and upward movement along the risk-reward trade-off. These changes have been supported by key elements of the financial sector reform program, such as the dramatic improvement in the infrastructure providing information on borrowers; the pressure on state-owned banks to adopt more profit maximizing market behaviors,⁵ as well as banking supervision regulations specially tailored to consumer lending. Within loans to the household sector,⁶ however, mortgage finance for personal housing, whose legal basis had been reset with the Mortgage Law of 2001, has remained extremely small, at no more than 1 percent of total lending and discounts. This state of affairs has reflected continued difficulties with the registration of titles and mortgages.

Although rising modestly in the course of recent years, SME (defined as enterprises with turnover up LE 20 million) lending has remained modest, amounting to less than 7 percent of total lending.⁷ This is below the levels in many other countries where SME financing has been identified as a major problem, such as in China. Existing prudential regulations do not appear to differentiate between SME and large enterprises financing, with an implicit regulatory bias toward lending to more established and larger firms. Recently though, a regulatory exemption has been granted to banks to encourage SME lending.

There are reports of a general lengthening of the maturities of both assets and liabilities in recent years, as banks have moved into retail lending, with maturities above 1 year often more than 30 percent of total. Regarding the maturity structure of deposits, the majority of deposits are short-term, up to 1 year, but the banks also offer certificate of deposits of 3, 5, and even 7 years. Reportedly, the banks generally try to match the maturity of their loans with that of their deposits, with a view to limit the interest rate (re-pricing) and liquidity risks. Long-term borrowing by banks has been limited, given the difficulties associated with the issuance of asset-backed securities.

The lack of a full-fledged local derivatives market would also limit the banks' ability to manage maturity mismatches. A legal framework for a financial derivatives market has been proposed by the EFSA, but awaits parliamentary approval. The banks' financial statements do show, however, that they use derivatives to some extent, including foreign exchange forwards and interest rate swaps. There is little evidence that banks are actively mitigating the credit risk, due to the lack of market-based credit guarantee or insurance facilities. The Credit Guarantee Company is the only known, and state-regulated, company providing guarantee mechanisms to

enable banks to extend credit to SMEs; it is largely funded by international donors. As of mid-2010, its portfolio of guarantees amounted to only LE 1.5 billion (0.3 percent of total lending, and an estimated only 4 percent of SME lending), though involving almost 160 thousand micro-enterprises and SMEs (reportedly, defaults did not exceed 4 percent).

While E-banking is widespread, there is currently no full legal framework to offer mobile phone banking.⁸ Guarantees, LCs, and other financial services are also a significant part of the banks' business. In addition, banks are very active in offering money market and mutual funds, which they mostly distribute (for a fee) on behalf of non-bank financial entities. In some cases, these are subsidiaries or affiliates of the banks. Some banks also serve as conduit for the distribution of insurance products.

So far, the banks have played an only limited role in providing microfinance lending. This market is dominated by NGOs and other specialized companies. Only two banks directly provide micro-financing, while two other banks support microfinance offered by other financial services companies. Banks in general are more interested in the wholesale financing of microfinance institutions.

Trends in the banks' performance and financial soundness. Inevitably, the timing of the work on this paper meant that the economic and financial impact of the Egyptian revolution was only emerging as the work was undertaken. With regards to the banks, in particular, interviews in the field suggested a significant decline in activity, rise in NPLs and necessary provisions, and a sharp overall decline in profits for 2011 by more than 20 percent. Despite the recent broad downgrade of Egyptian banks by international rating agencies (citing poor asset quality, low capitalization, and doubts about the government's ability to support banks), most bankers voiced optimism about a recovery in 2012 and longer term prospects. The review below should be viewed in this context. There could be significant deterioration in many financial performance indicators in 2011.

The Egyptian banking system has made significant progress in strengthening its financial performance and soundness in recent years, better positioning it to meet the financing needs for sustained economic growth going forward. This has reflected the implementation of the financial sector reforms, and cautious management practices that have built up provisions and capital in addition to expanding the banks' lines of business. It has boosted confidence in the banking system by both depositors and investors. Admittedly, one consequence of reforms was that aggregate credit grew more slowly than economic activity for some time, in sharp contrast to the developments observed elsewhere. However, this seems to have largely reflected both the clean-up of NPLs, and the elimination of non-prudential lending. It should not necessarily be interpreted as evidence of a worsening in the access to credit for emerging private businesses, even if the level of access clearly remains problematic. The financial, institutional, and operational restructuring of the three remaining public commercial banks, and its impact on both their balance sheet and income position, contributed to the overall improvement.

Despite improving trends, capitalization of the Egyptian banking system remains low by some standards, raising questions about the room for significant private sector credit expansion on its current basis. By 2010, more than 1/3 of all banks had a CAR greater than 20 percent. The current level of the CAR places Egypt at par with the average for the MENA and other regions of the world (with the exception of the Commonwealth of Independent States (CIS) and Sub-Saharan Africa), which is a sharp improvement from Egypt's standing at the beginning of the period under review. However, measured by the equity/assets ratio, the capitalization of the Egyptian banking system remains weak, at still below 7 percent. This is significantly below that in most comparator regions with the exception of developed economies (the ratio is typically 10–13 percent among emerging markets), and reflects a more leveraged position.

This under-capitalization has been made consistent with a reasonable risk-weighted CAR by the zero-risk weighting attached to the large portfolio of government securities. This is despite the less than pristine rating of government securities by the international credit rating agencies. While that treatment is in line with Basel I and even Basel II, under the discretion provided to the central banks to allow banks the use of a zero risk weight for domestic government debt in domestic currency even if not supported by current ratings, it remains problematic. There are two reasons for this: first, it does not recognize the actual risk situation; and second, it distorts the incentives for banks with limited capital to lend to government rather than the more productive private sector.

There was an improvement in the banks' assets quality, as evidenced by the decline in NPLs in percent of total loans to 13.4 percent by 2009, about half its level in the early 2000s. However, compared to the average for the MENA region, as well as all other comparator regions (with the recent exception of the countries of the CIS), the NPLs ratio is still high, and further resolution of outstanding NPLs remains a priority to clean up the balance sheet of banks and improve their profitability. Interestingly, the recent global financial crisis did not reverse the downward trend in the NPLs ratio, in sharp contrast with the situation in other regions, especially among AEs, emerging Europe, and the CIS. A substantial share of the Egyptian banks' income was put aside in recent years to build provisions against NPLs, with overall provisions covering more than 100 percent of NPLs by 2009.

Profitability indicators improved as well, with the average ROA and ROE reaching 0.8 percent and 13 percent, respectively, in 2009, almost twice their levels of 2003. Both indicators were affected little by the global financial crisis. Nevertheless, the rate of return on assets has remained well below the levels generally observed in all comparator regions before the global financial crisis, though the rate of return on equity has been more at par. The lower return on assets would in part reflect the high leverage ratio among banks, as noted earlier.

The relatively weaker performance of the state-owned banks continue to weigh heavily on the overall banking profitability indicators in Egypt, also raising questions about the consistency between the business model of state-

owned banks and the objective of diversification and enhancing access to credit. Indeed, excluding these banks, the rates of return on assets and equity among private banks (both domestic and foreign), have been around 1.7 and 20 percent, respectively, high by international standards. Lower interest margins (net interest income/ assets) among state-owned banks appear to be a main explanatory factor. Such lower returns at the state-owned banks would be consistent with them continuing to offer relatively high deposit rates to attract retail depositors and charge relatively low lending rates to traditional corporate borrowers.⁹

Regarding the sensitivity of the banks' soundness to various risks, credit risk associated with a potential deterioration in asset quality as a result of adverse macroeconomic shocks remains the main vulnerability. A stress test performed for the FSAP update (2007) considered the implications of a downgrade in each debtor category, resulting in additional provisioning, for each bank's CAR. The average CAR was reduced by a minimum of 3 percentage points and, more concerning, the share of system assets accounted by the banks falling below the minimum CAR increased significantly, essentially, because the state-owned banks were least able to withstand the shock. A factor that may have contributed to enhancing credit risk in more recent years would be the increased diversification of the loan portfolio of banks towards consumers and SMEs. At the same time, an associated reduction in loan concentrations towards large enterprises in the business sector may have had the opposite effect.

The Broad Regulatory Framework for Increased Access to Finance

Factors of the broad regulatory framework that have traditionally encouraged Egyptian banks to grant credit to mostly well established and connected large enterprises are multiple. They include distorted incentives associated with the dominance of state-owned institutions in both the non-financial and financial sectors; a related governance structure that is not market-oriented and discourages the taking of new risks; and significant gaps in the financial and informational infrastructure. This Section reviews the progress made in key areas of the broad regulatory framework most relevant for increased access to finance, and addresses certain remaining gaps.¹⁰

Reliable financial reporting and auditing. Reliable financial reporting and auditing facilitates access to finance by enhancing the confidence of creditors and investors, and the credibility of borrowers. The latest Egyptian Accounting Standards (EAS) were approved by a committee headed by the Minister of Investment in 2006, and became effective at the beginning of 2007. They comply with IFRS in all material respects. In 2005, the CBE published a set of auditing guidelines and rules to support the quality and independence of auditors assigned to audit firms that apply for bank credit. Seeking to ensure, inter alia, that IFRS standards fully apply to the financial statements of registered banks as well, the CBE approved on December 16, 2008 new rules for the preparation and presentation of banks' financial statements conforming to these standards.¹¹

Quarterly financial statements of banks are now substantially improved, in terms of both coverage and standardization, and quality of the financial information included. These financial statements are required to be certified by two auditors selected from a list of auditors approved by the CBE. Each bank must be fully audited by two auditors once each year. A gap relevant to incentives for enhancing access to finance is that the CBE quarterly reporting requirements do not seem to include either information on the structure and concentration of the bank's shareholders, or information on the loan concentrations in relation to the largest borrowers. This raises questions on the priority attached to such concentrations in the assessment of risks and overall bank governance.

With the growing significance of brokerage, financial leasing, and mortgage finance subsidiaries and affiliates, it is becoming increasingly important to require all banks to move to a quarterly reporting of their consolidated operations as well. This would enable solo and consolidated supervision of banking groups to be performed consistently taking into account the most current developments. Currently, consolidated financial statements for banking groups need only be reported on an annual or semi-annual basis, although some banks already disclose consolidated quarterly accounts.¹²

Well designed and enforceable secured transactions rules. The Mortgage Finance Law 148 of 2001 provided for the first time transparent procedures to foreclose on the property of defaulting debtors. It also allowed for the securitization of mortgages and the issuance of mortgage-backed securities. In line with provisions under the Law 88 of 2003, a real estate mortgage against a bank loan has to be registered with a local notary public. The administrative procedures to register a property right in the form of real estate title/deed have been streamlined, and the related costs reduced. Registration is of course necessary to make it possible for a bank to place an enforceable lien on the property.

Notwithstanding the above improvements, financial transactions continue to be hampered in practice by weaknesses in the legal and regulatory framework and its enforcement. In the case of many older urban areas, title registration remains a lengthy and uncertain process, even if now it is less costly. Only a fraction of the housing stock has a registered title, as registration of property is not mandatory in Egypt for a legal real estate transaction, except in the case of a mortgage credit application. Reportedly, 45 percent of new urban housing is produced by the informal sector, preempting mortgages because CBE regulations require proof of a building license. With the banks or housing finance companies often unable to extend mortgage finance to home buyers, the latter have had to rely on installments deals with the developer, if available. Furthermore, the lack of a centralized mortgage registry has been identified as a major weakness in the informational infrastructure.

Clearly, greater flexibility is needed to facilitate home mortgage financing, while recognizing the imperative of maintaining prudential lending practices and financial soundness. Already, an executive regulation allowing

mortgage finance for a “register-able” property has been issued, and banks do extend housing loans based on a “power of attorney”. It is also proposed to set up a simplified “interim” real estate registry, especially for register-able properties, which could form the basis for a special form of mortgage collateral that could likewise be registered in an interim mortgage registry.¹³ Another supportive measure would be encouraging the development of market-based title or “quasi-title” insurance, the latter specifically for register-able properties. There could also be a review of the CBE regulations generally prohibiting bank mortgage finance for residential units under construction and for informal housing, assuming strict conditions and guarantees under which such lending could be possible.

A significant gap with secured transactions appears to be the lack of a legal regulatory framework for the use and registration of a broad range of movable property as collateral. This is of particular significance in the case of lending to consumers and SMEs (see below). This issue was identified by several interlocutors as a major impediment to access to finance. The introduction of such a framework for movable collateral, as well as the establishment of a centralized registry for movable collateral is a priority. The regulations should clearly state the right of creditors to dispose of the collateral upon default without the need for court intervention.¹⁴ The centralized registry should also be designed to clearly establish the priority of secured creditors.

Finally, the outdated bankruptcy law needs to be revised because it focuses exclusively on liquidation. This un-necessarily increases the expected and actual costs of insolvency for all concerned. Reportedly, the court procedures for liquidation also continue to be slow and cumbersome, further making creditors extremely reluctant to lend. A new bankruptcy law should allow, in addition to liquidation, company re-organizations along Chapter 11 lines. This would provide for efficient debt workouts and restructuring that should include an option to convert debt into equity. The law would also establish specialized courts to deal with bankruptcy cases.

Progress with good corporate governance and financial disclosure.

Good corporate governance and financial disclosure enhances market discipline and efficiency, and promotes an incentive structure that encourages more diversified lending. All banks are subject to the corporate governance and disclosure requirements of the Egyptian Company Law, and of the EGX’s listing, delisting and disclosure rules, if the bank is listed. Bank-specific corporate governance requirements have been highlighted in the Law 88 of 2003. Inter alia, the Governor of the CBE has to be consulted for the appointment of a bank’s Board of Directors and its Chairman, as well as its Executive Directors in charge of credit, investment, portfolio management, external transactions, and risk management and internal controls. Fit and proper criteria for the Chairman of the bank, Board members and Executive Directors were introduced in 2004 and further strengthened in 2009, and are being assessed on paper and through interviews. There is now a requirement

that the majority of Board members must be Non-Executive Independent Directors. The CBE has also made it clear that it prefers that the Chairman of the Board is a Non-Executive Director, and requires an explanation if it is not the case.¹⁵ Furthermore, each bank must have an Audit Committee composed of three Non-Executive Directors, in addition to an Executive Committee. Moreover, the management of the bank has to submit to its Board of Directors, at least semi-annually, an evaluation of investment and loan portfolio risks, and measures to address them. However, there is currently no requirement to have a Risk Management Committee separate from the Audit Committee. A separate Risk Management Committee would allow it to focus exclusively on a forward-looking assessment of the risks faced by the bank. It could also be legally assigned the responsibility to vouch for the adequacy of the bank’s risk management policy.

The listing on the EGX of commercial banks operating in the country offers further support for improving corporate governance and transparency. In addition to quarterly financial statements, listed banks must disclose additional information on their governance and ownership structure that generally go beyond the CBE disclosure requirements for other banks. Additionally, listed banks are required to publish the quarterly Auditors Committee reports. The committee is established as per the Egyptian Code of Corporate Governance and the Listing and Delisting rules at EGX. This is further contributing to confidence as well as market discipline and efficiency. Disappointingly, among the 39 banks registered in Egypt, only 12 are listed on the EGX, and only 9 have a credit rating from an international agency.¹⁶ While the prospect of an IPO is likely to remain the main incentive for banks to seek a stock market listing, greater conformity between the CBE and EGX governance and disclosure requirements, through further strengthening of CBE requirements, could have the effect of tilting the banks’ decision to list (based on a consideration of costs and benefits) in that direction. To the extent that credit ratings of banks by approved credit rating agencies inform market discipline, banking supervision should review the use of such ratings in its supervisory framework, based on the Basel II guidelines. The objective would be to ensure that prudential regulations offer the proper incentives for banks to seek such ratings, recognizing at the same time the need for transparency and reliability.

While the State’s divestiture from joint venture banks and one state-owned bank, and the operational and financial restructuring of the remaining state-owned banks have contributed to better corporate governance, the still relatively large scale of state-ownership of banks implies inherent limitations to the role of market forces. Especially if the blanket (but unfunded) guarantee on deposits were to be viewed as stronger in the case of state-owned banks than private banks. On the positive side, there is evidence that some of the still state-owned banks are now run more competitively, developing new markets and products, and actively competing with the private domestic and foreign banks. Nevertheless, impediments remain. In particular, the ownership function at the restructured

state-owned banks remains fragmented, as the general assembly does not appoint/dismiss the Board of Directors (appointed by the Prime Minister), and the Boards would in practice still be dominated by Management.

Despite the progress made in recent years, there is still significant room for improvements in the amount, quality, and frequency of public disclosure of information by individual banks. In practice, beyond the balance sheet, income statement, cash-flow statement, and change in equity and profit appropriation information, the banks' financial statements often offer only limited information on corporate governance, and risk management and internal controls. There are in fact very large variations among individual banks in the quality of financial statements in this regard; and the same is true in the case of Annual Reports.¹⁷ Another difficulty is that the many banks that are either branches of foreign banks or unlisted subsidiaries of foreign banks do not publish separate Annual Reports at all, even though their foreign groups do, on an individual and consolidated basis, but without identifying separately the accounts of their Egyptian subsidiary.

Availability of reliable credit information. Egypt has made significant progress with regard to the availability of reliable credit information, a key requirement for facilitating greater access to finance, but more can be done. Such information is of course key to a lender's decision to grant a loan. The CBE's Central Credit Registry (CCR) envisaged in the Law 88 of 2003 was made fully operational with the CBE Board of Directors' regulations of April 26, 2005. It covers all loans above LE 30,000 extended by banks, mortgage finance and financial leasing companies, and also the Social Fund for Development. The lenders can access the CCR on line, and the database now includes both negative and positive information, as well as information on any rescheduling agreement. The regulations specify: the list of documents and declarations that banks, financial leasing companies, and mortgage finance companies must obtain from clients applying for credit, and the review process they must conduct before granting the credit; the reporting requirements to the CBE for new clients and the updating of the CCR to reflect the existing clients' latest position, on a monthly basis; and notifying the CBE on bank clients who are not regularly meeting their payment obligations, with special provisions as regards consumer loans.

With a view, inter alia, to broadening the scope for bankable projects, Amendments to the Law 88 of 2003 foresaw the establishment of private credit bureaus.¹⁸ The establishment of a private credit bureau offering a reliable and comprehensive database was a significant objective under the Financial Sector Reform Program supported by the World Bank. The private credit bureau "I-Score" established in 2005 as a regulated monopoly, majority-owned by the banking sector, became fully operational in March 2008. Membership is open to banks, mortgage finance and financial leasing companies, retailers (major department stores), as well as microfinance companies, and brokerage firms (for margin trading). The fee structure differentiates banks from non-bank members.¹⁹ For individuals, there is no low or upper limit for the size of loans covered; for SMEs, the size of loans covered range from LE 1 to LE 1 million (beyond, the CCR is the sole depository of the credit information). Currently, the I-Score data cover about 7.5 million individuals, and

83,000 SMEs, or about 95 percent of borrowers, except in the case of microfinance borrowers, where the coverage is significantly less. Only one network of microfinance NGOs is currently member of I-Score. National ID numbers are helping in setting up customer files. An I-Score report is now obligatory for any loans by banks (only) before extending the credit. Clearly, this requirement should be extended to the other financial intermediaries as well. The information collected by I-Score appears to be significantly broader than that of the CCR, providing additional inputs to the assessment of any potential borrower's credit worthiness (such as historical inquiries, payment history, un-honored checks and legal pursuits). Scoring models are extensively used. There is evidence that the work of I-Score has contributed to both an improvement in payment discipline among borrowers covered, and the number of individuals and SMEs with access to credit.

Going forward, a priority would be to ensure that the fees of the credit bureau do not discourage microfinance institutions, in particular, from becoming members of I-Score and using its credit information. It should be possible to negotiate fee structures/ packages that would allow almost all micro-finance institutions and loans to be brought under I-Score. Given the positive externalities involved, some form of fee subsidy from government could be considered. Consideration should also be given to invite major utility companies, including mobile phone companies, to participate.

The Management of I-Score has identified two potential areas for extension of its activities, which could also help with increasing access to finance. The first would be the creation of a central registry for both immovable and movable collateral (assuming for the latter that an appropriate legal framework is put in place), also consolidating all current sources of information on collateral. The second would be the creation of a SME rating agency, possibly modeled along the line of similar agencies created elsewhere, e.g. India's SMERA (Box 5.1). Again, modest government subsidies in these areas could offer a fairly large bang-for- the buck.

Box 5.1: Example of SME Rating Agency: India's SMERA

SMERA was the first comprehensive and independent credit rating agency specifically targeted at micro and small and medium size enterprises (MSMEs) established in India through a joint venture between leading business information services and banks. It offers two different scales for rating of a MSME: the first focuses on a size indicator based on net worth, and for each (of the four) net worth classification, two possible values for a composite appraisal indicator; the second focuses on a broader financial strength indicator, and for each (of the three) financial strength classification, two possible values for performance capability. The rating fee structure is based on the enterprise turnover, and in the case of eligible MSMEs, can be partially reimbursed through the National Small Industries Corporation (a state-owned enterprise fully owned by the Indian government). Up to 75 percent of the rating fee can be reimbursed, to a maximum of Rs 40,000 depending on the size of the enterprise's turnover.

