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REGIONAL ISLAMIC FINANCE FORUM
FUTURE PROSPECTS

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The Role of Islamic Finance in Egypt

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THE ROLE OF ISLAMIC FINANCE

INTRODUCTION

Islamic Finance has become an increasingly integrated part of the global financial system. Since the development of the modern Islamic finance in the 1960s, the Islamic finance industry has evolved from a fringe industry that catered to specific banking requirements of the Muslim community to a global industry encompassing banking, insurance and capital markets. The Islamic financial landscape has now been dramatically transformed with more diverse players with an extensive range of financial products and services.[1]

The global Islamic finance industry continues its quest to boost international competitiveness and to build a sustainably profitable business model. Islamic finance assets around the world are expected to climb 33 percent from their 2010 levels boosted by the aftermath of the Arab Spring uprisings and dissatisfaction with conventional finance in the wake of the global debt crisis. Islamic banking is a growing worldwide phenomenon. The number of Islamic financial institutions has increased significantly in the Arab Countries.[2] There are now around one hundred Islamic banks and financial institutions working in the private sector.[3]

Egypt has the longest experience of Islamic finance since it started in 1960s, yet it is underdeveloped compared to GCC countries, Iran and Malaysia. During the last few decades, Islamic finance in Egypt has been displaying growth and progress. 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 remain lagging behind. Political factors have been unhelpful for Islamic finance where it was seen as being associated with banned Islamists.

The development of the Islamic banking in Egypt in the aftermath of theEgyptian revolution of 2011 and the dominance of the Islamists parties (Freedom and Justice Party and Al Noor Party) in the Parliament are likely to have a positive impact on Islamic finance in Egypt. Egypt is viewed as a promising market for Islamic finance because of its large population and proven

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[1] IFSB, (2010), "Islamic Finance and Global Financial Stability".

[2] Abu Loghod, Hadeel, "Do Islamic Banks Perform Better than Conventional Banks? Evidence from Gulf Cooperation Council countries" , API/WPS 1011.

[3] Molyneux , Philip; and Iqbal, Munawar, (2005), "Banking and Financial Systems in the Arab World", Palgrave MaMillan.

interest in Islamic finance.[4] This chapter gives an overview on Islamic finance in Egypt, its prospects, and challenges in light of the recent developments post the January 2011 revolution.

Box 1: Principles of Islamic Finance

The underlying financial principles in Islamic finance have remained unchanged historically since their development over 1,400 years ago. Financial products must be certified as *Shari'a* compliant by an expert in Islamic law. Certification requires that the transaction adheres to a number of key principles that include:[1] (i) backing by a tangible asset, so as to avoid 'speculation' (gharar); (ii) prohibition of interest payments (riba); (iii) risk to be shared amongst participants; (iv) limitations on sale of financial assets and their use as collateral; (v) and the pohibition of finance for activities deemed incompatible with *Shari'a* law (haram), such as alcohol, conventional financial services, gambling and tobacco.

A. Developments of Islamic Finance

Modern Islamic finance emerged in the mid-1970s with the founding of the first large Islamic banks. Development initially occurred through marketing of a steadily expanding supply of *Shari'a* compliant financial instruments. This supply-driven model contributed to relatively slow growth until the mid-1990s, when demand increasingly drove the development of Islamic financial instruments. Rising awareness and demand for Islamic products, along with supportive government policies and growing sophistication of financial institutions, have together raised the rate of growth.

Key centers are concentrated in Malaysia and the Middle East including Iran, Saudi Arabia, Kuwait, UAE and Bahrain. Islamic finance is also developing in Asian countries such as Bangladesh, Pakistan, India and Indonesia, as well as African countries such as Sudan. These countries should provide fertile ground for future growth, although prospects for Islamic finance in some Middle Eastern countries could be affected by the spread of political upheaval in the region. The development of Islamic finance is being driven by *Shari'a* compliant institutions taking the opportunity to expand products and services that can be accessed by Muslim

[4] African Development Bank, 2011, "Islamic Banking and Finance in North Africa, Past Development and Future Potential".

customers and investors. This is leading to the expansion of retail and capital markets, helping, for example, to meet growing demand for infrastructure finance. The market is currently most developed in Malaysia, Iran and the majority of countries that form the GCC.

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. Islamic finance has shown resilience during the past two years at a time when global recovery has slowed and conventional banking in Western countries has remained under pressure. It is not unaffected by broader global macroeconomic problems as some Islamic banks are exposed to the volatile real estate markets. While less affected by the financial crisis and global economic downturn, Islamic finance faces various ongoing challenges, including management liquidity, compliance issues[5], and governance[6].