Entry and exit rules that promote competition. Greater competition should incentivize the banks to broaden their lending activities. Many restrictions that existed on new domestic and foreign banks trying to enter the Egyptian banking market have been formally lifted, but significant hurdles remain. The Law now makes clearer the procedures for consideration of an application and granting of registration (license). Nevertheless, the Law still seems to leave much discretion to the CBE for rejecting applications, and to lack disclosure requirements on the proceedings. The possibility under the Law for a foreign bank to start a green-field banking subsidiary in Egypt should also be clarified. The minimum capital requirement to obtain a banking license set in 2003 still looks high by international standards, but less so now that many countries have raised theirs in recent years.²⁰ In reality, most banks in operation today in Egypt obtained their license well before 1985. Since then, it appears that only one new bank registration was granted, in 2006. The CBE has applied a de facto moratorium on new licenses on the ground that Egypt has been “over-banked”.

While the de facto moratorium on new bank licenses would suggest a lack of competition associated with a static banking landscape, there have been, in fact, dramatic structural changes in this landscape. These have been associated with significant ownership changes brought about by divestiture, mergers, and acquisitions in the context of the government’s financial sector reform program. The foreign presence in the Egyptian banking system, including through subsidiaries in addition to branches, offers the prospect of a spill-over of know-how, good governance, new products and technology, and generally greater competition. A recent comprehensive study of the impact of financial sector reforms on the competitiveness and efficiency of the Egyptian banking system concluded that while the sector remains one of monopolistic competition, both competition and efficiency has increased since 2002.²¹ Having said this, banking concentration remains relatively high, with the three largest banks still accounting for about 40 percent of banking assets in 2009, but down from 50 percent in 2006. Interestingly, one private bank (the CIB) now occupies third place in terms of assets among the largest three banks, while back in 2006, the three largest banks were all state-owned.

The conditions for approval of new branches should give greater weight to the prospects for increasing access to finance in the location being considered. The current conditions were clarified in new regulations approved by the CBE Board of Directors on June 3, 2008. They emphasize (1) the need to focus on under-served areas, (2) the requirement that each bank is covered by LE 20 million of the bank’s capital, (3) the requirement that the bank currently abides by all prudential regulations, and (4) the submission of a full business plan for the branch, approved by the bank’s Board. These procedures were further streamlined in 2010, with a focus on financial soundness, risk management, and efficiency of the bank applicant. The density of SMEs in the locations being considered could be made a pivotal variable in the decision of which new branches to approve.

As to exit rules, the Law provides for clear circumstances under which the Board of Directors of the CBE can withdraw a bank’s registration, and specifies the various actions the Board can take with regard to any bank in financial difficulties, but a full-fledged banking resolution regime remains absent. In particular, the ability of the CBE supervisor to impose a moratorium on the bank’s obligations and to restructure its liabilities is unclear. In practice, banks have not been allowed to fail. The standard approach seems to have been merger encouragement, or bailout, with government or CBE support. While a source of stability for the banking system, this approach may have undermined the competitive advantage of healthier banks.

Going forward, ending the moratorium on new banks and further commercialization and privatization of state-owned banks are priorities, as is the introduction of a full-fledged banking resolution regime. In parallel to this, the introduction of a uniform, limited, and funded deposit insurance scheme should be considered, when macro-financial stability allows it. These reforms would contribute to create a level playing field and encourage growth and competition. The end of the moratorium, in particular, could open up the prospect of new “niche” banks (e.g. SME traders, manufacturers) filling up current gaps in the access to finance.

Addressing via banking supervision the problem of loan concentration in banks, through limits on large exposures and connected lending, should also force the banks to become more competitive in expanding their business (see further below).

Banking Supervision for Enhanced Access to Finance

This Section of the paper turns to banking supervision, the nature and direction of which can constrain or expand the scope for diversification in bank financing towards sectors currently under-financed sectors.

Enhanced access to finance necessitates that banks be able and willing to move up the ladder in terms of individual risk taking, and banking supervision must be supportive of this process. The proper pricing of risk then becomes central to the banks’ financial performance, soundness, and stability. At the same time, greater diversification of the banks’ activities can also, on the aggregate, reduce risks associated with excessive concentration in their loans and investments portfolio.

Clearly, risk-based supervision must accompany this development of the financial intermediation system. To this end, the Banking Supervision Department of the CBE has been revamped, in line with best international standards. A detailed program for capacity building in banking regulation and supervision during 2006–2007 was an important element of the World Bank supported financial sector reform program.²² The CBE supervises banks through a combination of prudential regulations, on-site inspections, and off-site monitoring. The supervision has focused on capital adequacy, asset quality, and liquidity, as well as on an assessment of the banks’ own ability to identify and manage risks, and the strength of their internal controls. Market and operational risks management are being given greater attention in the context of the move towards Basel II.

Here, we first offer a forward-looking review of the state of play with implementation of risk based banking supervision, and then focus on the interplay between prudential regulations and key concerns relating to access to finance, namely (1) encouraging diversification in bank lending; (2) supporting housing finance; and (3) facilitating SME financing.

Implementation of risk-based banking supervision. The legal and regulatory basis for a reformed banking system was reset in Egypt with the Law 88, The Law of the Central Bank, the Banking Sector, and Money, 2003,²³ which also defines broad parameters for risk-based banking supervision. Implementation of the Law 88 and subsequent regulations, in conjunction with the revamping of the Banking Supervision Department means that Egypt is now compliant or largely compliant with all the Basel Core Principles for Effective Banking Supervision and Transparency of Banking Supervision. The CBE supervises banks through a combination of prudential regulations, on-site inspection, and off-site monitoring.

Prudential regulations. They appear generally in line with best international practices. Various limits on exposures apply, including for single customer and related parties, the bank's related parties, investments, real estate lending, and exposure to single foreign correspondent. Regulations on exposure limits to single consumer and related parties and the bank's related parties which, although largely motivated by prudential concerns, play a role in encouraging loans diversification and therefore access to finance. These exposures have been a significant concern in the case of Egypt, and there has clearly been much progress in addressing them, though there appears to be room for some further strengthening.

On-site inspection, off-site surveillance, loans classification, and provisioning. The on-site inspection process is now fully aligned with a risk-based approach focusing on credit policy, the risk management system and internal controls, and the IT system. The on-site inspection focuses on the credit risk, compliance with prudential regulations, quality of corporate governance, risk management and internal controls, and financial performance and soundness of the bank. Market and operational risks are also assessed, though they currently have no direct bearing on the derivation of the CAR, even after the full implementation of Basel II due to its small size compared to credit risk.

There are doubts about the ability of on-site inspections to perform examination of banking groups on both a solo and consolidated basis. The process seems to be hampered by the lack of timely consolidated accounts, due to the different frequency of reporting. Furthermore, given the growing number of non-bank financial subsidiaries and affiliates of banks, the need to strengthen and formalize (with MOUs) the exchange of information between the CBE and EFSA is becoming more imperative. Recently, the CBE and EFSA supervisors have established a "coordination committee" which meets weekly. The increased significance of foreign banks as groups holding banking subsidiaries in Egypt also enhances the need for strengthened and

formalized (in MOUs) interaction between the CBE supervisor and its foreign counterparts. Off-site monitoring of the banks is fully operational and based on a wide range of information collected from the banks' weekly, monthly, quarterly, and semi-annually, depending on the type of information.

Stress-testing of banks has been introduced two years ago, and the Off-site Monitoring Division contributes to the "bottom-up" approach, with each bank being individually tested. Results are also sent to the Macro-prudential Unit and consolidated according to various objectives and criteria. It is interesting to note in this context that the Head of the Off-site Monitoring Division is currently also the acting Head of the Macro-Prudential Unit, suggesting close coordination, but also raising questions on the separate status of this Unit.

Stress testing is conducted annually (and on special events) on Egyptian Banking Sector to determine the combined impact of borrowers' credit rating's downgrade, EGP currency devaluation , and investments portfolio devaluation on banks' profitability, capital adequacy & liquidity.

The following were the underlying assumptions for stress testing conducted:

1. Haircut of Net income by 20%
2. Credit Test Assumptions:
 - Banks' collateral was reduced by 50%, excluding cash collaterals and banks' guarantee.
 - All corporate credit facilities and exposures of retail and SMEs were downgraded according to 4 scenarios:
 - First Scenario: 50% of corporate credit facilities in each notch and 10% of that in retail and SMEs were downgraded by one notch,
 - Second Scenario: 100% of corporate credit facilities in each notch and 20% of that in retail and SMEs were downgraded by one notch,
 - Third Scenario: 50% of corporate credit facilities in each notch were downgraded by two notches, and 30% of that in retail and SMEs were downgraded by one notch,
 - Fourth Scenario: 100% of corporate credit facilities in each notch were downgraded by two notches, and 30% of that in retail and SMEs were downgraded by one notch
 - Resulting shortage in provision after conducting the stress test is added to existing shortage or surplus (if any) in provision.
3. FX Devaluation Assumptions:
 - Assuming further devaluation of Egyptian pound against foreign currencies, and determine the impact on CAR
4. Investments portfolio Devaluation Assumptions:
 - Assuming different scenarios for devaluation of debt & equity investments and determine the impact on CAR.

The current focus is understandable given the current structure of banks' balance sheets, but will have to be broadened as exposures evolves, and also Basel II comes into effect. Stress testing for the interest rate risk (for both the cash flow and valuation effects of changes in interest rates) and the liquidity risk is likely to gain greater prominence.

The system for assessing credit worthiness ("Obligator Risk") and governing the loans classification and provisioning by banks in Egypt was revamped by the CBE in new regulations approved on May 24, 2005, in line with international standards. The general treatment of "watch loans" (i.e. loans regularly in arrears, but for less than 90 days)²⁴ and of their provisioning for the purpose of calculating capital adequacy is too lax. These loans attract a minimum 5 percent provisioning requirement which is, however, treated as a general provisioning. The apparent inclusion of these provisions in eligible capital would over-estimate the capital strength of the bank. It should be noted, however, that stricter criteria for loan classification and provisioning apply for consumer lending.

The main objective of the Macro-Prudential Unit is to regularly assess the financial soundness of the Egyptian banking system on the aggregate level, and the systemic risks it may face, taking into account broader economic and financial developments in the economy. In this context, a number of aggregate micro-prudential indicators relating mostly to banks are being monitored and published, as well as a list of standard macro-economic and market indicators that could shed light on the sources and nature of possible shocks.²⁵ Greater attention needs to be paid to the composition and maturity of capital flows, interest and exchange rate levels, adequacy, and volatility, possible sources of contagion effects, credit ratings, indicators of excess yields, and sovereign yield spreads. Outside banks, developments in other sectors of the economy also need to be closely monitored, including key financial data on nonbank financial institutions, nonfinancial corporations, households (in particular, debt levels and debt servicing burden), and real estate markets (in particular, price trends, and trends in real estate lending), as well as indices of financial markets' liquidity.

Capital adequacy. The CAR (risk-weighted assets and contingent liabilities to capital) is a key indicator of a bank's ability to absorb potential losses. It is also an indicator of the scope for further expanding risk taking activities, the need to contract such activities, or to add capital. It thus affects the growth of financial services and access to finance.

Until now, the CBE has generally applied the Basel Capital Accord²⁶ for the calculation of the CAR. It raised the minimum requirement from 8 percent to 10 percent in 2003. Tier I capital and Tier II capital have been recognized.²⁷ The framework is to apply both on a solo and consolidated basis for the banking groups (see, however, earlier concerns on the effective and timely implementation of this). The branches of foreign banks are not subject to the CAR requirement. Investments in banks and financial institutions, other than subsidiaries under consolidation, are apparently not netted from

the capital base as well, though goodwill and losses are. Assets and contingent liabilities are calculated on risk-weights ranging from 0 to 100 percent, and above 100 percent for some classifications. The latter applies to the financing of real estate development companies (when the leverage exceeds 2:1), with a risk-weight potentially up to 232 percent,²⁸ as well as for the financing for mergers and acquisitions, which carries a risk-weight of 150 percent in case the acquiring company is an anchor investor and 200 percent when it is not (e.g. investment fund).²⁹

So far, the banks have not been obligated to charge capital against either market or operational risk, for calculating capital adequacy. Reportedly, these risks are already assessed during the on-site inspections in determining capital adequacy. The move to a risk-based banking supervision is being further strengthened in the context of the phased implementation of the Basel II framework. Egypt banking supervision intends to implement the standardized approach, even if some banks already use an internal ratings-based approach. The implications of Basel II for capital adequacy mainly result from (1) a few modifications in the definition of eligible regulatory capital, (2) considerable refinements in the ways assets are risk-weighted for the purpose of calculating capital adequacy, and (3) the incorporation of capital charges for the market and operational risks.³⁰ One modification to eligible capital, which could constrain some Egyptian banks, relates to the deduction to be made for significant investments in commercial entities.³¹ Among the additional credit risk sensitivities, the requirement that past due loans and other higher-risk categories should carry risk-weights of up to 150 percent could also affect some banks. The requirement to charge capital for the market risk and, especially, operational risk could also be more problematic for some state-owned banks, reportedly.

The above adjustments and recognitions will certainly affect the CAR negatively, but perhaps not dramatically. In conversations, the Banking Supervision Department expressed confidence that Basel II standards would not expose significant capital shortages for banks in Egypt, based on the current minimum 10 percent CAR. However, and especially for the banks closer to this minimum CAR, banking supervision will need to assess whether the banks' remaining capital buffer is sufficient in view of their specific risk profile.

Basel III will have further implications for capital adequacy, and beyond, for access to credit.³² The global financial crisis of 2008–2009 exposed fundamental weaknesses in the business model and risk taking strategy of banks, especially those in the AEs which had been at the forefront of sophisticated forms of products (both on the asset and liability sides) to expand their on and off-balance sheet activities, and their incomes. The international regulatory and supervisory response to the crisis has been far-reaching, and by late 2010, broad agreement on significant changes in the regulatory and supervisory framework had been reached, forming the so-called Basel III framework. The limited direct exposure of the Egyptian banking system to developments in international banks and financial markets abroad shielded

it, for the most part, from the direct and worst consequences of the crisis. Nevertheless, Egypt will be affected by the new regulations. First, because the large international banks that operate branches in the country or are sole or majority owners of domestic banks will operate under the new framework. Second, because Egypt would be expected to implement the new framework domestically as well. This would strengthen banking soundness at a time when an expansion of the financial sector is poised to sustained economic growth.

Sound liquidity management. The ability of a bank to meet cash demands in more difficult circumstances is part of its financial soundness; and in this regard, the CBE has introduced strong liquidity management requirements. The policy was detailed in a February 22nd, 2005 CBE Board Decision obligating the banks to (1) develop or update their liquidity management policy, to be approved by each bank's Board and submitted to the CBE; (2) submit a memorandum reporting on their current liquidity management capabilities and experience; and (3) develop their IT and human resources to implement their strengthened liquidity management policy. This policy needed to cover: (1) an analysis of the relative importance of various sources of bank funding; (2) a statement of maturities of assets and liabilities,³³ for the purpose of identifying the maturity mismatches, setting maximum limits as a percentage of the bank's liabilities, and monitoring them; (3) a strategy to manage liquidity on a daily basis, based on a projected cash-flow identifying surpluses or deficits; and (4) a financing plan to address emergencies under a stress test scenario, to be approved by the concerned Board committee. The plan, to be reviewed at least once a year, would focus on setting a minimum amount of liquid assets to be maintained by the bank to face such emergencies, and on the ability of the bank to obtain additional resources from the local market (contingent borrowing arrangements with other banks, scope for securitization of part of the loan portfolio). Moreover, it would serve as a basis for setting maximum gap limits for each maturity bucket.

All these elements are consistent with the Basle Sound Practices for Managing Liquidity in Banking Organization (Basel, 2000), though the need to have an adequate system of internal controls over the bank's liquidity risk management process should also be stressed, including through independent reviews and evaluations. It has not been possible to assess in any detail how the current practices among Egyptian banks also conform to the revised international liquidity risk management standards introduced under Basel III, but the overall impression is that of great variance in standards among the banks, based on the disclosed information.

Encouraging diversification in bank lending. While mostly aimed at containing credit risk concentrations, limits to bank exposure to a single client and its related parties, and to parties related to the bank itself also serve to encourage diversification and competition. The introduction of these limits in Egypt in 2006 addressed a long standing problem, although by international standards, there continues to be room for further tightening of these limits. There is in fact evidence of a reduction in the concentration of loans in recent

years, as the number of clients with loans per 1,000 adults rose sharply from barely 30 in 2006 to about 80 by 2009. Nevertheless, the importance assigned to large exposures to single clients during the on-site inspection and off-site monitoring is still not entirely clear. As already mentioned, the requirement that such exposures be disclosed in quarterly financial statements would appear to be absent. In practice, they are not disclosed, while concentrations among customer sectors, geographical areas, business activities, and transactions with related parties, evidently are. There is a need to establish a stronger linkage between management of these exposures and progress with diversification and access to finance, in addition to the assessment of risks and capital adequacy. In particular, approval of new branches could, in part, be conditioned on the bank's performance regarding large exposures.

The system of loan classification, collateral, and provisioning must be reviewed from a perspective of access to finance because it affects the portfolio decisions of banks, and thus who receives credit. "General" rules based on traditional banking that focus on established corporations run the risk of ignoring characteristics related to lending to more diversified sectors. As a result, specific risks and access issues may not be adequately addressed. The regulatory challenge is to have rules that are flexible enough to accommodate the characteristics of particular borrowers, with a view to facilitating their access to finance, without sacrificing any of the legitimate risk-focused strength of prudential regulations.

Conservative rules currently apply for the type and value of collateral that can be deducted for purposes of calculating required provisioning. Generally, only cash, a third party bank guarantee, liquid market securities, and real estate are recognized. A Maximum 65 percent of the market value of liquid securities and 50 percent of the fair value of real estate collateral is deductible.³⁴ No allowance is made for collateral in the classification of loans. Greater flexibility in the collateral regime is needed to facilitate access to finance. This would apply to SMEs, in particular (see below).

Special credit risk classification and management as well as provisioning rules tailored for consumer loans, residential real estate loans,³⁵ and small enterprise loans have already been introduced. Some of these rules tend to be more demanding than in the case of business loans.³⁶ In particular, the loans are subject to a 3 percent general provisioning requirement, and credits that are in arrears for 30–90 days are already treated as sub-standard and subject to 10–20 percent provisioning. Others, however, appear fairly lax. For real estate loans in particular, the provisioning is based solely on the amount of unpaid installments. There is no early recognition that the entire loan might be bad. Furthermore, 100 percent of the Fair Market Value of real estate collateral can be recognized for residential real estate loans, which appears to be an exception to the 50 percent rule applicable for all other types of loans. Except for the general 3 percent provisioning requirement, other regulations for small loans related to economic activity are basically the same as for regular corporate loans.

The regulations applicable to retail lending do not seem to have hindered its rapid growth since 2005, with its share of total bank credit doubling to approximately 15 percent. However, this development has mostly reflected the surge in consumer loans (especially credit cards, personal loans, and car loans). Despite the accommodating regulatory environment, there was only limited growth in residential real estate loans and small loans related to economic activity in the period.

Mortgage finance. Access to home-ownership in Egypt for all social classes except the wealthiest is hampered by the limited development of a mortgage market in the country. Reportedly, total housing mortgages outstanding at end 2010 were less than EP 5 billion (75,000 customers), still representing less than 1 percent of GDP (compared to 14 percent of GDP in Morocco, for instance).³⁷ In the period, the number of mortgage finance companies rose from 2 to 13. Some 19 banks are now doing mortgage finance. Banks have been very cautious in expanding in this field, often providing limited financing to homebuyers under their general retail credit facilities, or to builders with collateral other than mortgage pledges.

The lack of, or difficulties with, real estate title registration and associated costs and uncertainties have been a major concern for banks and an impediment to lending (see earlier discussion). This, and issues related to the potential maturity mismatch between short-term deposits and long-term mortgage loans, have limited banks' ability to extend housing financing. Variable interest rates are the norm, transferring some of the interest rate risk to the borrowers. The rates are generally benchmarked on the developments of the middle of the CBE "corridor" for the interbank market interest rate, with the mortgage finance rate generally reset once a year. Maturities would be at most for 10–15 years.

The general rules for mortgage loan limits and eligibility (loan to value and installment to income) set by the Mortgage Law 148 are not particularly restrictive.³⁸ It is proposed to further relax the more demanding installment / income ratio limit of 25 percent for the low-income groups, by raising it to 30–35 percent, a proposal that seems reasonable, especially in view of pressing concerns to improve access to mortgage finance for these groups.³⁹ EFSA has proposed changes to current laws and executive regulation allowing it the authority to set such limits, as opposed to having them hard coded in the law. The law provides a number of incentives for banks to increase their role in real-estate financing: some exemptions to the loan/ value limit; right to purchase the mortgaged real estate in case of a short sale; facilitation of enforcement actions in cases of default, etc.... At the same time, the banks are expected to balance the maturities of their assets and liabilities related to the financing of real estate, abide by the general sound credit extension rules, submit a quarterly report on their balance of loans for real estate financing, and in any case restrict housing financing to 5 percent of their total loan portfolio. While tight by international standards, this limit is far from being a constraint so far.

Banks are competing with the mortgage finance companies for their share of the mortgage finance market, and there should be a level regulatory playing field to ensure that competition is fair. In fact, there are currently significant regulatory differences. For instance, provisioning requirements are laxer in the case of mortgage finance companies (1 percent general provisioning requirement rather than 3 percent for banks; 5 percent provisioning requirement for a one monthly installment delay rather than 20 percent for banks). Mortgage finance companies are also allowed to finance housing under construction, while banks are prohibited from doing so. On the other hand, mortgage finance companies are obligated to pay ½ percent of their mortgage interest charge into a subsidy fund to support access to mortgage finance by low-income families, while the banks are not. Different loans to value ratios and capital requirements may apply as well.

It appears that an increasing number of banks are acquiring mortgage finance companies, or setting up mortgage finance subsidiaries, rather than doing mortgage finance using their own balance sheet. This development could reflect the comparative advantages of mortgage finance companies in assessing credit, but could also result from of the potential for regulatory arbitrage. It raises two concerns: first, regulatory distortions would reduce the efficiency of financial intermediation, with a consequent adverse effect on growth; And second, transferring mortgage finance to a separate subsidiary is likely to complicate banking supervision even if the subsidiary is fully consolidated within the banking group, not least because the consolidated reporting requirements are currently less frequent, as highlighted earlier, and the need for closer cooperation with EFSA. The authorities should undertake a full comparative analysis of the differentiated regulatory and supervisory environments for mortgages between mortgage finance companies and banks. The objective would be to harmonize the rules where different rules cannot be economically justified. (Similar issues may be relevant in the case of leasing finance companies).

Foremost, finding some flexible solution to the title registration problem that does not undermine prudential principles is a main prerequisite for enhancing access to and growth of mortgage finance. It would open the door to the issuance of mortgage-backed securities and/ or covered bonds, as well as the development of a mortgage securitization market.⁴⁰ The earlier-discussed standardized mortgage procedures under a "registerable" property regime; interim title and mortgage registration; title or "quasi-title" insurance facilities; and review of the rules banning bank housing loans in the case of informal and under construction properties, are all policy measures that could prudentially address the access problem, pending a long-term resolution of the full title registration framework. The greater availability of mortgage credit guarantees or insurance could also incentivize the banks to offer more mortgage finance. The limited development and use of market-based credit guarantee or insurance facilities by banks in general applies to housing finance as well.

A significant development in the past few years has been the incorporation of the EMRC, with local financial institutions, the IFC, the CBE, the Mortgage Finance Fund (formerly the Guarantee and Subsidy Fund for Mortgages), and the CBE as shareholders. Its main business consists of refinancing or purchasing of long-term mortgages issued by banks and mortgage finance companies, using its capital and term resources that it raises on the capital markets. The availability of EMRC refinancing should encourage banks to extend long-term mortgages at competitive rates, and support the further development of the mortgage market in Egypt. So far, however, the demand from banks and mortgage finance companies has been easily met without the EMRC having to raise additional funds. Recently, high interest rates have contributed to a substantial decline in mortgage activities.

The issuance of bonds backed by mortgages or other assets would be a good substitute for mortgage securitization as a means of expanding long-term funding sources for housing finance.⁴¹ Such instruments may prove more transparent and financially sounder than securitization, and more flexible in getting around the difficulties related to title registration. The current strict rules for the public offering of bonds (150 subscribers minimum) could be reviewed, to see whether greater flexibility is possible.⁴²

Bank lending to the SMEs. The SME sector has played a critical role in supporting productive economic activity in Egypt, as it has elsewhere. It is destined to be a significant contributor to accelerating economic growth in the years ahead.

As has been the case elsewhere, SMEs in Egypt have found it difficult to obtain funding from the formal financial sector. Reasons for this can be attributed to weakness on both the demand side for credit (lack of proper accounting at SMEs, informal rather than formal business relationships, unclear business plans and weak management, difficulties in offering guarantees) and the supply side (banks are ill-equipped to assess the credit risk of SMEs and to do SME lending in a cost effective way). Sharp asymmetric information between borrowers and lenders thus prevails, and results in a less than optimal amount of financing going to the SME sector.⁴³ Banks do not lend much to SMEs, or charge a high premium. It is estimated that SME lending accounted for less than 7 percent of total lending in 2009 (extremely low by international standards),⁴⁴ while their contribution to GDP and overall employment would be more than 20 and 25 percent respectively, suggesting a failure in the optimal allocation of financial resources. Noteworthy is the fact that “small” enterprises in Egypt constitute the vast majority of SMEs, numbering almost 40 times the number of medium enterprises. There are large business opportunities for the banks to facilitate the passage from small to medium size status for the almost 200 thousand small enterprises now operating.

So far, the financing of SMEs appears to have occurred mostly through the three state-owned commercial banks, the CIB, and the Bank of Alexandria. However, other banks are expanding their activities in this sector as well, including subsidiaries and branches of foreign banks such as Barclays Bank. A

significant portion of the lending by the state-owned banks has been funded by the Social Fund for Development, also benefitting from resources of foreign donors. The banks have established special divisions and risk management techniques for the sector. The IFC has also recently signed an agreement with the Bank of Alexandria for the dissemination of its SME Toolkit in the local market.

The development of SME credit has been hampered by the lack of comprehensive banking regulations specifically tailored to such financing.⁴⁵ There has been a growing recognition that a targeted and holistic approach to the development of SME financing is called for, for instance to address the difficulty for the SMEs to offer traditional forms of collateral (real estate assets).

First, several factors must be looked at to assess whether the regulatory and supervisory environment is supportive of SMEs. First, the broader regulatory infrastructure must be conducive to the financing of SMEs as well, with:

- Minimum accounting and reporting standards manageable for SMEs.
- Credit bureaus or divisions of credit bureaus, specializing in SME assessment, using specialized tools such as credit scoring models for small enterprises.
- Efficiency in the legal enforcement of creditor and borrower rights in the case of transactions with SMEs.
- Specialized SME credit rating agencies (see earlier discussion).
- Raising the efficiency of financial intermediation and reducing the informational and transaction costs.

Second, the prudential regulations cannot, even unintentionally, be biased against the smaller enterprises. This may happen when the design of regulations is based on inputs more readily available in the case of larger enterprises. In this regard, the general approach is to have prudential regulations that are sufficiently flexible as to take into account special features of SMEs, not of course to have weaker ones. Thus,

The banks could be allowed to assume an SME exposure based on an asset conversion cycle or cash flow generation, Trust Receipts,⁴⁶ hypothecation of inventories or even machines, and the assignment of receivables in addition to more traditional forms of collateral.⁴⁷

A new legal framework for movable collateral would serve as a foundation for the above. The system would need to be supported by a centralized registry of movable collateral (as well as immovable collateral). The consolidation of existing collateral registries that banks must maintain under the law could be a good start for this task.

Third, bankers must have a **proper incentive structure** that encourages them to move into higher reward/ risk lending opportunities, rather than remain biased towards lending to large and well-connected enterprises. This can only be achieved through greater competition among banks based on market-oriented practices including corporate governance. Further, the commercialization and reduced dominance of state-owned banks

is likely to be a key factor in this regard, which would also be facilitated by further privatization. The current involvement of SOEs with SME lending may reflect more the fact that they have been chosen to implement the government's policies for the sector, and to channel available financing resources to it, rather than facilitate market-based diversification.

Box 5.2: Special Provisions for SME Funding

With a view to encouraging higher SME lending by banks, the CBE approved on December 16, 2008 special provisions to govern SME lending.¹ A specialized unit at the Egyptian Banking Institute is established to serve the banks in setting up specialized SME departments; the banks are to coordinate with the stakeholders policies targeted at providing credit to qualifying SMEs without prejudice to sound prudential rules; and to develop with the stakeholders the necessary infrastructure for the expansion of SME lending, including credit bureaus, credit rating companies, credit guarantee and insurance companies, etc. It is also proposed that all the stakeholders coordinate an effort to propose legislative amendments that would facilitate SME lending with measures that would address and minimize the associated credit risk.

More specifically, the special provisions also exempt the banks from the statutory cash reserves requirement (of 14 percent) for the amount of deposits equivalent to the amount of lending granted to SMEs since January 1, 2009. Qualifying SME lending is for firms with turnover or annual sales up to LE 20 million, and a paid in capital between LE 250,000 and 5 million. Notwithstanding the monetary policy or prudential reasons for a statutory cash reserves requirement, it can be viewed as amounting to a tax on financial intermediation for the banks. Hence, the exemption of this requirement targeting the SME lending is akin to a tax expenditure benefiting the bank and/ or the SMEs (of course, it also has implications for the bank's liquidity position). The final incidence of this tax expenditure is unclear, since banks could either simply enjoy a larger profit margin, or pass on the benefit to the SMEs in the form of a lower interest rate.

In addition to their own funds, informal sources, and the banks, the SMEs have had access to formal financing through the Social Development Fund (often channeled via the banks), and very recently, the SME stock exchange (NILEX).

In this regard, the regulations restate the guidelines the banks must comply with for the auditors who audit the financial statements of business customers applying for bank loans. In case of a partnership wanting to access a credit facility of less than LE 1 million, the auditor may be from the register of auditors for partnerships rather than corporations. Only in the case of micro-enterprises wanting to borrow less than LE 100,000 can the requirement of regular bookkeeping be waved.

The policy approaches need to address the fundamental information and institutional weaknesses that discourage lending to SMEs, rather than being merely palliative. They are preferable to approaches that take these weaknesses as given, and try to compensate the banks for their costs, or introduce "special"

treatments that in the long run may be adverse to financial stability and efficiency, as well as costly. Unfortunately, the recent CBE regulations giving a special exemption for the cash reserves requirement when deposit resources are used to extend SME loans, while well intentioned and accompanied by other positive measures, largely falls in this category of palliative (Box 5.2). General subsidy schemes for lending to the SMEs should be avoided, because they are very much second best in terms of their cost and poor targeting. Market-based SME loan guarantee/insurance scheme should be considered instead of subsidized state-run ones. This would not, however, preclude possible government intervention to facilitate the emergence of relevant institutions.

Credit guarantee/ insurance should play a more important role in mitigating the credit risk assumed by banks when they take exposures, especially longer term, to more risky borrowers such as the SMEs. In this regard, with the state-regulated Credit Guarantee Company the only significant player and covering only a very small amount of loans, there is a clear gap in the financial infrastructure for SME financing in Egypt.

The experience elsewhere with private sector-led Financial Guarantor Funds, in China in particular, should be studied to see whether they could be replicated in Egypt. Ideally, a Financial Guarantor Fund would leverage the informational and enforcement advantages it has over a bank to help enable SMEs to obtain, with the guarantee of the Financial Guarantor Fund, loans which they would not be able to get otherwise (or only at a significantly higher cost). Under the Financial Guarantor Fund, the risks are bundled, can be priced less than they otherwise would, and transferred from the banks to the Fund. Key to the financial soundness of these entities is that they are properly capitalized and that the fees paid by the beneficiaries properly price the risks associated with the bank loans. They must also genuinely be adding –value to the informational and enforcement activities. This is why local chambers of commerce/ business associations could be especially well equipped to be founder of such entity. Provided all these conditions are met, the existence of Financial Guarantor Funds should improve access and enhance efficient financial intermediation.

Specific regulations governing the securitization of SME loan portfolios should be issued, with a view to enhancing the amount of financial resources going to the sector. The securitization model offers the prospect of alleviating the likely bank capital shortage in the case of a significant move in the direction of SME lending, developing non-bank financial intermediation, and fostering greater integration between banking and the capital markets. The regulations will need to insist on the full transfer of the credit risk to the investors, and provide credit rating rules for such securities, in accordance with Basel II. SME bank credit growth targets could also be useful as an indicator of the progress made in supporting this under-financed sector. Nevertheless, they should not be binding, nor should financial penalties be associated with failure for a bank to meet them. At the same time, performance under these targets could be used by the central bank as a criterion for certain related decisions, for instance as regards allowing new banking branches.

NON-BANK FINANCIAL SERVICES REGULATION

EFSA, the Consolidated NIFI Regulator

The Egyptian Financial Supervisory Authority (EFSA) was created by Law 10 of 2009, which consolidated the Capital Market Authority (CMA), the Egyptian Insurance Supervisory Authority (EISA) and the Mortgage Finance Authority (MFA) into EFSA. EFSA is headed by a seven person Board, composed of the EFSA Chairman and two Deputy Chairmen, appointed for four-year terms and four additional members appointed by the Prime Minister. The Deputy Governor of the CBE serves as the seventh member of the Board. The Board is the final authority on all EFSA matters and has authority to set the EFSA budget. The EFSA budget includes funds appropriated by the government, fees collected by EFSA at rates set by law, revenue collected for services performed and fines imposed by EFSA for violations of the law.

EFSA was created to improve the effectiveness and efficiency of the regulatory system for NBFI by consolidating three separate agencies into one. Under the EFSA strategic plan, the discrete regulatory programs of each of the three agencies were to be consolidated by 2011. For example, there would be a single inspection program for all regulated entities, a combined enforcement program, a combined legal department, and a consolidated administrative support program. In addition, EFSA would develop a common risk-based supervision methodology for all NBFI. As of 2012, these goals have been delayed and no date has been set to complete the reorganization. To date, EFSA has consolidated its administrative support functions and its enforcement program. Other functions, such as the inspection units in each of the former agencies continue to operate separately and creation of a comprehensive risk-based inspection program has not been completed.

EFSA has a total staff of approximately 850. This includes 250 in the Insurance and private benefit plans office; 380 assigned to capital markets; and 120 to the mortgage finance, factoring and financial leasing group. The remaining staff works in the consolidated support offices. There is a significant shortage of professional staff in the Insurance and Private Benefit Plan Office, and the Mortgage Finance Office. The Insurance program includes only 90 professional and technical staff. This includes 30 professional and technical staff in the insurance inspection group and 25 inspection staff assigned to pension inspections.

EFSA has broad authority to bring criminal (not civil) proceedings for violations of all laws for which EFSA is responsible. Investigations and prosecutions require authorization by the Chairman of EFSA. The EFSA enforcement unit has approximately 30 staff; 20 are attorneys. EFSA may issue subpoenas for documents to any company or entity that it regulates. It has no authority to issue subpoenas to unregulated parties, which is a power found in many jurisdictions that enables a regulator to effectively gather critical data in a timely manner. If a proceeding has been brought for a violation of the Capital Markets Law, the Chairman of EFSA may approve

a negotiated settlement, provided that it imposes a money penalty of at least twice the minimum amount specified in the law for the violation.

Criminal violations are subject to prison terms of up to five years and/or fines of not less than LE 50,000 to a maximum of LE 20 million (§63). The Capital Market Law specifies lesser sanctions for certain violations (§64–69).

Insurance Regulation

Egypt's insurance Law 10 of 1981, as amended by Law 118 of 2008 and Law 10 of 2009 provides EFSA with broad authority to license companies, and approve appointments of senior officers and members of the board of directors. It is responsible for business conduct regulation and has limited rate-setting authority for MTPL insurance. EFSA oversees company solvency, reserve and capital requirements. It conducts on-site inspections of companies and can impose small fines for infractions. EFSA also has some degree of authority over governance. For example, EFSA approval is required for foreign ownership of more than 10 percent of a company.

Insurers are required to have minimum capital of LE 60 million. Only half of this amount is required initially, with the remainder in five years. The 2009 amendments to the insurance law prohibited a company from operating as both a life and property insurer. A separate license is required for life insurers, with an additional initial capital requirement of LE30 million.

While EFSA has broad authority to regulate sales practices, this authority does not extend to sales programs conducted through banks (bancassurance), which are subject to exclusive regulation by CBE. This is an important gap in regulatory authority as three major life insurers (including CIL, the largest by new business) gain most of their business through bank sales programs. Sales practice regulation has also been hampered by the lack of a vigorous enforcement program by EFSA and by CBE.⁴⁸

The 2007 FSAP Update contained a number of priority recommendations to support the establishment of a sound regulatory framework for the Egyptian insurance sector. These included restructuring the government owned insurance companies in preparation for privatization; expanding the professional capacity of EFSA staff; moving to a risk-based supervision model; and establishing risk-based pricing that eliminates cross-subsidization of product lines. The progress since this FSAP report has been limited.

Lack of competition has been a chronic problem in the insurance sector. The Egyptian insurance sector continues to be dominated by three state-owned insurance companies. In 2007, the government consolidated the three companies, along with the national reinsurance company, as a first step in the privatization process. In 2011, the government separated the life insurance and non-life insurance programs into separate companies. No date has been set for the third phase privatization of the life and non-life companies. To promote competition and broaden the insurance products offered, Egypt now permits foreign insurers to be licensed and foreign individuals to be officers and directors of insurers.

EFSA has made progress in rationalizing premiums for mandatory motor vehicle third party liability insurance (MTPL). Historically state-owned insurers cross-subsidized MTPL by charging higher premiums on other insurance products and by understating liabilities in order to lower reserve requirements.⁴⁹ This distorted competition with private insurers. In 2007, a Prime Ministerial Committee authorized an increase in MTPL premiums (by approximately 60 percent of the gap) and Law 72 of 2007 capped future claim payouts (which had been uncapped). In addition, a Prime Minister's Decree established a notional defendants fund for hit and run victims. Following these reforms, private sector insurers began entering the MTPL market for the first time. However, the lack of a comprehensive national data on vehicle claims makes it difficult to effectively calculate risk-based pricing of MTPL premiums and difficult for EFSA to conduct risk-based regulation of the insurers.

The creation of EFSA was intended to address two critical recommendations in the 2007 FSAP—increasing professional resources and adopting a risk-based supervision program. Neither goal has been achieved. The insurance program continues to suffer from insufficient trained professional staff and the risk-based supervision program has yet to be developed. EFSA has only 30 inspection staff responsible for both insurers and private benefit plan programs.⁵⁰ A lack of properly trained actuaries is a critical problem for EFSA and for the insurance sector in general. EFSA reports that there are only 19 actuaries in the country.⁵¹ EFSA believes that it has too few staff, and too few trained staff, to adopt a risk-based supervision program. Without actuarial staff, insurers cannot be relied upon to develop sound risk-based internal processes and EFSA cannot rely upon the data provided by insurers to develop a risk-based inspection program.

Private Benefit Fund Regulation

EFSA regulates only a segment of the private benefit fund sector. Under Law 54 of 1975, EFSA regulatory authority is limited to private plans in which the employees/beneficiaries contribute to the program. EFSA is responsible for supervision of 632 private pension funds (including funds that are limited to death and disability payments) with 4.7 million members and LE 26.7 billion in assets.⁵² Benefit funds based solely on employer contributions are not regulated. Private pension funds are typically described as DB plans even though benefits are not guaranteed.⁵³

Law 54 of 1975 and EFSA regulations establish a broad framework for asset investment. The regulation on investments establishes the following limits:

- Minimum 25 percent in government bonds
- Maximum 15 percent in corporate bonds
- Maximum 25 percent in equities
- Maximum invested in a single bond (non-government) or single stock must not be more than 5 percent of the fund's assets

- Maximum 10 percent of fund assets in one company (stock and debt) or 20 percent of the company's capital, however affiliated companies are not consolidated for this requirement
- Maximum 10 percent in real estate, and maximum 3 percent in a single property
- Maximum 25 percent in member loans and no single loan may exceed 75 percent of the value of the members benefit
- Maximum 10 percent in bank deposits in local or foreign currency with banks licensed by the Central Bank to operate in Egypt.
- Maximum 10 percent in other investments approved by EFSA.

EFSA regulation of pension funds suffers from inadequate professional resources and serious gaps in its statutory authority. As with the EFSA insurance program, EFSA requires more trained inspection staff and more trained actuaries. DB plans are required to have an actuarial evaluation at least once every five years, with large schemes are examined yearly. EFSA can require an actuarial evaluation by external examiners, paid out of fund assets. Unfortunately, this is difficult to achieve as most of the 600 private funds rely on the two EFSA-employed actuaries for actuarial services. The lack of authority over private pension funds that are not funded in part by employee contributions is a serious regulatory gap.

The gaps in the law also contribute to serious deficiencies in the management and solvency of private pension funds in Egypt. A non-professional board of directors manages private funds. The pension fund members elect members of the board and the board selects the chairman. The members of the board of directors are personally liable for their actions concerning the fund management. Typically, board members are compensated for each day they participate in fund activities. Under existing law, pension funds are not permitted to outsource fund management responsibilities or invest in common or pooled vehicles. This means that the very large number of small funds cannot hire professional portfolio management and must rely upon internal staff.

As might be expected, funds tend to be very conservatively invested. Notwithstanding the statutory investment diversification parameters, private funds are 95 percent invested in government debt and bank deposits. The strong preference for safety over performance may be heavily influenced by the personal liability imposed on fund directors.