Islamic banks exclude all speculative activities related to interest rate expectations since they are not based on the volatile principle of interest rate. Islamic banks entail more risk sharing than conventional banks as both investors and entrepreneurs share any risks that are involved in the business. Since banks operate in an environment characterized by the asymmetry of information, Islamic bank will certainly benefit from the risk reduction of moral hazard and adverse selection by providing equity and debt finance simultaneously.

B. ISLAMIC FINANCE, ECONOMIC DEVELOPMENT AND THE GLOBAL CRISIS

The link between Islamic finance and economic development has been addressed in recent literature. According to Farqani *et al* (2009) Islamic finance theory promotes economic development in three main ways: (i) its direct link to the real economy and physical transactions; (ii) its prohibitions against harmful products and activities; and (iii) its promotion of economic and social justice.[7] Islamic finance can play a critical and efficient role in enhancing economic

[5] In addition to the ongoing challenge of ensuring *Shari'a* compliance for all products, the cost of finance may be inflated by compliance risk: the risk that some assets could be judged non-compliant

[6] Multiple representation of some *Shari'a* scholars on bank boards could be addressed by development of internationally agreed code on representation. The skills base from which new scholars could be drawn is broadening.

[7] Mavrakis, Nadia, 2009, "Islamic finance: a vehicle for economic development", May.

development. This is in light of the fact that Islamic finance is based on participation rates associated with real economic movement[8].

Islamic finance cannot support such conventional finance activities as debt rescheduling, debt swap, speculation, and other purely monetary or financial activities that do not add to the real economy.[9] Moreover, Islamic finance integrates Islamic moral and ethical principles and, as such, prohibits financing products and activities that are non-*Shari'a* compliant, including alcoholic beverages, tobacco, and casinos. Therefore, Islamic banks improve productivity in the economy and reduce the social and economic costs of such products and services that generate negative externalities. This is based on the belief that, Islamic finance promotes economic and social justice among members of society. The prohibition of *riba* eliminates the injustice of conventional finance transactions caused by the lender receiving a positive return guarantee without bearing any of the risk with the borrower.[10]

The current global financial crisis has not only shed doubts on the proper functioning of conventional "Western" banking, but has also increased the attention on Islamic banking.[11] Some of the most important triggers of the global financial crises were "Excessive and imprudent lending by banks over a long period, housing bubble, global financial imbalances, securitization problems, lack of transparency and rating agencies". Many studies were conducted to investigate the performances of Islamic and conventional banks, but the conclusions of these studies differ sharply from each other. Some have suggested that commitment to Islamic principles helped Islamic banks to build a protective layer from the effects of the crisis. These include the principles of ethical behavior in practicing business, and the principle of risk sharing, and the availability of credit, first to purchase goods and services, and the restrictions imposed on the sale of debt, and short-term sales.

According to Maher Hasan and Jemma Dridi (2010)[12], Islamic banks performed better than conventional ones in 2008 in terms of profitability, credit and asset growth[13]. The Islamic banks'

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[8] Salahy, Abdel Haleem, (2009), "Efficiency of Islamic Finance Modes in continuing the crisis and business cycles".
[9] Kahf, M. (2007).
[10] Iqbal, Z., and Mirakhor, A. (2007).
[11] Beck, Thorsten; Demirgüç-Kunt, Asli and Merrouche, Ouarda (2010).
[12] Hasan, Maher and Dridi, Jemma, (2010).
[13] To assess the impact of the crisis, the paper uses bank-level data covering the period (2007–10) for about 120 Islamic and Conventional Banks in eight countries—Bahrain (including offshore), Jordan, Kuwait, Malaysia, Qatar,

profitability crunch was less than 10 percent, whereas conventional banks' profitability slumped more than 35 percent in 2008 compared with 2007. Moreover, Islamic banks have maintained stronger credit growth compared to conventional banks in almost all countries and in all years, suggesting that the system has great potential for further market share expansion and a possible contribution to market stability through the available credit. The same trend was maintained in the assets side, which was less affected by deleveraging and grew on average more than twice that of conventional banks during the period 2007 – 2009.[14] Consistently, Parashar and Venkatesh (2010) found that Islamic banks performed better than conventional banks during the global crisis (2006–2009).

The Islamic banking system's features make its activities more closely related to the real economy. This reduces its contribution to excesses and bubbles, but it also makes it more exposed and vulnerable to the second wave of financial crisis: the real economic downturn. Islamic banks lent a large part of their funds to the consumer sector and invested in assets that proved in time to be illiquid, sharing the losses of their activity with the stakeholders.