The prohibition on outsourcing fund management or pooling investments contributes to very high expense ratios for funds, which are not disclosed to fund participants. The 2002 FSAP indicated that typical expenses range from 5–25 percent of contributions. As a consequence of overly conservative investments and very high expense ratios, most investment portfolios have not kept up with inflation rates. They are unlikely to keep up in the future. This creates a strong likelihood that many pension funds may be unable to pay the benefits that beneficiaries anticipate.

The lack of sound data or properly trained staff at EFSA and in the industry makes it difficult to project the financial health of the industry or the extent of the shortfall. The 2002 FSAP indicated that EISA (EFSA's predecessor) estimated that almost all private insurance funds were not fully funded and that many of them may be technically insolvent. In the 2007, FSAP Update EISA estimated that only 34 funds were in a poor funding position, but acknowledged that the problem may be more widespread, especially among funds not supervised by EISA. EFSA has issued instructions requiring all private pension funds to report on their funding levels. A 2007 EFSA survey of 177 funds, representing more than 50 percent of assets under management, showed that approximately half were underfunded. These survey estimates could not be independently validated.

Legislation to update and reform the Egyptian private pension fund law has been drafted, but no action has been taken for several years. Proposed amendments to the law would address the gaps in EFSA authority, would require fund managers to be professionally qualified, would create a fit and proper standard for fund managers and board directors, and require a funded pillar requirement. The proposed amendments would permit outsourcing fund management and the use of common funds, including life insurers to offer these services. Because the proposed amendments would require funds to have professionally qualified fund managers, it is anticipated that small plans would outsource the asset management function.

New funds would also be required to be defined contribution plans only. The amendments would require funds to comply with a solvency margin equal to 10 percent of actuarial reserves. In addition, funds would be allowed to increase benefits only after the fund complies with the solvency margin. To deal with the early retirement issue, EFSA would require actuarially fair adjustment in benefits.

The 2007 FSAP update described the proposed changes in the pension law positively and recommended that enactment should be made a high priority. Notwithstanding general support for the reforms, no final action has yet been taken.

Mortgage Finance Regulation

The Real Estate Finance Law 148 of 2001 and the Financial Leasing provisions of Law 95 of 1995 provide EFSA with a broad range of legal responsibilities for regulation of mortgage financing, securitization, financial leasing and factoring. Banks, mortgage-financing companies, trusts, insurance companies and other companies participating in the mortgage sector must be licensed by EFSA. In addition to regulating mortgage finance companies, EFSA has responsibility for overseeing mortgage brokers, appraisers, foreclosure agents, credit rating and credit reporting companies. EFSA has established a licensing process for each type of participant.

EFSA has broad authority to establish industry standards for mortgage lending. For example, EFSA regulations set a maximum ratio for mortgage

amounts in relation to a borrower's income. In 2011, EFSA proposed increasing the ratio to permit borrowers to obtain mortgages in which the monthly payment equals 40 percent of the borrower's income. EFSA is also responsible for supporting the development of a model real estate registry system for Egypt's new urban communities.

EFSA, pursuant to Presidential Decree No. 4 of 2003, is responsible for administration of a mortgage finance subsidy and guarantee fund providing financing support for construction of low-income residential units. The fund can provide financing of up to LE 95,000 per unit. EFSA, also, oversees the Egyptian Mortgage Refinance Company (EMRC). EMRC was established in 2006 to provide long-term financing to mortgage finance companies and banks by purchasing loan portfolios and issuing securitized bonds. To facilitate securitization of mortgage loans, EFSA is responsible for developing standardized mortgage finance terms and agreements. The 2007 FSP update found that there has been substantial progress in developing the legal and institutional foundations for mortgage finance, the Capital Market Law was amended to provide a legal foundation for securitization of mortgage portfolios and other pools of assets.

Capital Markets Regulation

Egypt has the oldest capital market in the MENA region. The Egyptian Exchange (EGX) was created by the consolidation of the Cairo Stock Exchange (founded in 1903) and the Alexandria Stock Exchange (founded in 1883). At one time (1940's) the combined exchanges were the fifth largest in the world. After a dormant period from 1961–1992, the exchanges were revived as part of a national privatization program.⁵⁴ As described in Chapter 5, Egypt has devoted considerable effort and resources during the past two decades to building its capital markets. While its equity market has grown significantly, its fixed-income market has not grown to the same degree. EFSA has broad, but incomplete, regulatory authority over all aspects of Egypt's capital markets and the businesses and individuals that it comprises. This section will highlight key features of the regulatory system, including those aspects that could be improved and strengthened.

Regulating Corporations and Other Entities that Issue Securities

EFSA has a complex system for regulating the initial offering and sale of securities - both equities and fixed-income. A hybrid system combines disclosure-based and merit-based regulatory concepts.

EFSA and EGX both have regulatory authority over Egyptian companies with publicly traded securities. Under the Capital Market Law, EFSA has primary authority over any offering of securities by a corporation, responsibility for periodic disclosure regulation, and corporate governance. EGX, through its listing requirements imposes minimum standards for companies traded on the EGX. It also has primary responsibility for the secondary offerings of securities. EGX and EFSA both review applications

to list existing shares on the EGX. If the company is a bank, the offering must also be reviewed by the CBE. In order to offer and sell securities, a corporation must file a notice (prospectus) with EFSA. The notice must include a summary of three years of audited financial statements (or from the date of the company's creation if less than three years). Following approval by EFSA, the company must publish in two newspapers a summary of the prospectus fifteen days prior to commencing the offering.

The issuance of new shares requires a fairness valuation by an independent consultant. The fair value price set by the consultant is the maximum price at which the shares may be sold. Debt securities offerings must comply with several additional requirements. The offering must be approved by the general assembly of the company and the company must obtain an investment-grade credit rating for the offering.⁵⁵ In addition, a company must create a bondholder's committee to represent the interests of the purchasers after the issuance. EFSA has adopted shelf registration permitting partial sales over a one-year period. EFSA must complete its review in two weeks, unless it requests additional information. EFSA may also take two weeks to review each tranche of the offering. EFSA staff review all offerings. Following this review a recommendation is submitted to the EFSA Financing Committee, consisting of five senior employees of EFSA and headed by the Assistant Chairman of EFSA. The EFSA Board takes final action. The EFSA Financing Department has ten professional staff, including six accountants, three lawyers and one economist.

IPOs must reserve 10 percent for free float. The remainder of the offering is typically placed with large investors through a book-building process. Upon completion of the offering, there must be a minimum of 100 shareholders and a free float of 5 percent of the company total stock. Listed companies must file annual, semi annual, and quarterly financial statements (balance sheet, income statement, cash flow statement, stockholders' equity, and notes to financials) with EFSA and the EGX. A summary of the annual and semi-annual reports have to be published in two daily newspapers, at least one of which is in Arabic (Capital Market Law 6 and 7) within three months of closing. Quarterly reports, with audited financials, are filed within one month of closing. Moreover, in addition to the annual financial statements, companies have to file with EFSA the annual board report and the auditor's report one month before the general assembly meeting.

EFSA has a department that reviews all company reports. The department has thirty accountants on its staff. Following its review, EFSA may provide a company with comments and direct the company to amend the report. If the company does not comply with required modifications, EFSA may publish its remarks and required amendments in daily newspapers at company expense. Later filings, including documents that are late due to EFSA requests for additional information, are subject to a fine of LE 2000 per day. Company reports are publicly available at EFSA for five working days.

Corporate Governance Regulation

EFSA has the authority to review and regulate corporate governance practices. Listed companies must have a Board of Directors and a majority of the Board, including the Chairman, must be independent directors. All items on the agenda for the company's annual general assembly of shareholders meeting must be submitted to EFSA prior to the meeting. The general assembly invitation by the board chairman must be preapproved by EFSA if the agenda comprises any proposals pertinent to the capital structure of the company such as stock splits, capital increase, cash dividends...etc. All transactions in company stock by officers and directors of the company must be approved by EFSA and disclosed to the EGX prior to execution. The information is published by the EGX.

EFSA has the power to override resolutions passed at the general assembly meeting that benefit certain categories of shareholders or provide special benefits to board members. Shareholders representing at least 5 percent of a company's capital can file a complaint with EFSA within 15 days of the general assembly meeting and request EFSA action. Shareholders with 5 percent or more may also add items to the general assembly agenda.

Tender offers for 15 percent or more of a company's stock must be submitted to the company and EFSA and announced publicly two weeks before purchase of shares. All mergers and acquisitions transactions require a price fairness opinion from an EFSA licensed financial advisor, even if the transaction does not involve related parties.

Additionally, EFSA's autonomous unit the Egyptian Institute of Directors periodically issues a Corporate Governance Code, a 2014 release is currently being finalized in consultation with various experts and listed company representatives.

Accounting and Auditing Regulation

Egypt has adopted IFRS and IAS. However there are several significant variations in Egypt's interpretation and application of IFRS. Specific areas of variation include related party transaction accounting, accounting for employee benefits, and valuation of long-term assets (historical cost), lease accounting, and the treatment of reserve accounts. Banks and insurance companies in Egypt do not mark-to-market investment assets in practice.

Registration requirements for accountants could be more robust. Any person holding a university degree with 5-years' experience can be registered as an accountant and allowed to audit corporations. There are currently 16,000 registered accountants. However, the Egyptian Society of Accountants, a private professional association, has set more stringent registration conditions for its members. They are required to pass selective examinations and complete a three-year training program with a recognized audit firm. At present, the Society is composed of 1,200 members. Accountants who are members of the Society audit an estimated 80 percent of listed companies.

Law 123 of 2008 created an Auditors Oversight Board (AOB). The AOB is responsible for licensing auditors and creation of a quality control program to periodically review audit firm practices. The law empowers the AOB to require firms and companies to submit documents and other materials needed for quality control examinations. The AOB is also authorized to work with professional organization to recommend changes in Egypt's accounting and auditing standards. Any proposed changes to these standards must be submitted to EFSA for action. EFSA, in turn, must make a recommendation to the line ministry (currently the Ministry of Investment) to issue the proposed standards with a ministerial Decree. To date the AOB has played a limited role. The quality control review process envisioned in Law 123 of 2008 has yet to be established.

The Egyptian Association of Accountants (EAA) has a voluntary testing program to certify accountants and auditors. Individuals with three years of relevant experience may be licensed as an accountant or auditor. The CBE requires five years' experience to serve as a bank auditor.

Audit attestations must be signed by an individual and not by a firm. Listed company financial statements must be signed by 2 auditors. Any disagreement between the auditors must be disclosed, including the subject of the disagreement.

Brokerage and Intermediary Regulation

EFSA has broad authority to license and regulate market intermediaries. All brokerage firms must be licensed by EFSA and be a member of the EGX.⁵⁶ Under the Capital Market Law, an intermediary must be a corporation or partnership. Firm officers and directors are subject to a "fit and proper" review by EFSA and shall not have been convicted of a crime or misdemeanor during the preceding five years. EFSA has the authority to issue regulations on sales practices, internal compliance procedures, and capital adequacy.

EFSA regulations specify that brokers must have minimum paid-in capital of LE 5 million (Part 2, §125). EFSA regulation 68 of 2010 requires increased paid-in capital for firms with branch offices—LE 500,000 for each class II branch and LE 1 million for a class I branch. An additional LE 100,000 is required for additional marketing branches.

Brokerage companies must obtain licenses to perform specialized activities. Specific license is required to engage in the following activities—margin trading, short selling, on-line trading, intra-day trading (by customers), and customer custody. "Market need" is one of the factors considered by EFSA in approving licenses (Part 2, §127). In practice this has resulted in EFSA declining to license new firms and the total number of licensed firms has changed only marginally in more than a decade—146 in 2001 and 148 in 2010. Also, because EFSA cannot revoke a license due to the inactivity of a brokerage firm, a dormant or defunct firm can maintain its license in the hope of selling it to a new entrant that is unable to obtain a license from EFSA because of the lack of a "market need". As a result, there are a significant number of licensed but dormant firms.

The Capital Market Law imposes a wide range of customer protection requirements on licensed brokerage firms. These include a customer suitability ("know your customer") requirement, record keeping requirements, and operation of an internal compliance program. EFSA is also authorized to arbitrate disputes between customers and broker. The executive regulations of the Capital Market Law state that dealing/market-making activity must be conducted through a separate EFSA licensed company. There are no market-makers licensed in the Egyptian market to date.

Brokers rely upon commission fees and margin loans for revenue. EFSA permits margin lending for the purchase of designated eligible "liquid" stocks. Currently 83 EGX stocks are eligible collateral for margin loans. Clients interested in borrowing from brokers to purchase non-marginable stock are frequently provided with "overdraft" protection by brokers. Some brokers apparently provide overdraft protection for an extended basis to favored clients. In addition to violating EFSA limits on margin lending, it may create significant risks for other clients, as the cash used to purchase the securities may be withdrawn from the omnibus account for client funds.

In the event of a brokerage default that necessitates emergency action, EFSA would be unable to immediately protect client accounts. For example, if the broker is suspended or its operations limited, clients would have to individually transfer their account to another firm. If this occurred during a period of market volatility, clients may be harmed by an inability to execute trades. The international best practices approach is to authorize a regulator, an exchange or a court to appoint a temporary receiver or custodian who is empowered to take action to protect client assets.

EFSA is responsible for licensing and regulating mutual funds, venture capital and private equity firms and the managers of these entities. There are 73 mutual funds in Egypt, managed by 21 fund managers (38 fund managers are licensed). The mutual fund sector has grown steadily over the past decade. In 2001, there were 22 local mutual funds with total assets under management of LE 3.9 billion, managed by nine fund management firms. As of the end of 2010, total assets under management for equities open-end mutual funds were approximately LE 9 billion. This includes LE 509 million invested in eight Islamic funds. As of the end of 2010, the three closed-end funds had a combined NAV of slightly more than LE 3 billion. Profits from mutual funds are tax-exempt. Several offshore funds managed by Egyptian fund managers are significant investors in Egyptian capital markets. As of 2008 (last figures available) there were 17 licensed venture capital firms.

Mutual funds must be structured as joint stock companies, supervised by a Board of Directors. A majority of the Board must be independent of the managers and originators of the fund and may not be investors in the fund. EFSA may remove Board members or fund officers by written decision (§39). Only CBE-approved banks and EFSA-approved insurance companies may create mutual funds without establishing a separate fund joint stock company. All funds must have an internal compliance officer, an internal auditor, and

two external auditors (individuals). The internal controls officer must notify EFSA weekly of any unresolved customer complaints, any violations of the law, regulations or Decrees, and any internal control violations not resolved by the fund administrator within 1 week. Both external auditors must sign the funds financial statements.

The Capital Market Law requires that mutual funds have separate originators, managers and custodians. A bank custodian, regulated by the CBE, must hold fund assets in segregated accounts. The creator of the fund must initially invest in the fund an amount equal to 5 percent of the fund's assets. As the fund grows in size, the creator must increase this investment to maintain its 5 percent interest, until it reaches a maximum investment of three times its initial investment. Fund assets may not exceed 50 times the originators paid-in capital. EFSA intends to amend its executive regulation and lower the initial and maintenance investment amount to 2 percent of the initial fund size.

EFSA regulations impose diversification requirements on fund investments. A fund may not invest more than 10 percent of its assets in a single company, including related affiliates. In addition, a fund cannot own more than 15 percent of the total shares issued by one company. A fund may not invest more than 20 percent of its assets in another mutual fund or own more than 5 percent of another mutual fund. Investments in other funds, except MMMFs, must be in unaffiliated funds. A fund may not invest more than 20 percent of its assets in an affiliated company or in the debt (including commercial paper and short-term notes) of any one company. Funds are not permitted to engage in short selling or buying on margin. Funds may not trade with affiliates of the fund originator or fund manager. Finally, funds may not invest in an entity where it would have unlimited liability.

Mutual funds are required to keep an unspecified amount of the fund's assets liquid to satisfy anticipated redemptions. If the liquid funds are not sufficient to meet redemption requests, a fund may borrow up to 10 percent of fund assets for a maximum of one year, with Board approval. Mutual funds apply different fair value pricing techniques. Mutual funds must adopt a procedure for valuing assets where a market price is not available. In a market such as Egypt in which a significant number of stocks do not regularly trade, the fair value accounting method selected can have a significant effect on NAV and reported fund performance.

Investments and redemptions are calculated on the basis of the next day's NAV. Redemptions must be paid within two working days. A fund may only suspend redemptions for exceptional circumstances. This requires prior Board approval and prompt notification to and prior approval of EFSA. EFSA does not directly regulate mutual fund sales practices and personnel. EFSA does not review fund sales materials, other than the prospectus. In addition, it does not license or supervise sales personnel. The majority of mutual fund sales occurs in bank branches and is under the authority of the CBE. While employees of brokers are subject to suitability and "know your customer" requirements, bank employees are not subject to these standards of care.

EFSA reviews the mutual fund prospectus and periodic reports. EFSA staff must review the prospectus prior to initial sales. The prospectus must contain information on fund investment strategy, expenses, valuation procedures, and purchase and redemption procedures. EFSA considers the qualifications of officers, directors and fund managers as part of its initial review process. The CEO, fund manager and compliance officer must pass an EFSA qualifications review (interview). Mutual funds are required to file with EFSA quarterly and annual reports, both containing externally audited financial statements

MMMFs may invest only in short-term liquid fixed-income securities. The maximum maturity for any security is 13 months and the maximum average weighted maturity of the fund assets is 150 days. No more than 10 percent of fund assets may be invested in securities of one issuer (other than the government). The MMMF's Board must set and disclose the minimum investment grade of investments, which may not be lower than BBB. Mutual funds provide limited disclosure to investors. While MMMFs must calculate NAV on a daily basis, other mutual funds are required to calculate NAV and publish in newspapers on a weekly basis. Funds are not required to publicly disclose any information on the actual fund holdings, even in summary form.

EFSA Oversight of Self-Regulatory Organizations

EFSA has broad oversight authority over two SRO - the EGX and the MCDR. Law 10 of 2009 creating EFSA provided broad authority for controlling and supervising NBFIs, markets and instruments, including capital markets. Presidential Decree 191 of 2009 governs the governance and supervisory powers of the EGX and Presidential Decree 192 of 2009 provided EFSA with regulatory authority over the EGX. EFSA must review all SRO rules concerning listings, member regulation, trading and clearance and settlement. EFSA and EGX Chairman have the authority to halt trading on a single stock and accordingly all stocks.

The EGX has an ambiguous legal status. It is wholly owned by the Egyptian government and has an independent status but it is not a corporation. It is governed by Presidential Decree No. 191 of 2009 and subject to oversight by EFSA. The Prime Minister appoints the Chairman and Vice Chairman of the EGX. The Governor of the CBE appoints one member. The remaining members are elected among member firms and listed companies. EGX has primary responsibility for market surveillance. It has a full-time market surveillance staff of 12. While both EGX and EFSA may order halts or suspensions in trading in a listed stock, the EGX typically takes action. In addition to monitoring unusual trading in EGX listed securities, it also monitors whether prohibited persons are trading MCDR. It has the authority to suspend suspicious trading MCDR until requested information on beneficial ownership is provided.

EGX conducts its self-regulatory functions through a listing committee and a membership committee. The EGX membership committee is responsible for overseeing member brokerage firms. EGX staff review daily capital

adequacy reports from all member firms. When a firm's net liquid capital falls below 110 percent of its risk-weighted capital, it must provide EFSA with an explanation and a plan for increasing its capital. EFSA may suspend a firm if it falls below its minimum capital. They also monitor other firm's activities; including internal compliance, margin lending, segregation of customer accounts, and sales practices and customer service. EGX performs these functions by reviewing member firms' reports and books and records. No on-site inspections are performed. EGX has limited enforcement and disciplinary authority over its member brokerage firms. EGX has the authority to impose non-monetary sanctions on its members and their employees for violation of EGX rules. It may issue warnings or impose time-limited suspension. Any sanction imposed may be appealed to EFSA for review. EGX may also consider complaints against members received from customers and can direct firms to compensate customers.

MCDR is the only CSD in Egypt. It began operations in 1996 as a not for profit corporation, licensed under the Capital Market Law No. 95 of 1992 and subject to the CSD and Registry Law 93 of 2000. MCDR is jointly owned by sixteen banks (50 percent), eighteen brokerage firms (45 percent) and the EGX (5 percent). No company (and its related parties) may own more than 5 percent except for the EGX. It is managed by a CEO who Chairs its Board of Directors with equal representation from banks, custodians and brokerage companies, plus one representative of the EGX. MCDR provides clearance, settlement and depository services. EGX equity trades settle on a T+2 cycle. The settlement cycle for debt and unlisted securities is subject to bilateral agreement of the parties. Settlement is on a DVP basis with ownership transferring on settlement date. The securities leg is settled on a gross basis, while the cash leg is settled through the CBE on a net basis. The MCDR processes all EGX trading and acts as a central depository of EGX-listed securities, as well as unlisted securities should the companies opt for depositing its securities with MCDR. It is not a central counterparty (CCP) and is not a custodian. While MCDR is not a custodian, it records securities ownership in the name of the beneficial owner, as well as the name of the bank acting as custodian and its records serves as the definitive register of shareholders. It is responsible for payment of dividends to beneficial owners and providing notices to investors.

MCDR operates a settlement guarantee fund (SGF). The fund covers all settlement failures. It also can be used by EFSA to unwind trades that EFSA determines resulted from insider trading. The fund is not responsible for investor losses due to the failure of a market participant. The SGF fund has LE 200 million, with a LE 400 million back-up line of credit. Member firms are assessed payment amounts through a formula involving the volume of trading plus a risk factor based on the firm's failure rate. There is no obligation on the part of MCDR participants to replenish the SGF if it is depleted or to top it up if the level is deemed inadequate in light of market activities and risk exposures.

LEGAL AND INSTITUTIONAL FRAMEWORK

A clear, fair and effective legal framework is an essential prerequisite for a modern and efficient financial sector. This framework should include a comprehensive corporation law, laws governing contracts and commercial transactions, bankruptcy laws and debtor-creditor rights and obligations, and uniform accounting and auditing standards. However, a well-designed legal and regulatory framework is not enough for a sound and efficient financial system. It needs to be complemented with an adequate and supportive institutional infrastructure to ensure enforcement. For example, an effective framework should include credit-reporting services, legal registries to perfect lending agreements, and generally accepted standard forms of agreements. Most importantly there must be an educated and well-staffed judiciary of the highest integrity.

During the past decade, a number of improvements were made to the applicable laws in Egypt and several institutional changes were initiated. While these changes represent an improved environment, large gaps in the law and the implementing environment continue to exist. Some of the laws are poorly written or out of step with modern financial transactions, especially those applicable to secured transactions, bankruptcy, and the settlement of disputes. In addition, many of the new laws remain untested. Collateral legislation is both inadequate and poorly enforced. Property-rights registration and titling issues make it difficult for firms, especially small and medium size firms, to use land assets as collateral. Moreover, even when collateral is registered, there is no information on its value.

Delay and inefficiency in the judicial system continues to exacerbate the problem and hinder lending. Legal proceedings are slow and cumbersome, and often drag on for several years. This deters banks from initiating bankruptcy and foreclosing procedures on defaulters. There are also no specialized judges with knowledge of financial markets or credit risk issues; this affects the quality and reliability of decisions.

In the current political environment, it is unlikely that the commercial laws of Egypt will be a high priority in the near future. However, legal modernization and reform is essential to future private sector economic development and for continued development of the national financial sector. The reform efforts of the previous decade should be seen as a foundation for further improvement. In particular, there are two areas of the law that represent major impediments to developing a modern financial system: (i) the law on secured transactions; and (ii) bankruptcy law and procedures. In addition to addressing these two impediments, improving the effectiveness and efficiency of the judicial process should be a third priority. These topics are discussed in greater detail in the following section.

Secured Transactions

Laws that govern secured transactions are vital to the financial system of a country. An effective system for secured transactions reduces lending risk by enabling lenders following a default to recover through the sale of the collateral.

This in turn makes it easier for persons or companies to borrow money and typically to borrow at a lower cost. Secured transactions are particularly important for new borrowers, including newly established firms and those recently privatized companies with no credit history.⁵⁷ Egyptian law recognizes three major forms of security: mortgage, pledge, and business charge.

Mortgage is a secured transaction in which the borrower agrees that the lender will hold legal title to the asset used as collateral until the loan is fully repaid. While a mortgage is most frequently used when real estate (immoveable property) is the security, in Egypt ships and aircraft may also be mortgaged. The Civil Code of 1948, Articles 1030–1084 and 1096–1129 govern mortgage loans. The code was amended by the Real Estate Finance Law 148 of 2001 to provide that banks may seize mortgaged property in the event of a default even if the borrower has other assets. The 2001 amendments authorize five types of entities to engage in mortgage lending: banks, mortgage finance companies, trusts, insurance companies, and other entities that EFSA licenses to offer mortgage loans. These amendments also authorized the use of securitization for pools of mortgages. While the use of mortgages has increased since 2001, the process of perfecting a mortgage continues to be costly and complex. All mortgages must be evidenced before a notary. The doctrine of specificity applies to both the mortgaged property and the secured debt. Specific identification is “often inconvenient, sometimes impractical and always theoretical.”⁵⁸

Pledges are secured transactions in which the borrower retains legal title to the asset but the lender (or a designated third party) acquires possession. As such a pledge is unsuitable for any transaction in which the security is a useful or productive asset (such as manufacturing equipment). These transactions are governed by Articles 1096 - 1129 of the Civil Code. There are two other important drawbacks to using a pledge under current law: (i) the law only recognizes possessory pledges of movables, since non-possessory pledges of movables do not exist (under the doctrine of false wealth); and (ii) future assets cannot be pledged, since the pledged property must be adequately specified in the pledge agreement.

Business charges (also known as equitable charges in some jurisdictions) are the third form of secured transaction in Egypt. In this transaction, a borrower retains ownership and possession of the collateral and the lender has a contractually guaranteed right to seize the asset in the event of a default. In Egypt, a business charge agreement must be notarized. As with a pledge, the principle of specificity applies and future assets (other than inventory) cannot be used as collateral. Business charges are governed by Law 11 of 1940 (*fonds du commerce*).

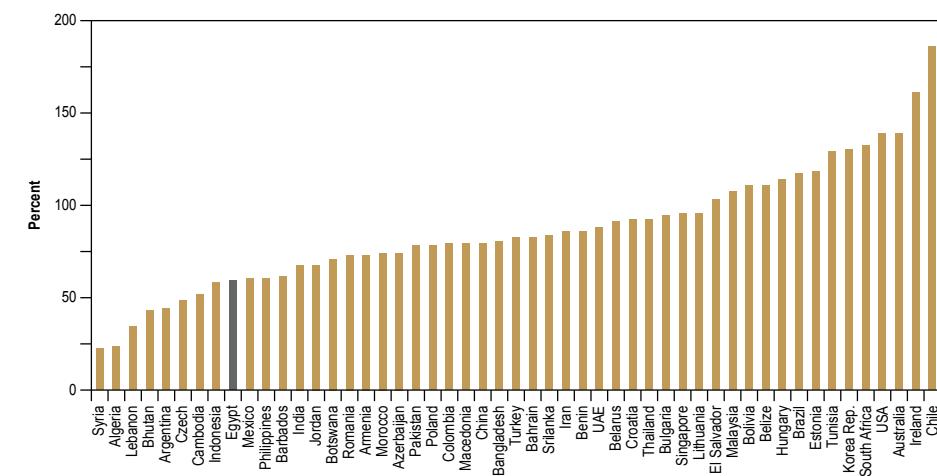
Several legal reforms of the past decade appear to have achieved some measure of success. For example, the 2001 amendments to the civil code in the Mortgage Finance Law have contributed to a significant increase in the availability and use of mortgages for residential property. This increase is also due in part to the creation of the EMRC in 2005, funded by loans from the World Bank and the IFC. Another promising development in the past decade has been the establishment of a national credit registry/ credit-reporting bureau. This is a critical component of a modern secured lending infrastructure. In 2005, a national credit bureau,

I-Score, was established under the leadership of the CBE, with support from the IFC and Dun & Bradstreet. It became operational in 2007 and CBE granted it a license in 2008. As of 2009, it had records on more than 4.3 million individuals and 43,000 SME.⁵⁹ Virtually all banks and NBFIs are contributing credit information to I-Score. In the latest IFC Doing Business Report, Egypt received the highest possible score on the depth of credit information index (0–6).⁶⁰

While these reforms have been positive, many aspects of Egyptian law on secured transactions require further reform. The traditional limitations that are embedded in the three forms of secured transactions have restricted the development and use of a variety of modern secured transactions to finance commerce that are in widespread use globally, such as leasing and factoring. Although several legal reforms were adopted to address these limitations, the results have been mixed. For example, Egypt's first leasing Law 95 of 1995 was amended in 2001 to enable companies to use leases to finance the purchase of vehicles for passenger transportation. However, this reform did not address the problems of enforcing ownership rights such as the frequent delays and high legal costs in collecting overdue payments. This has led the industry to move towards “client-based leasing”, where the decision to make a leasing contract is based on the client's creditworthiness, rather than relying on asset-based leasing.⁶¹ Factoring is a vital technique in many countries that enables retail companies to use accounts receivables as collateral for loans and lines of credit that can serve to address operating cash flow difficulties.

The lack of a centralized property register continues to be an important infrastructure deficiency. Because mortgages continue to be registered with a local notary public, it is difficult for secured lenders to adequately protect their interest and enable others to confirm its existence. Overall, the rights of creditors are not well served under current Egyptian law. The annual IFC Doing Business Survey found that Egypt ranks among the lowest countries (Figure 5.1).

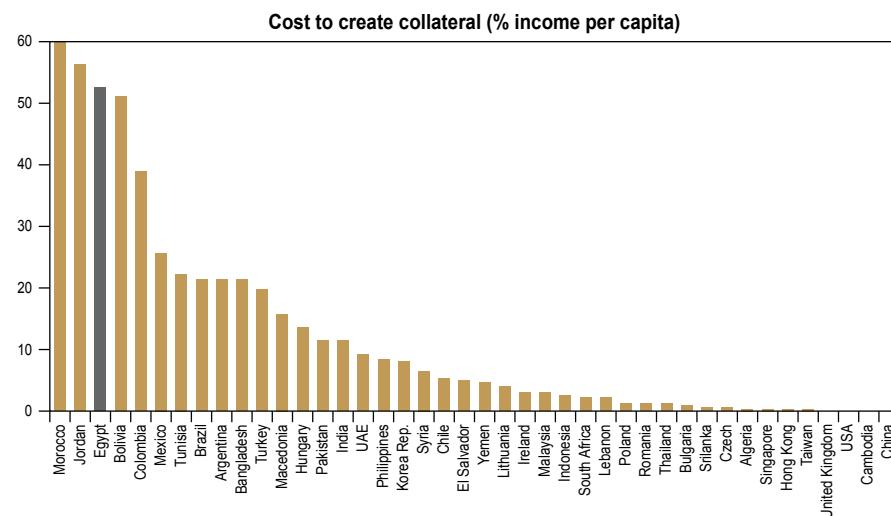
Figure 5.1: Legal Rights of Creditors in Egypt and Other Countries



Source: Doing Business.

The shortcomings of the law on secured transactions do not stop at the conceptual framework, but include how the rules on enforcement are drafted and applied in practice: (i) the rules are complex by design and formalistic; (ii) procedures for enforcement are time-consuming (notification, attachment, and sale by public auction); (iii) the process of sale is inefficient, resulting in modest proceeds; and (iv) private sale and strict foreclosure are not permissible under law. Again, Egypt stands out internationally in this area. An index of the costs to create collateral shows Egypt to be ranked among the most costly (Figure 5.2).

Figure 5.2: Cost to Create Collateral in Egypt and Other Countries



Source: Doing Business.

These shortcomings negatively affect the lending environment. The inability to use moveable property as non-possessory collateral precludes many individuals and new companies from obtaining financing. Legal uncertainties, costs and delays in enforcing a legal interest when a default occurs affect the availability and cost of a loan. The Sale of Commercial Concerns Law of 1940 governing business charges fails to address the needs of those using the system. The Model Law on Secured Transactions provides a comprehensive template for modernizing the law on secured transactions in emerging economies. It presents solutions to issues relating to the creation of a security, the forms thereof and enforcement procedures that ensure efficiency of the system and is consistent with Civil Law traditions.

Bankruptcy

A modern and comprehensive bankruptcy law is a critical precondition for an effective private sector economy. In a modern market economy, some entities will succeed and some will not. When an entity fails, the law must promptly address the rights of creditors and debtors, and the resolution and

extinguishing of debts and obligations. The rights of secured and unsecured creditors must be differentiated, and the rights of differing ownership interests, of management, and of employees must be recognized. The law must provide for a wide range of outcomes, including continuing operation by a debtor in possession, limited or comprehensive reorganization or restructurings, or liquidation. The judiciary must have broad and flexible powers to act swiftly and with finality. Judges must have specialized expertise in order to understand complex financial transactions and to gain the confidence of the commercial and financial sector. Most importantly, the public must have confidence in the impartiality and integrity of the judiciary.

The current bankruptcy law in Egypt is severely outdated and too narrowly drawn. It is based upon a century-old bankruptcy code that predates modern commerce. Articles 550-772 of the New Commercial Code of 1999 represent the most recent legal reforms since the 1960s. These amendments did not make significant conceptual changes to the Code of 1883, which it replaced. They adhere to the historical perception that a bankruptcy is a violation of moral principles of trust between debtor and creditor. Also, they focus on personal, not commercial or corporate, bankruptcy. Moreover, save for a solitary and ambiguous provision (Article 702), the rules focus on liquidation and fail to provide any legal mechanism for reorganization.

Another problem with the existing law, containing more than 200 articles, is that it is overly complex and time-consuming. Additional delay arises because the court plays a very active role in supervising and approving all aspects of the process. Because the code is focused on liquidation as the eventual outcome, typically the last step is the sale of the debtor's assets via public auction, which results in only modest proceeds and is generally not beneficial to either creditors or debtors.

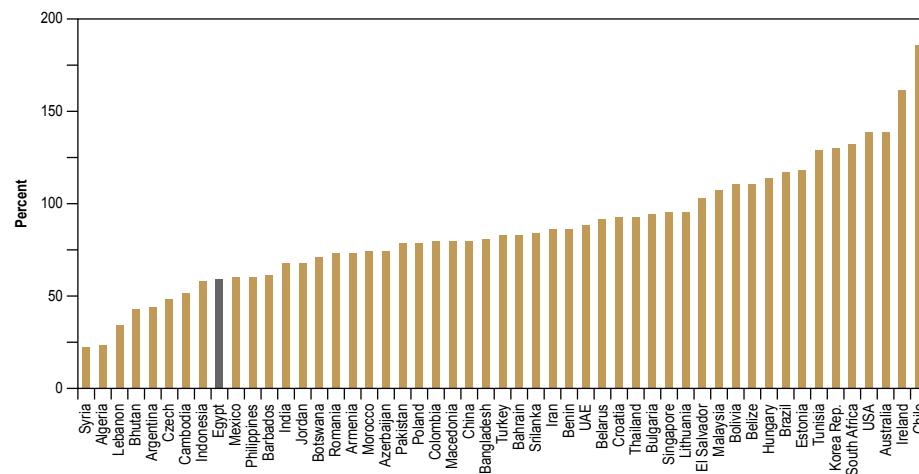
The deficiencies in the bankruptcy code contribute substantially to inefficiencies in modern commercial transactions. It is a major contributing factor to the excessive guarantees and collateral demanded by lenders, including banks and NBFIs. It also severely hinders access to finance by SMEs, particularly start-ups that lack a long credit repayment history. Global comparisons demonstrate the extent and severity of the problem. The 2012 Doing Business survey ranked Egypt 139 of 185 countries in ease of resolving insolvency. According to the Survey, average resolution time was 4.2 years and the proceeding cost an average of 22 percent of total assets. Creditor recovery averaged 17.6 percent of outstanding debts.⁶² "Scrapping the existing laws and imposing new rules for bankruptcy would be a significant means to rapidly facilitate access to finance for businesses, especially small and family-owned ones."⁶³

Judicial System Reform

Laws are seldom self-executing. The impact and effectiveness of legal reform depends upon the judiciary that must interpret, apply and enforce the law. An effective judiciary must be expert in the law and judicial process and it must be impartial and have the highest integrity. The judiciary must also

understand the importance of timely adjudication and management of its docket. A judiciary needs to ensure their correct application and enforcement, or at least support their implementation.

Figure 5.3: Dominance of Collateral-Based Lending in Egypt



Source: Egypt ICA.

Historically, the Egyptian judiciary has been criticized for excessive delay, uncertain or inconsistent application of existing law, and inefficiency in taking action to enforce decisions. The consequences of these flaws were several. Civil, commercial disputes typically took three–five years for final resolution. Delays of this length had a substantial adverse effect on loan defaults and efforts to enforce collateral agreements. A lack of expertise in complex commercial transactions, coupled with antiquated laws that were not written with modern commercial transactions in mind often led to decisions that did not clarify the law or fully resolve litigated questions. The Economic Court Law 120 of 2008 was enacted to address these important problems. The law created a new court to deal with 18 commercial laws, pertaining to financial transactions and banking; it was anticipated that judges assigned to this court would be specially trained and would be expected to effectively manage their dockets to improve speedy resolution of disputes. The court was divided into separate departments for government–private party disputes and disputes between private parties.

The success of the Economic Court Law is still uncertain. One commentator identified anecdotal evidence “that the introduction of economic courts has been helpful”.⁶⁴ According to one source, “as of November 2010 no publicized test case had entered the economic courts”.⁶⁵ Because of the limited and uncertain success of the Economic Courts, 92 percent of bank lending requires collateral (Figure 5.3). Moreover, banks engaging in secured lending continue to require a substantial ratio of collateral to loan, typically at least 60 percent of the loan amount. This substantial burden further restricts SME access to finance.

CONCLUDING REMARKS

The Egyptian regulatory system for the non-bank financial sector has had a series of noteworthy accomplishments over the past decade. Notable accomplishments include the creation of EFSA, amendments to the insurance law, continued progress on the reorganization of the state-owned insurance companies toward eventual privatization, promising growth in the mutual fund sector, adoption of IFRS accounting standards and reduction in the number of illiquid stocks listed on EGX. Progress has been made in the past decade in strengthening the regulatory, supervisory, and legal framework necessary to support financial transactions and intermediation. There is now better market transparency, and greater availability of information, particularly credit reporting data. The legal environment and infrastructure for mortgage lending has improved and the Economic Court may eventually achieve the goal of greater speed in resolution and more expert adjudication.

The consolidation of NBFI regulators into a single regulatory agency has not achieved its objectives yet, largely because completion of the consolidation has been partially postponed. It is recommended that EFSA complete the transition from three separate agencies to a single consolidated regulator. As part of the process, EFSA should continue its efforts to improve its on-site inspection programs in all areas of responsibility and develop an internal risk-rating capacity in conjunction with its transition to a risk-based supervisory program. Law 10 of 2009 should be amended to provide EFSA with comprehensive administrative enforcement authority. In addition, EFSA should have the authority to take “prompt corrective action” if a firm fails, to prevent systemic risk and to protect clients of the firm. Finally, EFSA must expand the number of professional and technical staff in each program. Increasing the number of professionally trained and certified actuaries should be a high priority.

Investor and customer protection must be a core objective of all regulatory programs. In this regard, EFSA regulation of mutual funds should emphasize improvements and enforcement in the quantity and frequency of disclosure to fund investors. Mutual funds should be required to make NAV publicly available daily and should be required to send investors updated disclosure on fund performance, investment strategies and information on fund holdings on a regular basis. EFSA and CBE should develop uniform procedures for regulation of mutual fund sales practices by bank employees. MCDREFSA should expedite the establishment of the arbitration center mentioned in the Law 10 of 2009.

Future economic development will continue to be constrained if essential legal reforms are not accomplished. It is recommended that Egypt enact a comprehensive reform of its secured transaction laws. The Model Law on Secured Transactions provides a comprehensive template for modernizing the law on secured transactions in emerging economies. Similarly, comprehensive reform of the bankruptcy code, which facilitates reorganization as an alternative to liquidation, is a critical precondition to economic development. In conclusion, these recommendations on improving NBFI regulation and legal reform will not guarantee future economic growth in Egypt but they will contribute measurably to a strong and fair capital market, enhanced protection of investors and the public and greater access to finance, at lower costs to borrowers.