However, 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.[15]

According to Salman Syed Ali (2011)[16] Islamic banks (in MENA region) were more stable during the financial crisis, mainly due to three factors. First, Islamic banks' financing activities are more tied to real economic activities than their conventional counterparts. Second, Islamic banks avoided direct exposure to exotic and toxic financial derivative products. Third, Islamic banks in general have kept a larger proportion of their assets in liquid form than their conventional counterparts. It is worth noting that Islamic banks and financial institutions start getting affected at a later stage in an indirect manner.

Saudi Arabia, Turkey, and the UAE. The key variables used to assess the impact are the changes in profitability, bank lending, bank assets, and external bank ratings.

[14] Flavius Caba, Maria (2011).

[15] Hasan, Maher and Dridi, Jemma, (2010).

[16] Ali, Salman Syed, (2011), "Islamic Banking in MENA region".

C. ISLAMIC FINANCE IN EGYPT

Evolution of Islamic Finance in Egypt

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.[17] Deriving inspiration from the idea of German saving banks, the Mit Ghamr Savings Bank aimed to mobilize the idle savings of the majority of the Muslim Egyptian population without transgressing the laws of the *Shari'a* and to provide them with *halal* returns on their savings as well.[18] According to its founder and manager, El-Naggar (1974),[19] the role of this bank was threefold. First, to act as an efficient intermediary between the supply and demand of capital. Second, to act as an educational centre for economic efficiency, saving education and banking habits. Third, to set a dynamic factor in mobilizing the idle capital for investment, thus, reducing hoarding and the problems of capital formation.

This early experiment was closed down by the authorities who preferred to see a state controlled banking system with finance allocated in a manner consistent with government development priorities rather than through uncontrolled local initiatives, which had the potential to emerge as alternative centers of economic power.[20] 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.[21] 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 practice it became a source of soft loans for co-operatives and craft syndicates, largely a financing arm of the

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[17] 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).

[18] Molyneux , Philip; and Iqbal, Munawar (2005).

[19] El-Naggar, A., 1974, pp. 246-247.

[20] Kahf, Monzer, (2004), "Islamic banks: the rise of a new power alliance of wealth and *Shari'a* scholarship", in Clement Henry and Rodney Wilson, (editors), The Politics of Islamic Finance, Edinburgh University Press, p. 19.

[21] 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).

Ministry of Social Affairs. It is not regulated by the CBE, being a hybrid government agency and credit union rather than a bank.[22]

The experience of the NSB demonstrates how far the Egyptian government has not only been able to take over ideas from those interested in promoting Islamic finance, but has successfully controlled the agenda, and adapted an Islamic institution to serve its own purposes. It has pre-empted other similar initiatives, and ensured it has an agency, that can be used to influence NGO activity and involvement with the low-income Muslim masses.[23]

Table 1: The Position of Egypt in *Shari'a* Compliant Asset Rankings

Year	Rank	Assets	No. of Institutions
2006	12	3.9	3
2007	12	5.7	3
2008	12	6.3	3
2009	12	7.2	3
2010	14	7.9	2

***Source*:** IFSB (2012).

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 central bank. The Faisal Islamic Bank of Egypt obtained a license from the CBE on June 14th 1979, to become the first Islamic bank established in Egypt, shortly followed by Al Baraka Bank of Egypt, which was awarded its license on May 8th 1980.

It is evident that the interaction between the government and the Faisal Islamic Bank of Egypt has affected both parties, as although the Faisal Islamic Bank of Egypt remains a relatively small institution, its influence on the government has been much greater than its size might suggest. Initially, Sadat allowed the bank to start because it suited the government's purposes in developing relations with Saudi Arabia, and attracting investment. At the same time, the

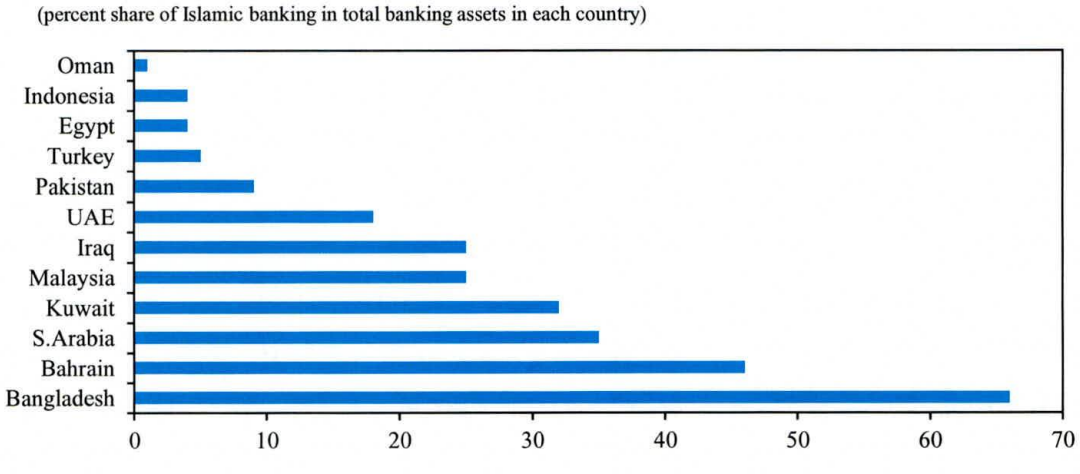
[22] African Development Bank, (2011).

[23] Rodney, 2003. "Arab Government response to Islamic Finance: The case of Egypt and Saudi Arabia" in Roberson, B.A. "Shaping The Current Islamic Reformation" P (143-163). EBSCO Publishing.

government wanted to control and infiltrate the organization[24]. In addition to licensed banks, a number of Islamic investment companies were established in the 1980s, the largest of which was the Al-Rayyan Company. These were unregulated and functioned informally, but as they offered investors very high returns, they attracted large amounts of funds. The absence of adequate legal and regulatory provision for Islamic finance created significant problems. Under Ex-President Mubarak successive Egyptian governments have been even more cautious in their approach to Islamic finance, as it is viewed as a means of satisfying some of the demands of those urging the more widespread application of the *Shari'a* law, while at the same time not applying the law in practice to the mainstream financial system.

Egypt is ranked the fourteenth in terms of 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 is very small[25]. This was a drop from the initial rank of 12th during the period 2006–2009 in global Islamic finance (Table 1). This indicates that the growth rate of Islamic finance in Egypt was less than that of some other countries, and that the Islamic finance

Figure 1: Islamic finance penetration in selected countries



Source: The Banker, Maris Strategies

[24] Following the Peace Treaty with Israel, Sadat wanted to assert his Islamic credentials as a counterbalance. Hence, on 26 May 1980, a referendum was held to change the constitution so that the *Shari'a* could be recognized as the source of Egyptian law.

[25] 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).

penetration in Egypt defined as the share of Islamic banking in total banking assets is very limited.

Figure 1 shows that the share of Islamic banking in total banking assets in Egypt was about four percent in 2010, which is very small compared to that of most countries that have Islamic finance. Islamic banking only accounts for 3 to 4 percent of Egypt's $193 billion banking industry compared to 46 percent in the United Arab Emirates. Egypt has a very low penetration rate of Islamic Banking compared to other countries.

Islamic finance is underdeveloped in Egypt. There is the political factor that prevented the growth of Islamic finance as it was seen at being associated with the previously banned Islamists political movements. Another reason is 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 conventional banks in terms of capital requirements, liquidity ratios and financial reporting. These are not always helpful for Islamic banks however, as they are often at a disadvantage in relation to conventional banks 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 Banking in Egypt

Even though Egypt was the first country to start Islamic banking in 1963, Islamic bank 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*.[26] During the period 2008–2010, the Islamic banks activities increased, showing growth rates of Islamic banks' assets of 10.5 percent, 14.3 percent and 9.7 percent in the years 2008, 2009 and 2010 respectively. However, these

[26] BlomInvest Bank, (2009), "Islamic Banking in the MENA region", Economic research department, February, www.bloominvestbank.org.

growth rates were less than those of the GCC countries. It is worth noting that the government of Egypt under Mubarak was hostile to Islamic finance, keen on keeping a secular country concerned with political agenda of the Islamist groups. Although some Islamic banking was permitted, it was confined to the fringes of the banking system.

Despite there having been over three decades of Islamic banking experience in Egypt, Law 88 of 2003, contains no provision for Islamic finance. The January 2011 revolution, and political and economical developments associated with it revealed the dominance of the Islamist parties. In this fluid situation there are opportunities as well as challenges to Islamic banking and finance, and questions about how the industry should respond.[27]

Major Islamic Banking Players in Egypt

Banks are the main source of the Islamic finance in Egypt. The Islamic banking industry can be divided into three modes or groups (Box 2). 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 National Bank for Development.

- **Islamic branches:** There are mainly two state-owned banks that have Islamic branches. These banks are: Bank Misr and National Bank of Egypt, 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 Watany Bank, private-owned bank, both of which introduced Islamic financial products.