ENDNOTES

- 1 According to the IMF data base on Financial Access Survey (FAS).
- 2 Factors that appear to have contributed to the attraction of bank deposits are (1) the explicit (though not “funded”) deposit guarantee of the government for state-owned banks, and now also private banks; (2) reasonably attractive interest rates on term and savings deposits, even if often negative in real terms given the persistent inflation; and (3) the perceived lack of other “safe” instruments of store of wealth.
- 3 However, the number of bank depositors per 1,000 adults (only about 440) is less than in most comparators (600 on average in the MENA region, and more than 1,500 on average in emerging Asia), which is evidence of a persistent gap in the access to banking services. The number of bank branches per 100,000 adults (about 8) is among the lowest in the world, and so is the number of ATMs (about 9). Noteworthy, is the importance, outside the banking system, of Egypt Post, which serves over 17 million clients through 3,700 outlets country-wide. It offers payment and deposit services, including savings accounts, but no credit facilities. There is little doubt that some form of integration of Egypt Post, or parts of it, within the banking system would offer the promise of a dramatic extension of financial services.
- 4 That regulation is common elsewhere, and based on sound prudential considerations.
- 5 See World Bank (2010).
- 6 Which include consumer loans (credit card, auto, and personal loans), personal housing real estate loans, and small enterprise loans.
- 7 World Bank (2010).
- 8 Reportedly, two mobile phone companies have recently been granted a license to operate mobile phone banking, but the start of their operation has been delayed.
- 9 Nevertheless, for the banking system as a whole, improved efficiency indicators have underpinned the upward trend in profitability. In particular, the ratio of operating expenses to net income has been on a declining trend in recent years, falling to well below 40 percent, now more in line with best international outcomes, while the ratio of net income to personnel expenses has almost doubled in the period under review. In addition to a stronger, developing, and more diversified banking sector there has been a decline in recent years in the interest margin component of total income.
- 10 A comprehensive earlier analysis of the nexus between access to finance and growth in Egypt is provided in World Bank (2007).
- 11 Regulations on “Preparation and Presentation of Banks’ Financial Statements, and the Principles of Recognition and Measurement”; available on the CBE website in Arabic. These rules became fully effective on January 1, 2010.
- 12 In consulting the English language websites of various banking groups, it would appear that even Annual Reports are sometimes not prepared on a consolidated basis.
- 13 World Bank (August 2011).
- 14 See World Bank (March 2011) flagship paper for an assessment, region-wide, of these issues.
- 15 Additional corporate governance and disclosure requirements have been included in a recent draft regulation, awaiting Board approval. They cover remuneration and compensation policies, risk management, and further rules on Board member qualifications.
- 16 The latter includes 3 state-owned commercial banks (which basically have a sovereign rating). Even excluding the 12 banks that are either wholly-owned subsidiaries or branches of foreign banks (generally listed on other markets and rated globally), this leaves 15 banks not listed anywhere, and 18 banks not rated by any international credit rating agency.
- 17 This judgment is based on a web-based analysis of the current state of the banks’ disclosure practices in Egypt.
- 18 The CBE Board of Directors approved on January 6th, 2005, set the rules regulating the work of credit bureaus and the exchange of information.
- 19 For banks, there is a one-time fee of US\$10,000, and annual fee of US\$10,000 as well; for non-bank, these fees are US\$3,500. There is also a fee charged per credit report.
- 20 The requirement is LE 500 million for a domestic bank, and US\$50 million for a branch of a foreign bank. Levels observed in other countries are now often in the US\$ 20 – 60 million range.
- 21 See Poshakwale and Binsheng (March 2011).
- 22 This program was funded by the EU under a technical assistance program agreed with the European Central Bank and four European central banks. Resident advisors from the ECB assisted with the implementation. The Department currently has eight divisions: On-site Inspection, Off-site Monitoring, Regulations, Licensing, Basel II Implementation, Central Credit Registry, Legal Cases, and Macro-Prudential divisions. The Department is headed by a Sub-Governor of the CBE, and is represented on the CBE Board by one of the two Deputy Governors. Heavy emphasis has been placed on recruiting the best qualified managers, and upgrading the information systems making use of the latest technology. The quality of the staff has been enhanced, with Senior Management of the CBE placing great importance on capacity-building and training. New internal guidelines supporting risk-based supervision have been put in place, including for IT use. A data warehouse conforming to international standards is being set up.

- 23 And its executive regulations, and subsequent amendments (Law 162 of 2004, and Law 93 of 2005).
- 24 Often referred to as “specially mentioned” loans in other jurisdictions.
- 25 These indicators mainly cover economic growth, balance of payments variables, inflation, interest and exchange rates, trends in lending, and asset prices.
- 26 Of 1988, amended, in particular, in 1996 to incorporate market risks.
- 27 Specifically, the core capital (Tier I) consists of the paid-up capital, reserves and retained earnings. Supplementary capital (Tier II) is composed of the general provisions, the subordinated borrowing of more than five-year maturity (provided that 20 percent of the value of these loans is amortized in each year of the last five years of their maturities), 45 percent of the difference between the market value and the book value of long term investments. The supplementary capital should not exceed 100 percent of the core capital, and subordinated debt should be limited to 50 percent of Tier I capital.
- 28 See CBE decision of October 2, 2007, op. cit.
- 29 See CBE decision of January 6, 2009.
- 30 BIS (2006, 2009).
- 31 Under Basel II, the threshold for significant would be 15 percent of the bank’s capital for individual significant investments in commercial entities, and 60 percent of capital for the aggregate of such investments.
- 32 BIS (2011).
- 33 Seven maturity buckets are to be considered: following day, 1 week or less, over 1 week to 1 month, over 1 month to 3 months, over 3 months to 6 months, over 6 months to 1 year, over 1 year.
- 34 The CBE has recently been updating the rules applicable to those experts registered with the CBE for the purpose of attesting the value of collateral and guarantees on bank loans.
- 35 Credit cards, personal and auto loans, and real estate loans for residential housing.
- 36 These include loans to artisans, professionals, and youth projects, as well as to firms generating less than LE 1 million in annual revenue (i.e. micro-businesses under CBE classification).
- 37 The growth since 2005 was rapid, but this is because it started from an almost non-existent baseline.
- 38 A maximum financing ratio of 90 percent, a limit of 10 percent of the financier’s capital for any single borrower and its related parties, and a limit of 40 percent of the borrower’s total gross income for income brackets other than low income brackets.
- 39 See World Bank (August 2011).
- 40 The rules for MBS holdings and permissible leverage ratios need to be further developed and standardized, as does the securitization infrastructure (rating agencies, external source of credit enhancement).
- 41 See also World Bank (March 2011).
- 42 Special regulations on credit to real estate development companies were introduced by the CBE on October 2, 2007, with a view to reducing the risks associated with this activity. In particular, these companies were obligated to establish a special account for each project, which allowed for the transparent calculation of a financial leverage ratio, defined as the project’s liabilities, including financing and down-payments from reserving clients, divided by the company’s funds allocated to the project. The latter is also used in the calculation of the required risk-weight for the purpose of calculating capital adequacy.
- 43 For an excellent analysis of these problems and their implications, see de La Torre and al. (July 2008), and Beck and Al. (November 2008).
- 44 World Bank (2010).
- 45 Besides the regulations governing small loans for economic activity referred to earlier, and which include loans to firms with a maximum business size of LE 1 million (i.e. micro-finance loans under the CBE criteria).
- 46 Buyer of inputs subject to a Trust Receipt pledges to the bank the inputs it has purchased, but is authorized to transform them into final products, while the bank retains its interest.
- 47 See for instance the SME regulatory framework introduced by the State Bank of Pakistan.
- 48 Recognizing the importance of this area, CBE has imposed a freeze on any new bancassurance agreements until applicable rules are strengthened.
- 49 Mandatory profit sharing by officers, directors and employees of state-owned insurers may influence decisions on reserve provisioning. Egyptian law provides that officers and directors of state-owned insurers receive 5 percent of company earnings and employees receive 10 percent. This may influence decisions on the size of company reserve accounts.
- 50 EFSA, with US AID’s assistance added a program to strengthen its pension supervision capacity. As part of its training program, thirteen of thirty inspection staff have been sent to other countries for training.
- 51 Because of the shortage, the four trained actuaries at EFSA also work part-time for regulated insurance companies and pension funds. EFSA has worked with Cairo University on developing a program to train persons to become actuaries.
- 52 The large number of private pension funds is deceiving as the 25 largest private funds control roughly 50 percent of the market share. Statistics are as of 2009.

- 53 As of 2010, only 25 of the 632 regulated plans were defined contribution plans.
- 54 A detailed description of Egypt's primary and secondary markets for equity and fixed-income securities is contained in Chapter 5. This discussion of capital markets regulation should be read in conjunction with Chapter 5.
- 55 EFSA Decision 71 of 2009 approved 7 local credit rating agencies in addition to the three global rating agencies – Moody's, Standard and Poors, and Fitch.
- 56 148 firms are licensed members of the EGX. However the industry is highly concentrated. The top 30 firms accounted for more than 80 percent of traded value in 2010.
- 57 For details see: Safavian, M. Fleisig, H., and Stienbuks, J. (2006), *Unlocking Dead Capital: How Reforming Collateral Law Improves Access to Finance, Public Policy for Private Sector*, World Bank, March 2006; and Fleisig, H. (1998), "Economic functions of Security in a Market Economy" (in: Morton J. and Andenas, M. (eds), *Emerging Markets and Secured Transactions*).
- 58 Wood, P. (1995), Comparative Law on Securities and Guarantees, p.5.
- 59 Country Finance: Egypt, Economist Intelligence Unit, December 2010, ("EIU- 2010"), P. 39.
- 60 International Finance Corporation, Doing Business 2013 – Egypt, ("Doing Business 2013"), p. 55.
- 61 OECD, Business Climate Development Strategy, Phase 1 Policy Assessment, Egypt Access to Finance, July 2010, ("OECD"), P. 53.
- 62 Doing Business 2013, p. 98.
- 63 OECD, p. 9.
- 64 Thorsten Beck, Tilburg University and CEPR Financing Egypt's New Future: Opportunities and Challenges, 2011, p. 32.
- 65 EIU - 2010, p. 34.

6. FINANCIAL SECTOR DEVELOPMENT AGENDA

A considerable body of research suggests that getting the financial system to work effectively is crucial to achieving these goals. This report has examined the Egyptian financial system, tracing its evolution through history, comparing it to that present in other, comparator countries, and identifying features of the Egyptian financial system that officials might consider examining more closely as they seek to implement reforms that promote economic growth, reduce poverty, and expand opportunities. As Egypt moves towards a new vision offering more equitable opportunities and active participation by citizens in their governance, it also faces challenges. Yet, the current environment also offers opportunities for improvement and reform, including creating a more inclusive financial system.

It would be worthwhile that Egypt explores the different types of fiscal commitment mechanisms and policy options. Fiscal rules are useful mechanisms, and developing countries have used them with varying degrees of success. Brazil, Chile, and Colombia have used them with relative success, in spite of the differences in the legal frameworks. To pave the way for this medium term objective, the fiscal reform agenda of the immediate future must take great strides in the areas of transparency in the fiscal reporting and ensuring comprehensiveness of the budget. Without these two, no fiscal commitment mechanism will work, and any fiscal adjustment will be sub-optimal because the full spending and revenue envelopes are not known to the decision makers.

It is also critical at this stage in Egypt to mitigate the risk of the reversal of reforms. The interim governments that were appointed post

the 25th of January revolution were not in a position to make long-term strategic decisions, and were often pressured towards unsustainable populist policies. The hostility towards those previously benefitting from privilege and corruption should not lead to a universal condemnation of market mechanisms and private sector led financial sector reforms. This could be achieved by enhancing the policy dialogue and consultations with all stakeholders, including government officials, Parliamentarians, political forces, academia, private sector, civil society, and development partners. The following lines will reiterate the nine pillars that lay the foundation of a comprehensive agenda for financial sector development in Egypt.

Deepening and Broadening the Financial System

The concept of the financial depth frontier (Beck and de la Torre 2007) builds on the two main barriers that financial institutions and markets face in deepening and broadening: (i) transaction costs and the resulting scale economies of financial services at the level of the user, the institution, and the market and (ii) systemic and idiosyncratic risks. Fixed transaction costs in financial service provision result in decreasing unit costs as the number or size of transactions increases. These fixed costs exist at the level of the transaction, client, institution, and even financial system. In addition to costs, the expansion in the supply of financial services, especially credit and insurance services is constrained by risks, particularly the risk of default. The risks can be either contract specific or systemic. As systemic risk increases, it enlarges the set of borrowers and projects that find the cost of credit unaffordable and are thus priced out of the credit market.

The financial depth frontier is determined by state variables that are either exogenous to the country—such as country size and state of technology—exogenous to the financial sector policy makers—socio-political stability, economic structure—or policy areas that are not subject to short-terms changes including contractual and information frameworks, market development etc. These state variables provide not only a floor for the costs of financial service provision but also the environment in which financial institutions can manage their risks. Using the concept of state variables allows us to define the financial depth frontier as a rationed equilibrium, that is, the maximum sustainable depth and breadth of a financial system. This frontier is different for savings and payment services, in which the transaction costs are the decisive market friction, and credit and insurance services, in which the risk dimension is an additional important friction. However, the frontier is also determined by demand-side constraints, including voluntary exclusion or exclusion for religious reasons.

While a broader set of data would be needed to locate the frontier in the case of Egypt, the previous discussion has shown that Egypt's financial system is far its frontier of possibilities, while there is also significant room for the frontier to move out. This section of the report will discuss areas of deepening and broadening the financial sector, which would be followed by key sectoral specific recommendations. First, macroeconomic stability is a

pre-condition for financial deepening, to sustain a high frontier and push it further out. Second, institution building in the areas of contractual and information framework is critical to push out the frontier. To benefit from a wider frontier, however a redefinition of the role of the government is necessary, beyond the substantial reforms of the past years. Similarly, the lack of competition and regulatory constraints prevent the financial system from reaping the benefits offered by new technologies. Finally, we argue for a new regulatory approach that gives more space to market-based financial innovation, while at the same time fosters more market discipline.

It is important to stress that the further deepening and broadening of the financial system can only take place in the context of a stable, but open political environment. A stable political environment will also be critical in terms of attracting urgently needed foreign capital flows, both directly but also through the banking system.

Macro and Socio-Economic Stability

A sound and effective financial system depends critically on the macroeconomic environment in which it operates. Maintaining fiscal discipline and—partly affected by this, monetary and real, exchange rate stability is critical for long-term finance and the Finance for Growth agenda. Maintaining fiscal and therefore monetary discipline will be more difficult in the coming months and years, as public pressure on fiscal policy will increase, partly due to the democratization of the political process. However, it will be more than ever critical to reduce crowding out effects on the banking systems and in bond markets and thus give sufficient space for private sector lending.

It is important, however, to understand that a stable macro-environment—a low and stable inflation rate, a sustainable fiscal position and stable exchange rate—is a necessary, though far from sufficient condition for further financial deepening and broadening. Macroeconomic stability determines the location of the financial depth frontier; however, it does not determine the location of the financial system with respect to the frontier. Egypt had achieved a certain degree of macro- and socio-economic stability over the past decade or so, without having been able to reap the benefits in terms of a deeper and more inclusive financial system.

Improving the Institutional Environment

The financial system ameliorates informational problems before investments are made; it affects corporate governance by reducing informational problems after investments are initiated; it facilitates risk diversification; and it eases the mobilization of savings by lowering information and transactions costs. Building the institutional framework for financial institution and markets to function effectively is the quintessential market-developing policy area. Such reforms address deficiencies in the state variables that keep the frontier too low. On the one hand, important reforms have been implemented over the past years, which earned Egypt the title “Doing Business Reformer of the Year” in several occasions. Most notably, the

establishment of I-Score, the privately-owned and managed credit bureau, constitutes an enormous improvement in the informational framework as already discussed above. Anecdotal evidence suggests that the introduction of economic courts has been helpful.

Nevertheless, further reforms, are urgently needed as basis for enabling more long-term finance and expanding the universe of bankable entrepreneurs. Specifically, the lack of a centralized property register holds back the mortgage market; currently, mortgages are registered with a local notary public, which does not allow for checking claims on a national basis. There is no legal and institutional framework for movable collateral. Further, the insolvency regime is ineffective, focusing exclusively on liquidation rather than allowing for restructuring of viable enterprises, which undermines its effective use. Many of these reform needs are discussed in other parts of this report.

Reforms of the contractual and information frameworks will help push the frontier out. They will enable the creation of new or deepening of existing market segments—such as mortgage finance, derivative markets etc.—and thus provide possibilities to deepen the market. As in the case of macroeconomic stability, however, these measures are necessary but not sufficient conditions for deepening and broadening the financial system. This will require additional policies that we will discuss next.

Redefining the Role of Government

The Financial Sector Reform Program launched in 2004 has significantly contributed to a redefinition of government's role in the financial system by substantially reducing the ownership share of government in banking. It is important however, that this progress not be reversed under current political pressure in political transition process. It is important to understand that a private-sector led financial system is critical for its positive impact on economic growth, notwithstanding an important role for government, a topic we will return to shortly. Such a private-sector led financial system, however, has to function within a competitive environment and within a regulatory framework providing the right incentives for sound risk decisions.

Developing clear ownership policies. Given popular opposition, alternatives to the privatization of government-owned banks should be explored, including management contracts. Examples from Sub-Saharan Africa, such as the National Microfinance Bank in Tanzania, have shown that such an approach can be useful. Under a management contract, a private firm assumes the overall responsibility for the operation and maintenance of a service delivery system and retains the freedom to make day-to-day management decisions. In the context of further restructuring of government-owned financial institutions, it is critical to come up with a clear ownership policy that defines objectives and role of government authorities in government-owned financial institutions. This ownership policy should be published and should not be subject to frequent change. An interesting

option, also applied successfully in several Latin American countries, has been to move away from offering retail services through specialized developmental financial institutions to a wholesale model, such as through the SFD. In general terms, it is important that the government undertake a holistic review of the sector and, for each institution and program, explore and define a mandate, a set of different options, and a framework of funding of subsidies. If the government considers subsidies in the financial sector necessary, then such programs should be made available for both private and state-owned financial institutions to the same extent, to thus create a level playing field.

Redefining the relationship between market participants and authorities. As important as addressing the governance issues in public-sector banks and leveling the playing field between public and private financial institutions is to redefine the relationship between private market participants and supervisory authorities. This would imply adjusting the regulatory framework for privately owned banks, with the goal of balancing supervisory and market discipline, where the emphasis is currently completely on the former. Specifically, the regulatory approach is currently one of guidance of market participants. Two examples include the rather rigid branch regulation policy and the lack of a bank resolution framework, which implies the impossibility to force the exit of weak banks. This regulatory and supervisory approach is best understood on the background of several decades of financial repression with heavy-handed regulatory involvement. The further rebalancing of supervisory and market discipline is thus as much an issue of attitude as it is an issue of specific regulations. Redefining the relationship between market participants and supervisory authorities has benefits both in terms of market-enabling and market-harnessing policies. It can help foster the necessary innovation, partly through more competition, and help increase financial stability by strengthening market discipline and fostering more adequate risk decisions.

While we advocate a reduced role of the government in retail provision of financial services, there are other ways that the public sector can help move the financial system towards the frontier beyond macroeconomic stability and institution building. One of these market-enabling policies is to provide risk mitigation tools, such as credit guarantees, which can help overcome market frictions, including the lack of collateral by many SMEs and mitigate liquidity and maturity risks. As so often, the devil is in the detail of pricing, funding, and institutional structure. The important assessment criteria for credit guarantee schemes are additionality and sustainability. How many credit-worthy borrowers who previously did not have a loan could be included through an existing or potential scheme, this requires not only an assessment of the additionality effect in itself, but also an assessment of the credit-worthiness of the additional borrowers. The other important criterion is financial sustainability. The design of the scheme can be critical for reaching these two goals.

Fostering Competition and Innovation

Redefining government's role is still on the more general policy level, but is not an objective per se. Rather, defining the relative roles of public and private sectors ultimately has the goal of ensuring competitive and sustainable financial markets. Competition is critical for setting incentives for financial institutions to maximize the exploitation of the possibilities created by a conductive macroeconomic environment and technology and thus push the financial system towards the frontier. However, this entails a sophisticated approach that has to balance the need for innovation and the need to reduce the risks of fragility. Competition has been shown to be critical for deepening and broadening the financial system, but can also have negative repercussions for stability if coupled with a weak regulatory framework. In this context, it is important to understand that market structure is not the same as competition; even concentrated banking systems can be highly competitive if there is a level playing field among several strong players, contestability achieved with the threat of entry, and competition from players outside of the sector. On the other hand, a dispersed banking system of niche banks typically shows a low degree of competition.

Allowing new players to enter the sector. There is an implicit de facto moratorium on new bank licenses as evidenced by the fact that since 2006 no new bank has obtained a license. Egypt seems to be lacking a clear policy concerning new bank entry, be it domestic or foreign players. The background for this seems to be the consolidation process of the past seven years, which led to the exit of several weak banks and emergence of overall larger-and better capitalized - banks. To ensure the necessary competitive pressure, opening the banking sector for new players is critical. In addition to allowing new entry, there are other means to encourage competition between incumbent institutions and thus deepen and broaden the financial system. In terms of access to markets—and as noted in other parts of this book --the playing field across banks is not even, with only some banks being PDs for government securities, while others having only indirect access. Using the franchise value and the network coverage of the Post Office for outreach purposes can increase significantly access to banking services, as the example of Brazil has shown.

Going beyond the banking sector. Fostering competition implies looking beyond the banking system. As noted in several previous instances, the non-bank sector is underdeveloped. One segment that can complement the banking system as well as provide competition is the microfinance segment. Currently limited to the NGO model, new legislation foresees them taking corporate form and being supervised by EFSA. However, they would still be limited to credit services. In the medium-term, it might be advisable to allow sound microfinance institutions to start collecting deposits –a move that would imply supervision by the CBE rather than EFSA. Alternatively, one could think of a separate regulatory form, such as micro-deposit taking institutions. Innovation for the financial system can also

come from outside the financial system, such as from telecom companies providing mobile payment services. It is important for regulators to focus on the specific financial services offered or proposed, not the nature of the institution providing or aiming to provide the services. This view encourages the unbundling of financial services across banks and nonbank actors. As long as the risk of consumer abuse is adequately guarded against, different actors should be encouraged or at least not discouraged from providing narrowly defined services. This could include deposit collection services by non-financial corporations, including supermarkets and others, working with banks in the form of agency agreements, or payment services offered by telecom companies.