Full-Fledged Islamic Banks

Faisal Islamic Bank of Egypt was established under Law 48 of 1977, amended by Law 142 of 1981 and its Executive Regulations.[28] The bank aims at consolidating the basis of Islamic banking practices and developing it further by introducing successful practical applications of the

[27] Wilson, Rodney, 2011, "The Determinants of Islamic Financial Development and the Constraints on its Growth", ISBN: 978-967-5687-15-0 , Islamic Financial Services Board , www.ifsb.org.
[28] Faisal Islamic Bank of Egypt, (2011), "Annual Report 2010", Cairo.

legitimate concepts, which are at the core of Islamic transactional jurisprudence. The bank is currently listed in Egyptian Stock Exchange Markets. It has a branch network of 14 branches and its assets are worth around LE 27.7 billion as of June 2011.[29] In 2010, the number of the banks operating branches reached 24 branches all over the country. Over 70 percent of its funding comes from what it describes as savings pools, most of which comprise investment accounts placed on a *mudaraba* basis whereby the depositors share in the bank's profit rather than earning an interest based return.

Al Baraka Bank Egypt is an Egyptian commercial bank and part of Al Baraka Banking Group, a Bahraini joint-stock company. Al Baraka Egypt was incorporated in March 1980. It was listed in the Egyptian Stock Exchange in 1984. Total assets of Al Baraka Egypt grew in 2010 by 11 percent to reach US $2.36 billion. In 2010, Al Baraka Egypt opened 2 new branches, bringing the total network to 21 branches and 4 foreign exchange bureaus, while its ATM network was expanded to 20 from 18 the year before. During the year it launched several new products, including its L.E 50 million Al Mutawazin investment fund, was oversubscribed by 125 percent as well as, a time share leasing finance scheme to assist customers in the purchase of real estate, together with (non-profit) Umrah and Hajj loan schemes. Al Baraka Bank in Egypt is growing, the rate of growth is modest and the scale of business and profitability in relation to its fairly extensive branch network seems low.[30]

National Bank for Development (NBD) was founded in June 1980 as a commercial bank with an initial capital of L.E 50 million, and a goal of developing the private sector startups. The bank has more than 2,000 employees, 69 branches, and 65 ATMs across Egypt. The bank also has a specialized microfinance division serving more than 40,000 clients nationwide through 42 dedicated units. In 2007 Abu Dhabi Islamic Bank (ADIB), one of the first banks to promote Islamic banking globally, acquired NBD.31

After the acquisition NBD launched a new strategy that stresses the importance of adhering to *Shari'a* principles in all of the bank's practices. NBD is now offering a broad spectrum of *Shari'a*-compliant banking products, including car and goods *Murabaha* financing for

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[29] African Development Bank, (2011).
[30] African Development Bank, (2011).
[31] National Bank for Development, http://www.nbdegypt.com/about-nbd/aboutnbd.

consumers, as well as short and long-term financing for corporate clients using *Murabaha*, *Wakala*, *Musharaka* and *Mudaraba*. In addition, the bank also offers customers *Shari'a* compliant deposits such as current and saving accounts and *Sukouk*. NBD has also launched several new *Shari'a* compliant products, so for the first time in the Islamic banking sector in Egypt as the bank introduced the "Yousr *Murabha* personal finance program", as well as "Islamic *Sukuk* program" through *wekala* contracts that achieved remarkable success surpassing EGP 1 billion.[32]

Islamic Branches

Bank Misr was established in April 1920 as a commercial bank. It was the first state owned bank to establish dedicated branches for Islamic transactions, to provide all banking, financial and trading activities for all sorts of economic and financial activities. The bank has 32 Islamic branches and offices covering all governorates of Egypt. The funds of such branches are completely separate from other branches providing conventional banking services and all its *Shari'a* compliant business is supervised by the head of the Fatwa Committee at Al-Azhar University, the oldest centre of Islamic scholarship in the world.

Table 2: Main Financial Indicators (Faisal Islamic Bank of Egypt) *(in USD Millions)*

Main Financial Indicators					
	2010	**2009**	**2008**	**2007**	**2006**
Total Assets	5553	5040	4311	3997	3488
Loans Advances	4810*	4420	3877	3588	3094
Customers' Deposits	5054	4637	3967	3668	3169
Shareholder Equity	379	353	353	223.7	215.3
Net Profit	59	2.6	15.4	21.27	20.8
Liquidity Ratio (percent)	19.8	36.85	22.91	25.47	48.54
Capital Adequacy (percent)	n.a	16.27	15.4	11.11	10.22
Return on Equity (percent)	5.46	6.4	8.02	9.7	9.66
Return on Assets (percent)	n.a	0.45	0.66	n.a	0.6

Sources: 1-Data information center 2-EMIS
* Estimated

[32] Loutfy, Nevine, 2011, "The National Bank for Development in Cooperation with Abu Dhabi Islamic Bank Announces the Financial Results for Fiscal Year Ending 12-31-2010", http://www.nbdegypt.com/uploadedfiles/FinancialReport/Q4-Press-Release-2010.pdf.