Increasing availability of information. Competition can also be fostered by broadening the use of financial infrastructure. For example, it is important to encourage the use of credit information by microfinance institutions, if necessary with a subsidy on the costs. Another important policy tool to foster competition is through transparency, by, for example, starting with publishing more information about banks. The decision by CBE to begin disclosing and publicly disclosing on its website the consolidated banking sector financial statements and related indicators is a welcome first step. Other areas where more transparency and disclosure can help relates to account-related fees and conditions for customers.

Strengthening the Regulatory Framework

We have discussed the role of competition to push the financial system towards the frontier and the necessary changes in the role of government that this implies. In the following final sub-section, we focus more specifically on regulatory policies that can help push the financial system towards the frontier, while at the same time preventing it from moving beyond the frontier. Some of these policies will also have an impact on competition.

Designing a flexible framework. The Egyptian authorities have introduced an exemption from reserve requirements for the amount that banks lend to SMEs. Rather than having exemptions or regulatory “subsidies” for SME lending, it would be better to have a regulatory framework that is flexible towards lending to different client groups. Regulations more conducive to fostering SME lending would be to allow for more flexibility in terms of which asset classes can be used as collateral in loan provisioning rules. Similarly, relaxing the rule that all corporate borrowers (including SMEs) have to have audited financial statements can help to expand the bankable share of enterprises. There are also areas where there is regulatory overreach, such as the branch requirements that seem rather burdensome, including the requirement that banks need a certain capital to open a new branch and have to submit a business plan. Similarly, a less restrictive approach in terms of permitting new products can be conducive for the necessary financial innovation to deepen and broaden Egypt's financial system to the benefit of its users.

Introducing Shari'a-compliant products. Another important area for regulatory reform in the coming years will be on Shari'a-compliant finance. As discussed above, there is most likely considerable latent demand for Islamic financial products. It is important that the regulatory authorities keep an open mind concerning this growth area. In this context, it might be important to introduce the necessary infrastructure for Islamic products, including a Shari'a-compliant discount window. However, it might also require careful risk-based supervisory monitoring. The regulatory framework of Islamic banking needs further work to make it consistent with international practices, while maintaining the unique features of Islamic finance and not compromising Shari'a principles.

Focusing on accountability and market discipline. Regulatory policies that allow for more innovation and focus less on prohibition should be accompanied by a stronger focus on accountability and market discipline; this should include encouraging more banks to list on the stock exchange, and to obtain credit rating from international credit rating agencies, as well as establishing an incentive-compatible bank resolution framework that allows for the failure of banks without disrupting the remaining financial system and the economy at large. Ongoing governance reforms for commercial banks, including the forthcoming Corporate Governance Code for the banking sector and including governance criteria in the supervision process are welcome developments in this context.

Boosting Unusual Access to Finance

Promoting SMEs access to finance. An inclusive financial system can play a pivotal role in job creation, poverty reduction and overall sustainable economic growth. Smaller enterprises are important contributors to total employment, job creation, and overall economic development. In Egypt, according to empirical evidence, small and young enterprises are the main creators of new job opportunities. Entrepreneurship and new business formation is a linchpin to the process of innovation and creative destruction. Young enterprises are five times more likely to be 'gazelles' and are estimated to be 3.5 times more likely to grow (measured by employment) than other enterprises. Yet, Egypt has a very low business entry rate. Weak governance, privileged lending, lack of a level playing field, and unequal access to markets, contributed to limited economic opportunities and jobs, as well as an underdeveloped SME sector, hence, ensuring equal access to markets and restoring citizens' confidence and are prerequisites for generating equal opportunities and creating productive jobs.

Boosting microfinance. Microfinance proved to be critical to expanding private sector development and addressing economic challenges in Egypt. At the microeconomic level, access and use of appropriate financial services improves household welfare and spurs household enterprise activity, offering greater opportunity and choice to low-income households. Microenterprises suffer disproportionately from low financial

intermediation and are offered limited financial products. On the supply side, banks are reluctant to lend to micro enterprises, especially young and new ones, due to the perceived associated risk. Furthermore, banks continue to lend based on collateral as opposed to cash-flow, narrowing the opportunities for these enterprises that often do not have sufficient collateral. Banks in Egypt effectively serve privileged large well established enterprises. Attempting at those hindering factors is key in capitalizing on the impact of microfinance on the alleviation of poverty in specific and on the economy as a whole.

Enhancing rural finance. Development of the rural sector and the reduction of rural poverty, also remain constrained by lack of access to finance. Responding to the development needs of rural areas requires a multi-pronged approach. Global literature has amply demonstrated that one of the key elements is the provision of quality financial services to the country's cultivated areas. Better access to financing of essential inputs will help in the enhancement of crop productivity, which would then contribute to poverty reduction and to economic growth. However, in Egypt, the agricultural sector receives only one percent of total lending compared to 38 percent and 26 percent for industry and services respectively, while agriculture provides direct and indirect livelihood for approximately 55 percent of the population. Poverty in Egypt is heavily concentrated in the rural agricultural sector and the gap between this sector and other economic sectors has been widening, while delivery of financial services to rural areas has declined.

A Better Performing Banking Sector

It is important to keep the momentum and pace of reforms at the CBE, specifically regarding the publication of the Financial Stability Report, conducting the stress-testing exercises, close monitoring of banks' portfolios and NPLs, and applying Basel II framework to all Egyptian banks. A main challenge for policymakers in Egypt is to design a framework that ensures functional independence of the CBE. This implies that better coordination between fiscal and monetary policy is needed to anchor expectations. This independence is needed to ensure the CBE's ability to influence inflation expectations and maintain them within the inflation target range. To achieve this, the policymaking framework must ensure that expectations of fiscal events, which are exogenous to the CBE, are not incompatible with price stability. Under political pressure, and faced with social unrest, authorities could be tempted to choose policies addressing short-term concerns, which could undermine long-term private sector-led growth. Hence, a mechanism that contains fiscal expectations within certain bounds is a necessary element of an economic policy framework.

Increasing the soundness of the banking sector. Also, as mentioned by Tapscott and Ticoll (2003), to increase the soundness of the banking sector (Conventional and Islamic), countries should consider the following strategies: (i) speeding up the electronic delivery systems in the financial

sector and benchmark the systems to global standards; (ii) increasing the flow of information across all the stake-holders in the financial sector; (iii) upgrading the legal framework to meet the needs of the new economy; and (iv) strengthening the internal and external relevance of governance in the banking sector to stem out market failures and corruption, including e-corruption. This report showed that despite the contracting demand for credit, credit to the government provides an alternative use of funds to the banking sector that accounts for the major part in the decline of credit to the private sector. Hence, fiscal adjustment will imply credit flowing back to the private sector.

Limiting exposure to government risk. To expedite the transition, the bank's exposure to the government risk, especially of public and specialized banks, could be limited to a specific level. For instance, in Brazil, the limit for credit operations of banks with sub national governments and state owned companies was set at 45 percent of equity. Currently in the US, law restricts the amount of exposure banks can have to a single counterparty to 25 percent of their regulatory capital. Recently the UAE central bank set new limits of 100 percent of the capital base for all lending by a bank to governments of the seven-member UAE federation and their non-commercial entities, and 25 percent to individual borrowers. In Mexico, a similar regulation was adopted, but was conditional on the banks capitalization: banks with capital ratios above 15 percent will have an exposure limit to single sub-sovereign entities of 40 percent of their Tier 1 capital, while less capitalized banks at the minimum regulatory level of 8 percent would have an exposure limit of 12 percent of Tier 1 capital. In Egypt, the sub-national entities are not major sources of risk, but lending to the national government and state-owned enterprises should have some cost in terms of the capital adequacy regulation of banks.

Developing NBFI Services

Policy recommendations to develop NBFI services. It would be advisable to develop a plan to establish a central database along the lines of the Turkish TRAMER system so that claims provisions and premium rates may be accurately determined. Policy makers should consider establishing a surplus lines risks pool. Concerning pension policy, in order to achieve a greater degree of social transfer progressivity, it is critical to create more fiscal space, reduce the scope for directed investments and provide more opportunity for the institutional investor sector. Furthermore, in order to enhance access, it is suggested that a strategy be developed to actively support the development of the micro-insurance sector. This could involve an enhancement of Misr Life's business model and the development of micro-Takaful. To provide more fiscal space to enhance services to the rural poor, incentives should be provided for employers and individuals to take out health insurance. It is recommended that policy makers do not establish a new state owned reinsurer but should instead consider supporting the development of properly capitalized privately owned regional reinsurers in

Egypt, or taking an interest in an already established regional reinsurer. Furthermore, a program should be established to enable Misr Insurance and Misr Life to achieve benchmark staffing levels over the medium term and to offer market level remuneration packages so as to be able to attract high quality professionals. Policy makers should also consider putting public sector insurance staff group life arrangements onto same basis as other plans. Finally, it would be important to further modify the law to make it illegal for any salaried officer of an insurer, and his immediate family, to own an insurance agency

Regulatory and supervisory measures to develop NBFI services.

With regards to the risk rating of insurers, authorities should institute more objective risk matrixes including numerical measures such as IRIS ratios and solvency ratios (using risk based capital measures). It is also recommended for the law to require EFSA to apply corrective actions based on risk ratings and to enable EFSA to apply meaningful sanctions in accord with the relevant IAIS Core Principles. With regards to, private pension funds, it is recommended that the Draft Private Pension Law is enacted. All proposed recommendations should take place within twelve to twenty four months.

Promoting Capital Markets

A three-prong equity market development strategy is proposed. Expanding the functionality and capacity of the EGX is the first prong. Building a robust institutional investor base to increase the supply of investment capital and the demand for equity securities is the second component of this strategy. The third prong focuses on growing the number of publicly listed companies on the EGX through complementary initiatives.

Expanding the capacity of the equity market. The EGX should be encouraged and authorized to expand its range of securities products and range of permitted trading methods. The EGX does not have derivatives products and it operates with a number of prudential rules that are intended to reduce trading volatility but also reduce market liquidity and efficiency. These rules include limitations on intra-day trading, limitations on margin trading in some stocks, a prohibition on short selling, and price limits and trading halts. The statutory prohibition on brokers engaging in proprietary trading, although likely ineffectual, also adversely affects market efficiency and liquidity. These limitations are common in new, undeveloped markets. Reducing market volatility is also a common regulatory priority in new markets. However, these types of restrictions should be viewed as temporary and transitory. If a secondary market is going to develop into an effective vehicle for price discovery and investment opportunities, it must evolve and its rules must, over time, balance the risks of volatility with the benefits of market liquidity.

Stimulating the EGX through sale of government shares. The EGX problems of limited free float and low liquidity and turnover could be ameliorated by an orderly, transparent and disciplined government sale of

some portion of its substantial shares in companies that are publicly listed on the EGX. This would provide a stimulus to the EGX. The resulting increase in the number of available shares of “blue chip” Egyptian companies would also assist in the growth of an institutional investor sector in Egypt. In Egypt, the government has historically played a pivotal role in economic growth. Given how engrained this role is in Egypt, it would be unrealistic to assume that it could be abandoned entirely. However, the government must recognize that the benefits of its role in the economic development of specific companies will likely decline over time as the companies grow and become well established.

Using insurance companies and pension plans to build the institutional investor base. The absence of a meaningful domestic institutional investor base has been a significant constraint on EGX development. Life insurance companies and pension funds are financial intermediaries with long investment horizons who can provide long-term investments and professional market sophistication to an equity market. In Egypt, the appropriate regulatory agencies should review their prudential guidelines on asset allocation to ensure that insurance companies and pension plans allocate an appropriate portion of their assets to equities. This approach would be highly beneficial to equity market development and it would be consistent with international best practices for the regulation of insurance companies and pension plans. In the same vein, the legal proposals to require pension plans to retain professional investment managers and permit the use of pooled investment vehicles, would also achieve both objectives—market development and effective regulation of these institutional investors.

Promoting private equity and venture capital. Egypt should emphasize the importance of growing its private equity and venture capital (PE/VC) industry as an initial provider of investment capital and managerial expertise to small promising companies. First stage companies may be too speculative for public investors and too small to be of interest to institutional investors. The fixed costs of being a publicly listed company may be too great and too burdensome for first stage companies. VC/PE can be more effective sources of investment capital. In this model, the IPO and listing should be viewed as the goal for the second stage of growth, after the company has become viable and has grown to a sufficient size. The companies that succeed and grow following private investment can go public through an IPO. The IPO provides the exit strategy for VC/PE. The investing public benefits from being able to invest in a larger company with a track record of performance and a clearer understanding of further investment potential.

Renewing commitment to public-private partnership development initiatives. Several important PPP projects have been suspended or postponed since 2011 due to government uncertainty over the merits of the project, and possibly because of concerns over the terms of the project. These projects could be vital to stimulating the Egyptian economy. The government should carefully review the merits of the project and terms of the project. Going forward on the most important and most attractive PPP

would not only provide a stimulus to the Egyptian economy at a time when it is most needed. It would also be an important signal to foreign investors that Egypt should continue to be viewed as one of the most attractive emerging market countries, as it was for the past decade. Future government privatization efforts should be conducted through public offerings via the EGX. One of the benefits of a functioning, transparent secondary market, is its use as a vehicle for a governmental “exit strategy”. Instead of engaging in a private, negotiated deal to privatize government ownership, which can create the perception of corruption or cronyism, the government can sell its interest via an equity offering on a stock exchange. The market will set the fair price, and all investors can participate equally.

An effective equity market must be deep, liquid and efficient. And it must be fair. An effective regulatory program must encompass a wide array of duties. The recommendations on NBFI regulation in this report should be viewed as an integral component of a national equity market development strategy.

Developing the Money Market

Liquid money markets may be supported or constrained by how the CBE manages liquidity. This may involve several complex trade-offs, particularly in situations where there is chronic excess liquidity (e.g. in presence of large capital inflows), or undeveloped institutional arrangements on the government’s institutions cash flow management. These are medium-term and complex reforms. However, there is also another set of operational changes, such as a robust Repo market framework that can have a positive short-term impact on money markets. Two sets of reforms are proposed: (i) develop a sterilization framework over the medium-term supportive of money and debt market development. This complex reform is generally implemented over time and requires strategic decisions at the highest level. It would also require an in depth assessment of current monetary policy instruments and how they can evolve into the new framework with the participation of different areas within CBE, including at least Monetary Policy, Market Operations and the Payment System; and (ii) Develop a robust Repo market framework covering both T-bills and T-bonds in equivalent terms. This is a reform with high operational content. It can be developed in the short term but would require a significant upgrade in the T-Bond settlement infrastructure.

Government fixed income markets. Egypt had been making substantial progress in the implementation of an agenda of reforms initiated in the second half of 2008 to develop its government fixed income markets. As conditions stabilize, implementation should resume and cover all relevant building blocks for the development of government fixed income markets. Reforms in money markets, the investor base and clearing and settlement infrastructure (as suggested in their respective sections in this report), should be complemented by other recommendations related to primary and secondary markets. Reforms in primary and secondary markets would be leveraged by a careful review of the set of incentives and obligations of PDs

to foster competition in auctions, support the strategy to reduce refinancing risk (e.g. grant incentives for active participation in liability management transactions) and improve liquidity in secondary markets.

Primary Markets. There is a need for the design and introduction of an issuance calendar adapted to a post-revolution period. Authorities should reassess and resume a benchmark building strategy taking into account limitations brought on by the revolution. They must also implement measures to mitigate refinancing risk. These measures are urgently needed to address large concentrations of debt coming due especially in 2013 and may entail liability management transactions (buybacks and switches), improvements in cash management and other types of funding transactions (via different instruments or in distinct markets).

Secondary Markets. Policymakers should consider eliminating the PD “de facto” monopoly in the T-Bond secondary markets, as well as adopting an electronic trading platform with auto-match options. Another important measure is creating a securities lending facility provided by Ministry of Finance to PDs. In order to strengthen price dissemination and transparency in secondary markets, they must implement quoting obligations by PDs.

Non-government fixed income markets. The development of non-government fixed income markets cuts across reforms that affect different segments of the financial sector (e.g. government debt markets, insurance and pension funds). In this section, only those aspects that have a direct impact on the fixed income market will be mentioned. Details can be found in the background chapters by market segment. As a first step, it is recommended to establish the development of corporate bond markets as a priority in the access to finance agenda with a selection of actions that could play a catalytic role. Given the scope of the areas of work involved, a steering committee formed by the relevant governmental agencies in consultation with market participants could be established. Three core axes for the reform plan are suggested. These include: (i) continue the reforms initiated in the government debt market, as described above, so that it becomes a provider of reliable price references for non-government fixed income instruments and the creation of an efficient infrastructure; (ii) upgrade primary market rules with the aim of introducing flexibility and making institutional investors the drivers of non-government fixed income markets; (iii) give priority to a very flexible issuance framework for commercial paper aimed at institutional investors; (iv) develop a hybrid primary market model aimed at institutions adapting the exempt public offering regime implemented in other EMEs; (v) move gradually from a merit based into a disclosure oriented primary market regime (e.g. remove the investment grade minimum requirement); (vi) explore options to facilitate access by smaller companies with lower credit ratings; (vii) develop third party guarantee schemes for individual or collective issuance; and (viii) authorize issues below investment grade and develop a true private placement regime.

A diversified investor base. A more diversified investor base would benefit both the government and the non-government fixed income

markets. It is recommended to reinforce growth of NBFIs and their role in disintermediation with an emphasis on mutual funds given their stronger potential for growth. Three complementary sets of actions are suggested (i) continue planned reforms in the insurance and private pension sectors including changes in their investment regulations so as to reduce dependency on bank deposits; (ii) modify regulations to reduce dependency on banks to develop mutual funds (e.g. reduction of 5 percent of NAV in funds, exclusivity of banks in funds distribution); (iii) reinforce oversight and regulations on the mutual fund industry (e.g. broader diversity of funds, clearer differentiation between funds and implementation of regulations preventing conflicts of interest).

A robust clearing and settlement infrastructure. A robust clearing and settlement platform is essential for the development of the government and non-government fixed income markets. In that aspect, it is recommended a decision be made on the institutional set-up of the CSD platforms that would minimize market segmentation and broaden access to settlement services to non-bank intermediaries with the potential to become active in secondary market trading. The institutional set up could follow either of two models: Model 1: CBE is responsible for the settlement of T-Bills directly and for T-Bonds through a sub-custody account at MCDR (see diagram above) and Model 2: CBE becomes responsible for the settlement of both T-Bills and T-Bonds, whereas MCDR remains in charge of the settlement of equities and corporate bonds. Furthermore, substantial upgrades to existing platforms should be implemented. This could be planned in short term and medium term phase. Short-term upgrades would concern mainly government securities including: eliminating the pre-deposit obligation for government T-Bonds; implementing a securities lending facility by Ministry of Finance; including settlement facilities for both legs of repo transactions (registration of both legs and automatic settlement of the second leg); harmonizing the settlement cycle of T-Bills and T-Bonds. Medium term upgrades would include the full automation of the CSD at CBE; the ability of MCDR to settle OTC fixed income trades; settlement of the cash leg of both government and non-government securities in CBE money; enhancing risk management schemes to allow for short selling.

Developing the Leasing Industry

There remain several constraints facing the leasing industry that have inhibited its growth and its ability to achieve its full potential. Of these inhibiting factors, perhaps the most crucial is the scarcity of long-term funding. Moreover, the relatively limited development of capital markets does not support the issuance of bonds to provide long-term funding. In order for the leasing industry to access the amount of long term funding needed to grow exponentially, the bond and asset-backed securities markets need to be further developed in order to extend the average maturity of leasing contracts and better serve potential and existing clients.

Strengthening the judicial and legal system. A stronger judicial system, which is able to enforce foreclosures and ensure the efficient and effective repossession of assets in case of default, is key to developing a supportive regulatory environment for leasing. There is a great deal of confusion in the tax and accounting treatment of leasing as well as a general inconsistency with international standards. The existing fiscal legislation treats financial leasing as a type of rent, not a form of financing, and hence, does not create a level playing field between leasing and other forms of credit. The definition of leasing in the law must be adjusted to reflect a clearer, more precise definition that differentiates this type of financial transaction from all others including property hire or rent to prevent abuses of tax benefits and double taxation. While the establishment and development of economic courts is a step in the right direction, greater capacity building of these courts and the training of judges—especially in leasing concepts—is necessary for greater overall effectiveness. In order to increase the industry's client base, it would also be of great benefit for the law to be amended to allow for leasing for non-commercial purposes.

More effective registry procedures. The leasing industry in Egypt is also in need of a sounder institutional environment to operate within, particularly through the establishment and development of more effective registry procedures. The absence of a registry for leased assets increases the risk to the lessor and hinders the expansion of the market. The law in Egypt currently imposes requirements to register individual leasing contracts instead of the asset themselves. This is not only a cumbersome procedure for the lessor, but it also inhibits the development of a secondary market for moveable assets. It is vitally important for the industry that I-Score move forward with the establishment of its moveable assets registry.