The United Bank was established on June 29, 2006, and is now the third largest banking entity in Egypt with a branch network of 37 arms countrywide and a paid-in capital that amounts to L.E1 billion as of June 2011. The central bank owns 99.9 percent of the United Bank. The bank has established "*Rakhaa*" sector regarding all banking transactions that abide to the Islamic *Shari'a* provisions and cope with the newest international banking standards. Within "*Rakhaa*" services there are *Ethar* certificate - *Alodhia* instrument and *Dyar* real estate financing services. In addition to the investment certificates that have been conformity of the Islamic *Shari'a* provisions like the 3–year and 5–year certificates with a monthly or semi-annual return and also with a variable monthly return either in the local or foreign currency.

Table 3: Main Financial Indicators (Al Baraka Bank) *(in USD Millions)*

Main Financial Indicators					
	2010	**2009**	**2008**	**2007**	**2006**
Total Assets	2398	2074	1900.1	1643.3	1338.3
Loans Advances	1201	954	864	695.82	609
Customers' Deposits	2097	1791	1705	1489.6	1188.6
Shareholder Equity	144	129	111.8	96.1	96.1
Net Profit	19	8	28.33	21.27	12.32
Liquidity Ratio (percent)	n.a	n.a	21	21	62
Capital Adequacy (percent)	n.a	n.a	11	14	18
Return on Equity (percent)	n.a	n.a	27	22	13
Return on Assets (percent)	n.a	n.a	1.6	1.4	1

Sources: 1-Data information center 2-EMIS
* Estimated

Islamic Windows

Principle Bank for Development and Agricultural Credit was established in July, 1931 as an Egyptian Joint Stock Company under the name of the Agricultural Credit Bank then by virtue of Law 105 of the year 1964. It was transferred into General Egyptian Institution for Agricultural and Cooperative Credit (public institutions), afterwards Law 117 of year 1916 was issued changing it into a public holding entity under the name of the Principal Bank for Development and Agricultural Credit in the Arab Republic of Egypt.

This bank provides Islamic Banking Services that include: investment activity and Islamic finance, investing funds according to the participations system (*Musharka*) and financing the different business activities and economic enterprises. The bank conducts these activities in order to invest funds and to utilize capacities through partnerships (*Musharka*) and capital interaction with business according to the rules of Islamic *Shari'a*.[33]

Table 4: Main Financial Indicators (National Bank of Development)

Main Financial Indicators (in USD Millions)	**2010**	**2009**	**2008**	**2007**	**2006**
Total Assets	2107	1787	1639	1707	0
Loans Advances	873	623	966	819	0
Customers' Deposits	1895	1679	1503	1529	0
Shareholder Equity	84*	84	95	190	0
Net Profit	n.a	n.a	n.a	n.a	0
Liquidity Ratio (percent)	n.a	n.a.	21.67	21.09	0
Capital Adequacy (percent)	n.a	n.a	12.29	15.34	0
Return on Equity (percent)	n.a	-9.7	-14	n.a	0
Return on Assets (percent)	-14	-4.58	-8.18	4.2	0

Sources: 1-Data information center 2-EMIS
* NBD started its Islamic Banking activities in 2007

Al Watany Bank of Egypt (AWB) was established in 1980. It was acquired in 2007, by the National Bank of Kuwait (NBK) to start operations in Egypt for the first time. AWB capital reached L.E 1 billion in 2008, while the number of branches reached 26, which are strategically located. Al Watany Bank provides various banking solutions that meet financial needs in accordance with the Islamic *Shari'a* principles that have been approved by the *Shari'a* supervisory committee.[34]

Tables 2, 3, and 4 shows the main financial indicators of the Individual fully-fledged Islamic banks (Faisal Islamic Bank of Egypt, Al Baraka Bank and National Bank of Development) while table 5 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 moderate growth rate of main financial items (Total Assets, Loans Advance, Deposits and Shareholders' Equity). In addition to

[33] PBDAC (2012).
[34] Al Watany Bank, "Islamic Banking", http://www.alwatany.net/islamicbanking/default_en_gb.aspx.

this, 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 National Bank of Development 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.

Table 5: 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 (%)	**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 (%)	**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 (%)	**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 (%)	**4.602**	**5.034**	**5.562**	**6.370**	**4.424**

Sources: 1-Data information center 2-EMIS

As far as the share of Islamic banks in total banking sector is concerned, table 6.5 shows these figures. It is clear from the table that share of Islamic banks in total banking sector was around 4.5 percent on average during the period (2007–2010). The share of Islamic banks in total assets of the banking sector was 3.65 percent in 2006 because there were only two Islamic banks (Faisal Islamic Bank of Egypt and Al Baraka Bank). The share of Islamic banks in total loans of the banking sector was much higher than the ratio of the total assets, as it reached about 8.1 percent on average during the period (2007–2010), which indicates that the Islamic banks contribution in loans is higher than their relative important of total assets. The share of deposits was around 5.65 percent on average during the period (2007–2010) which is also higher than their share in total assets. The table shows that the share of equity of Islamic banks was about 5.3 percent during the period (2007–2010) on average which is consistent with the level of capital of

banking sector which indicates that Islamic banks meet the regulatory minimum capital requirements.

C. ISLAMIC FINANCIAL PRODUCTS IN EGYPT

Sukuk

A sovereign *sukuk* would be issued by year-end on June 30 2012, as part of a large capital raising exercise to help revive the economy and make up the significant drop in gross national revenues from tourism and foreign direct investment caused by the Arab Spring Unrest in 2011. This exercise marks a new direction for Egypt's government, which has traditionally relied on local bank credit to raise money.

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 economic activities; the implementation did not result in activation of this instrument due to the lack of integrated regulations for the issuance of these *sukuk*. However, in early 2012, the government announced that they will be issuing foreign currency denominated *sukuk* or certificates of deposits mainly targeting the Egyptians abroad.

As part of the its plan to develop and diversify the financial instruments to increase the ability of corporates and other different juridical entities to access financing, EFSA prepared a proposal in order to provide a legal framework for using the sukuk as one of the financing instruments, and assesses a fair balance of rights for each issuer, underwriter and all participants in the capital market.

The proposal includes an amendment to the Articles 35 and 37 of the Executive Regulations of Law 95 of 1992, in addition to introducing two new articles numbers (7 repeated) and (44 repeated) to the Executive Regulations of the Law 95 of 1992. These amendments aim at having complete regulatory and legal framework for the issuance and usage of *sukuk* and to expand the scope of the activities that can be financed through *sukuk*, and to allow the issuance of *sukuk* in the form of partnership (*Musharakh*), where the underwriter is a partner and shareholder of the enterprise and is not only a creditor as it is the case of the existing regulations. The amendments aim also at identifying the legal authority that is responsible of issuing *sukuk*. The proposal also

modifies the return's text to be suitable for the different types of *sukuk* and their returns. The amendments specified the necessary regulations for issuance and subscription processes in order to protect the *sukuk* holders' rights. The proposed amendments have been prepared in a form that allow the issuer entities of the sukuk to set the detailed conditions for the activity or the project that these sukuk will be used for funding. The issuer can choose any form of issues including, *mudarabh, musharaka, murabaha*, and *Ijara*.

D. The Future of Islamic Finance in Egypt

Although Egypt is the most populated Arab country with a large Muslim population (more than 90 percent) it has hardly been involved in the recent expansion of Islamic finance.[35] The revolution and the formation of several Islamist political parties, which have dominated the new Parliament in 2012, have increased prospects for Islamic finance in Egypt. Several Islamic scholars are promoting the Idea that Egypt becomes a new hub for the booming Islamic finance.[36] According to data from Bankscope 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 new Islamist parties have the development of Islamic finance, one of the key priorities in their reform agenda. This could lead to Islamic finance playing a major role in the recovering of the economy.[37] Today, Islamic political parties demand to restructure the banking and finance sector into a pure *Shari'a*-compliant financial sector, and are submitting to the Parliament a new law that aims at setting the legal and regulatory framework for *Shari'a* compliant financial products.

It is only natural for Islamic countries to establish an economic system in line with *Shari'a* principles that also define the general lifestyle. This could be an opportunity to attract investment from Islamic financial institutions in the Gulf region, enhancing capital inflow to rebuild the economy maximizing investments from the oil rich GCC economies.[38] This could also be

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[35] Jaffer, Sohail, (2012), "Reviving Takaful In New Egypt", February.
[36] On Islam & News Agencies, (2011), "New Egypt Eyes to Be Islamic Finance Hub".
[37] Marzban, Shehab, (2012), "The Role of Islamic Finance in Post-Revolution Egypt", February.
[38] Jaffer, Sohail, (2012).

revenue to tap on, the experience and knowledge in these countries. However the Islamic finance industry faces several challenges. Some of the major constraints are very similar to those of conventional banks, 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.[39]

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 provisions 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. The managers of Islamic banks may have been attending some short-term courses either on the job or elsewhere, but there are not many formal training programs that fully prepare employees of Islamic banks for the needs of the system. Most Islamic bank employees, including managers and financial experts, come from traditional sources lacking the necessary expertise in and commitment for Islamic banking.