Increasing the availability of data and broadening understanding of the sector. One of the reasons the industry is not achieving its true potential is the lack of understanding of the sector and the limited information and data available on it. There is a lack of experience, skills and understanding of the sector by current practitioners and potential lessors as well as a general lack of awareness on the part of government officials including agencies responsible for asset registration, courts, and the tax authority. Both EFSA and the Egyptian Leasing Association have an important role to play in creating both a greater understanding as well as greater visibility for the industry. While the quarterly reports issued by EFSA are helpful and a positive step forward, the data available remains to be limited with only a few specific indicators being tracked on a regular basis and on an aggregate and cumulative level. Producing reports and disseminating information on the sector should be one of the Egyptian Leasing Association's main objectives.

Taking advantage of current circumstances. Although the industry has not grown as much as it has the potential to, especially in the past year, the circumstances surrounding the transition period in Egypt

can be extremely advantageous to the industry. Due to the government's increased domestic borrowing to reduce the fiscal deficit and the associated crowding out of the private sector, it will become increasingly difficult for banks to extend loans, especially to start-ups and SMEs. These exceptional circumstances provide an excellent opportunity for this vital and vibrant industry to play an important role and serve a sector, which is the backbone of the Egyptian economy and a major source of employment.

The most urgent outstanding reform issues are: (i) setting up a central database to collect MTPL exposure and claims run off data so as to be able to accurately determine outstanding claims provisions and to set adequate premium rates (it is likely that a surplus lines risk sharing mechanism will also be required); (ii) passage of the Private Pension Law so as to strengthen EFSA's ability to supervise this sector and to ensure that professional fund management capacity is in place; (iii) developing a set of rules so as to enable the issuance of additional bancassurance licenses, this will also need a stronger and more engaged supervisory regime; (iv) upgrading EFSA's ability to risk rate insurers and private pension funds and take appropriate enforcement actions; and (v) developing a medium term plan to deal with staff related cost structures in Misr Insurance and Misr Life. Other desirable reforms are listed in tables 15 and 16.

Key development opportunities. Micro insurance, Takaful and health insurance, are key development opportunities and policies should be supportive of these growth areas; however the new pension/disability system could be either beneficial to the insurance or contractual savings sectors or seriously threaten future growth, depending on the details of its operation. Further consideration should be given to the application of contribution and benefit caps to create fiscal space and improve equity.

Developing Egypt's Mortgage Market

The following recommendations represent key strategic areas, which could serve to support a more efficient, robust, and dynamic mortgage market, better equipped to deliver the necessary housing investment Egypt requires.

Regulation of developer installment loans. Developer installment loans should be fully regulated as consumer credit. Although no depositors are involved they represent a significant systemic risk and the collapse of a developer could have disastrous repercussions on the wider sector as well as individuals directly.

Commission comprehensive review of developer financing. The current system of financing is neither sustainable nor best practice. A comprehensive review of the way developers finance themselves should be conducted with the aim of creating a safer and more sustainable system. Such a review should consider the following issues: (i) security of down payment for pre-sales—consideration should be given to establishing an escrow system which would protect buyers who have made a down payment on a property depositors and (ii) developer financing - CBE should lift some

of the uncertainty faced by banks in this area by issuing a more definitive statement of its policies, setting clear limits and guidance on permissible lending by banks to developers.

Alternatives to the escrow scheme. An alternative to the escrow scheme could be a fully funded guarantee mechanism that is self-funded by the developers. This would require developers to pay premiums into an independent fund that would provide purchasers with a guarantee of: (i) the completion date of the purchased unit and (ii) the completion of the unit in the case of the bankruptcy of the developer. The main advantage of such a scheme is that it would become self-regulating. The guarantee fund would have a natural incentive to uphold and improve governance standards in the industry. It would be able to set standards for financial disclosure and reporting. It would also be able to bar some developers from the scheme who do not meet certain standards either initially or on an ongoing basis. Participation and compliance with the requirements of the scheme would be an indication of credibility, thus increasing consumer confidence with respect to participating developers who would in turn strive to obtain and maintain such credibility.

Regulatory measures to better monitor maturity mismatch risks. This will curb the strong reliance on the deposit base for long term lending. This need not be a drastic regulatory change but should be one, which at least limits the ongoing term transformation phenomenon. This would reduce systemic risks in the market and encourage banks to fund themselves using longer-term liabilities, which is not the case currently.

Additional resources for EFSA for mortgage regulation and market supervision. EFSA should recruit additional experienced supervision staff able to work on mortgage regulation. The transition from MFA to EFSA and then the subsequent changes that have occurred in management at EFSA has left EFSA without the necessary experience and personnel to deliver the requisite level of supervisory oversight for the mortgage market. There is a need to strengthen the qualifications, experience and number of mortgage supervisors.

Improved property registration mechanism. This is a major obstacle, which at current rates of property registration will take another decade to overcome. In this regard: (i) more effort should be made to encourage people to register their properties; and (ii) a lower level of accuracy should be required for the mapping of title documents to remove bottlenecks in the system. A move to ‘general boundary’ principles could yield efficiency improvements and a much more rapid rollout of the systematic registration program. As long as effective dispute resolution mechanisms are included, this should not be an insurmountable obstacle.

Expand and progress the Affordable Housing Program. The Affordable Housing Program affords major social benefits, as well as economic benefits through job creation. It is likely that over the coming few years, the

Affordable Mortgage Finance Project together with the NHP will be the main drivers of the mortgage market. By generating mortgage loans, lenders will be enabled to invest more in their systems and reduce the spreads charged on each loan.

Develop Islamic housing finance. Islamic housing finance needs to be developed more fully both as a product serving the needs of customers within Egypt, but also as an economic opportunity to be part of a growing sector in the region. Developing compliant Islamic Finance Products with more generally applied principles on the prohibition of Riba (interest) would also potentially open up Egypt’s market more fully to capital market investors who may be interested in buying such things as Sukuk bonds.

Islamic Finance

Developing a legal framework. Special laws for the introduction and practice of Islamic Banking must be put in place. Such laws would facilitate the operation of Islamic banking side by side with CB. This set of laws will be concerned with the establishment, functioning and supervision of Islamic banking in the country. The legal framework of Islamic banking must include, among other things, the following: (i) higher risk-weighted capital asset requirements because of the incentives for Islamic financial institutions’ to engage in risky activities and the absence of an incentive to use collateral; (ii) stricter information disclosure requirements and close monitoring are also important since deposits are not protected and depositors tend to allocate funds across banks according to their risk preference; (iii) rules to ensure that Islamic financial institutions have adequate capabilities for project evaluation, appraisal, selection, auditing and monitoring, because Islamic financial institutions face a stronger investment risk since direct investment (projects) are the main source of return for depositors and minimal use of collateral is required.

Promoting corporate governance. The corporate governance framework should protect shareholders’ rights. These include property rights, the right of representation, the separation of ownership and control, etc. The corporate governance framework should also ensure the equitable treatment of all shareholders, including minority and foreign shareholders, as well as recognize the rights of other stakeholders, whether covered by explicit or implicit contracts. It should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the bank and ensure the strategic guidance of the bank, the effective monitoring of management by the board, and the board’s accountability to the bank and to shareholders.

Human capital formation. Because the adequate supply of qualified staff is vital for the continuing expansion of the Islamic banking industry and for proper risk management, it is critical to increase the supply of Islamic scholars. Furthermore, it is extremely important to have the people with the

right kind of skills and commitment to run Islamic banking, since managers of Islamic banking are not well trained in the use of Islamic modes of finance. The employees and management of Islamic Banking also need to be trained in modern techniques of financial management, especially risk management, as well as information technology.

Improving risk management. Improving risk management is very important as Islamic products are becoming more complex and sophisticated with financial innovation. Given the specific nature of risk, Islamic Banking need a specific risk management approach. Reserve requirements in this case should be relatively higher to cater to huge default risk as well as to prevent depositors' losses in case of poor performance and rapid capital outflow. In addition to that, engaging some of bank's capital into its investment operations and not only depositors' funds, would limit the risk of moral hazard. In fact, Islamic banking tend to be more conservative than their conventional counterparts, possibly leading to lower profits. Also, because of the PLS principle and the implied lack of protection for depositors, information disclosure requirements should be particularly strict in Islamic finance. The government, along with other stakeholders, can work with domestic and international standards setting institutions to build and strengthen the financial infrastructure. A better understanding of the risk management and governance issues of Islamic financial institutions will help governments in performing enhanced risk monitoring, and timely management of financial sector risk. As in conventional finance, there is a need for an integrated crisis management framework in Islamic finance to ensure that any emerging crisis in the Islamic financial system will be adequately managed. Such a framework involves having the mechanism and vehicles to address short-term liquidity problems, removing troubled assets from the balance sheets of financial institutions and resolving solvency issues in Islamic financial institutions.

Enhancing the Integrity of the Financial Sector

Important steps for more effective banking supervision. With respect to reliable financial reporting and auditing, there is a need to include in the banks' quarterly reporting requirements information on the structure and concentration of the bank's shareholders, and on the loan concentrations reflecting the largest borrowers, given the relevance of this information to the incentives for enhancing access to finance. Furthermore, with the increased significance of brokerage, mortgage finance, and financial leasing subsidiaries and affiliates, it is becoming increasingly important to require all banks to move to quarterly reporting of their consolidated operations as well.

There should be a requirement to have separate Risk Management and Audit committees. Greater conformity between CBE and EGX governance and disclosure requirements, through further strengthening of CBE requirements, should encourage banks to list. In addition, the CBE should develop incentives that encourage banks to seek an international credit rating, for instance by making it a condition for banks to undertake certain types

of borrowing. Despite significant progress in recent years, concerns remain about institutional limits to the effectiveness of good corporate governance at the state-owned banks. The fragmentation of the ownership function and the continued dominance of management at these banks need to be further addressed. Generally, there is still significant room for improvements in the amount, quality, and frequency of public disclosure of financial information by banks. Generally, in Egypt there is a need to further develop the capacity to assess market and operational risks, which will gain significance with the full implementation of Basel II. Doubts regarding the capacity to perform examinations of banking groups on a solo and consolidated basis also need to be addressed, specifically by strengthening and formalizing the exchange of information between the CBE and EFSA.

The stress-testing of banks will have to consider broader scenarios than downgrade of borrowers' credit risk, to include interest rate and liquidity risks, especially as exposures broaden and Basel II comes into effect. The minimum 5 percent provisioning requirement for "watch loans" should not be treated as a "general" provisioning, but as a "specific" provisioning, impacting on the CAR. The Macro-Prudential Unit may want to broaden, in its analysis, the scope of potential structural imbalances and shocks that can affect financial stability. Also, the CBE ought to disclose regularly the NPLs ratio of banks (i.e. NPLs over total loans). Finally, there is a need to continue assessing the implications of both Basel II and Basel III for capital adequacy of each individual bank, and at the aggregate.

Facilitating SME financing. There is strong evidence that the development of SME financing has been hampered by the lack of comprehensive banking regulations specifically tailored to such lending. overarching factors must be examined: first, the broad regulatory infrastructure must be conducive to SME lending. This calls for minimum accounting standards manageable for SMEs, credit bureaus specializing in SME assessment, efficient legal enforcement of creditor and borrower rights in the case of transactions with SMEs, and specialized SME credit rating agencies; and second, prudential regulations cannot, even unintentionally, be biased against smaller enterprises. This calls for the banks to be allowed to take on exposures to SMEs based on a much broader choice of possible collaterals. As already mentioned, this would require a new legal framework for movable collateral, supported by a centralized registry for all types of collateral.

Incentivizing banks to take on higher risk/reward lending. Banks must be provided an appropriate incentive structure that encourages them to move into higher reward/risk lending opportunities. This can only be achieved through greater competition, based on market-oriented corporate governance. Further commercialization and the reduced dominance of state-owned banks, will likely be a key factor in this regard, which would also be facilitated by further privatization. Furthermore, credit guarantees/insurance should play a more important role in mitigating the credit risk

assumed by banks when they take exposures, especially longer term, to more risky borrowers such as SMEs. In this context, the experience elsewhere with private sector-led Financial Guarantor Funds should be studied to see whether they could be replicated in Egypt. Local chambers of commerce/ business and professional associations could be especially well equipped to create such an entity. Finally, specific regulations governing the securitization of SME loan portfolios should be issued, with a view to enhancing the amount of financial resources going to the sector.

Building an effective NBFI regulatory program. Completing the consolidation of regulatory programs within EFSA should be viewed as an essential core requirement. While the events of January 2011 and June 2013, the uncertainties of the transitional government postponed many planned initiatives, resuming the effort to integrate the separate regulatory functions should be a first-order priority. Strong executive leadership, clear support from the national government, and a significant increase in trained professional and technical staff are required for success. Building an effective NBFI regulatory program will also require providing EFSA with additional legal authority in several areas. In the event of a financial failure by a licensed intermediary or other supervised entity, EFSA should be empowered to take prompt corrective action when needed to protect the public and to prevent systemic financial crises. EFSA should also have the authority to revoke the licenses of registered entities that are no longer able to meet regulatory standards or that become dormant. EFSA should also be authorized to regulate all private pensions and benefit programs. A comprehensive legal reform package should also define the legal status of the EGX and provide MCDR with the legal authority and responsibilities of a CCP for securities clearance and settlement processing.

The EFSA enforcement program has grown in recent years. To promote continued growth, Law 10 of 2009 should be amended to provide EFSA with comprehensive administrative enforcement authority. The Egyptian legal system does not recognize the concept of a civil enforcement action. As such, EFSA enforcement proceedings must begin as criminal actions and then be settled for money penalties. While some misconduct may warrant criminal sanctions, most EFSA violations are better addressed through a civil sanction, involving a fine, possibly a suspension, and an agreement to remediate conduct. The process of charging criminal misconduct and then settling for civil remedies may create a public perception of impropriety when prominent persons or companies are charged criminally and then punished only with a fine. Instead of undertaking fundamental changes in the Egyptian legal system, EFSA should be empowered to act through an administrative process. Such a process would have to be designed to provide defendants with full procedural due process protections, including a hearing on the record before an independent adjudicator. The powers available for administrative enforcement proceedings should be sufficiently broad to encompass violations under all of the laws administered by EFSA.

Development of the equity market and private fixed-income market requires the development of a robust institutional investor sector. Strong regulatory oversight of the institutional investor sector must accompany this effort. In this regard, EFSA should work closely with the CBE to develop a mandatory uniform code of conduct for insurance company and mutual fund sales practices and business conduct. In the same vein, EFSA should use its existing regulatory authority to mandate improvements in public disclosure requirements for private benefit plans and mutual funds. Investors should have full and prompt access to critical information on investing performance, fees and expenses, and account value. Minimum plan benefit information is also essential.

Opportunities exist for EFSA to improve its application of existing authority to important regulatory concerns. For example, EFSA should ensure that licensed intermediaries are adhering to restrictions on client purchases of illiquid stocks with borrowed funds. EFSA should also complete its transition to a risk-based examinations program and should take steps to promote the use of internal risk-based rating systems at insurance companies. Building a strong and effective NBFI regulatory structure presents a significant array of challenges. While these challenges may be difficult, they are achievable. A foundation has been built in the past decade. Success in the next decade should be the goal.

Implementing Appropriate Legal Reforms

It is critical to understanding the existing legal environment and evaluating efforts of legal reform that have taken place over the past decade. The Egyptian Revolution has resulted in many positive outcomes, one of which is the desire and power to change and reform institutions that have proved ineffective or represented an obstacle for efficiency. This positive outcome is yet to be applied in the legal and regulatory arenas and it is yet to be seen how the holders of power will apply it to address historic inefficiencies and impediments.

Assessing the legal environment. Reforms in post revolution Egypt should commence by a full study and review of the shortcomings of the existing legal and regulatory system and to assess in a neutral and fair manner the legal reforms that have taken place over the past decade with an objective of understanding what went wrong and why and also to continue and reinforce successful reforms. Understanding the shortcomings of the status quo including pre-revolution reforms is key to approaching reform. The prevailing legal framework in Egypt constrains the cost and terms of finance. Some laws are poorly written, especially those regarding secured transactions, bankruptcy, and settlement of disputes. Moreover, the court system, though well reputed for its impartiality and independence, suffers from several drawbacks that keep it from helping expedite debt collection and resolve other financial disputes.

There is a difficulty in discussing specific reform concepts absent the well-articulated and comprehensive policy objectives made by the new

Egyptian government. Yet it is important for policy makers to appreciate that fundamental changes are needed. International experience offers several models and policy choices for consideration by Egyptian policy makers. Policy makers should aim for a root and branch reform that would result in a law that is responsive for the needs of Egypt and can be adequately enforced by the existing regulatory institutions.

Enforcing laws on collateral. Laws on collateral are poorly enforced. Property-rights registration and titling issues make it difficult for firms, especially SMEs, to use land assets as collateral. Even when collateral is registered, there is no information on its value. This inadequate legal and judicial system has resulted in uncertainty and high cost, making banks reluctant to lend or opt to over collateralize their lending.

Reforming the law on secured transactions. Shortcomings in rules for secured transactions have hindered access to finance. Egyptian law recognizes three major forms of security, mortgage, pledge, and business charge, all of which are governed by rules that have shown various shortcomings in actual practice. These shortcomings have negatively affected the lending environment. The lack of non-possessory charges over moveable property deprives both lenders and borrowers of important collateral. Egyptian law can benefit from reforms that aim at changing the conceptual structure of the law. The Model Law on Secured Transactions represents the most comprehensive work in the field of reforming the law on secured transactions in emerging economies. It presents solutions to issues relating to the creation of a security, the forms thereof and enforcement procedures that ensure efficiency of the system and is consistent with Civil Law traditions.

Amending the bankruptcy law. The bankruptcy rules are embodied in the New Commercial Code of 1999 under Articles 550–772. These rules provide few conceptual changes to the Code for 1883, which it replaced. They adhere to historical perceptions of the bankrupt betraying the trust vested by the creditors, and focus on personal bankruptcy as opposed to corporate bankruptcy. A review of the rules—more than 200 Articles—shows that the process is multi-layered, complex, and time-consuming. It is important that Egyptian policy makers appreciate the role and function of bankruptcy law and to shape the law in light of chosen objectives that include: (i) providing an efficient process to help expedite settlement of bankruptcy cases, in an impartial, fair and within a reasonable time; (ii) providing the necessary mechanisms to distinguish between viable and unviable firms and assisting viable firms in overcoming any temporary financial difficulties; (iii) assuring participants in the market that the law will interfere to protect their legitimate expectations and interests; (iv) taking into account the social and economic implications of bankruptcy, this includes among other things, the interest of employees; and (v) dealing with insolvent entities at an early stage.

Reforming the Court System. The Egyptian court system, though well reputed for its impartiality and independence, suffers from several drawbacks that have resulted in it failing to provide an expeditious avenue

for debt collection and resolution of other financial disputes. Bold reform ideas need to be considered, which include: (i) Access to justice and with it the cost of litigation and the financial impact of losing a case; (ii) Appointment of judges from the bench; and (iii) Reforming the appeal process. No change can take place absent a root and branch reform, which Egypt not only needs but is capable of doing it in the coming few years.

The revolution, and its associated unforeseen risks, adversely affected the performance of the financial sector and interrupted the reform program. The prolonged political transition has contributed to the delay and ambiguity about policies and directions. Although this period has presented many challenges, it has also created many opportunities for reform. A core objective of Egypt's economic planning going forward must be to support the establishment of a well-functioning financial sector. Prospects for reform are widespread and encompass many aspects including deepening and broadening the financial system through an improved macroeconomic environment; fostering competition and innovation; improving the institutional and regulatory framework; enhancing the soundness of the banking sector; reducing exposure to government risk; developing NBFI services, capital and equity markets, the leasing industry, and the mortgage market. Moreover, it is important to ensure that the demands of the people are met with regards to the provision of Islamic Shari'a-compliant financial products. It is imperative that policymakers not be diverted from the objective of sustainable economic growth by giving into populist demand and resorting to short-term remedies.

CONCLUDING REMARKS

A well-functioning financial system fosters competition by allowing not only households but also promising firms to enter the market. A poorly functioning financial system can become an impediment to entrepreneurship and growth. Successful financial policy reforms are those that intensify competition in the financial system, enhance the quality of financial services provided to the non-financial sectors, lower entry barriers facing non-financial firms, and increase the rate of new firm entry and old firm exit. Thus, a better functioning financial system reduces the degree to which accumulated wealth shapes credit allocation and increases the degree to which the likelihood of future economic success determines the flow of credit.

Following the January 2011 and June 2013 revolutions, Egypt had been confronted with many challenges but also major momentum for change and reform. Besides overcoming the political challenges, Egyptian officials are working on creating a policy and institutional environment to foster sustainable and inclusive economic development, and aiming at uplifting Egyptian people standard of living, and expanding the overall economic horizons of the country. This is exerted in determination of meeting the Egyptian citizens' aspiration for a better life, and equal opportunity in a fair and competitive economy—key demands of the revolution.

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