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. Decisions are left to various authorities in the country leading to differences in acceptable practices. As a result, a product or service may

[39] Nasr, Sahar, (2011), "Islamic Finance in the Arab World: Challenges and Prospects", World Bank, 2011 Cambridge Business & Economics Conference (CBEC), June 27-29.

be considered *Shari'a*-compliant in one country, but not in another. These differences may result from protectionist or nationalist factors, but are often theological.[40]

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. Although the principles of Islamic finance inherently limit the exposure to certain risks, risk awareness and risk management frameworks in Egyptian Islamic banks could be further improved. Special risks associated with Islamic finance include displaced commercial risk,[41] *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. A limited range of possible funding sources leads to concentrated liabilities, imbalanced funding mixes and stretched capital management strategies.[42]

In terms of product innovation, the Egyptian Islamic financial institutions are lagging behind. The sustained growth of the Islamic banking industry calls for financial diversification which requires encouraging financial innovation, developing a broader range of *Shari'a*-compliant banking products and capital market. 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. Therefore, demand for scholars to work on these boards is large, compared to a low supply, as it is still a growing market. This job is highly demanding, as the candidate should have a large and profound knowledge of both the *Shari'a* and the financial field.

This shortage of specialists has a major impact on Islamic products before it can be introduced to the market. Furthermore, due to *Shari'a* requirements, Islamic products tend to be more complicated than their conventional counterparts, since they usually involve more than one concept, and non-standard transaction structures. Thus, more human resources are needed for the

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[40] BlomInvest Bank, (2009).

[41] "Displaced commercial risk" is a term reflecting the risk of liquidity suddenly drying up as a consequence of massive withdrawals should the IFI's assets yield returns for unrestricted investment account-holders lower than expected, or worse, negative rates of profits.

[42] Nasr, Sahar, (2011).

development of these products. This is another obstacle for the industry's growth and innovation that can be eliminated as soon as new *Shari'a* scholars with sufficient financial skills enter the market and reduce the current gap between supply and demand.

Regulatory framework for Islamic banks, similar to conventional banks, is more likely to grow in environments where the regulatory system is built on a solid foundation. There is a lack of robust regulatory framework in Egypt. As previously mentioned there were concerns of labeling financial products by regulators to maintain the secular structure of Egypt. This was also compounded by poor knowledge of Islamic banking among a large segment of the public. Many citizens would like to have access to *Shari'a* compliant products but their knowledge concerning the principles is limited. Overall, there is a lack of awareness of the Islamic banks in Egypt and the benefits of their Islamic products.

CONCLUDING REMARKS

The global Islamic finance industry has witnessed remarkable growth in the last two decades. It is expected that it will increase during the coming few years and the growth will be expanded not only in the Islamic and Arab countries, but also in other countries where Muslim communities exist, such as the UK and USA. Many studies have demonstrated that there is a positive relation between Islamic finance and economic development. During the financial crisis of 2008, the performance of Islamic banks was good and less affected than that of conventional ones.

Even though Egypt was the first country to adopt and implement Islamic finance, the growth rate of Islamic finance in Egypt was less than that of some other countries, such as the GCC countries and Malaysia. The share of Islamic banking activities in the total banking sector was less than 5 percent. The Islamic banking industry in Egypt consists of: full-fledged Islamic banks (Faisal Islamic Bank of Egypt, Al Baraka Bank and National Bank of Development), Islamic branches and Islamic windows.

There is a proposal for issuing a legal framework for using *sukuk* as one of the financing instruments that play an important role in funding investment. Although Egypt has the longest experience of Islamic finance, there are still many obstacles facing Islamic finance. The most important is fear of the government of the expansion of Islamic movements. Another obstacle is the lack of rules and regulations governing Islamic banking up till now.

After the January 2011 revolution and the formation of several Islamist political parties, which have dominated the new Parliament in 2012, it is expected that Islamic finance will expand in Egypt. Islamic finance is one of the key priorities in the reform agenda of new Islamist parties, as there is a proposal introduced by Freedom and Justice Party to set and establish an Islamic Banking Law and regulations, which in turn will expand Islamic finance.

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