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Sources for Financial Services: The Banking Sector

Sahar Nasr

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SOURCES FOR FINANCIAL SERVICES: THE BANKING SECTOR

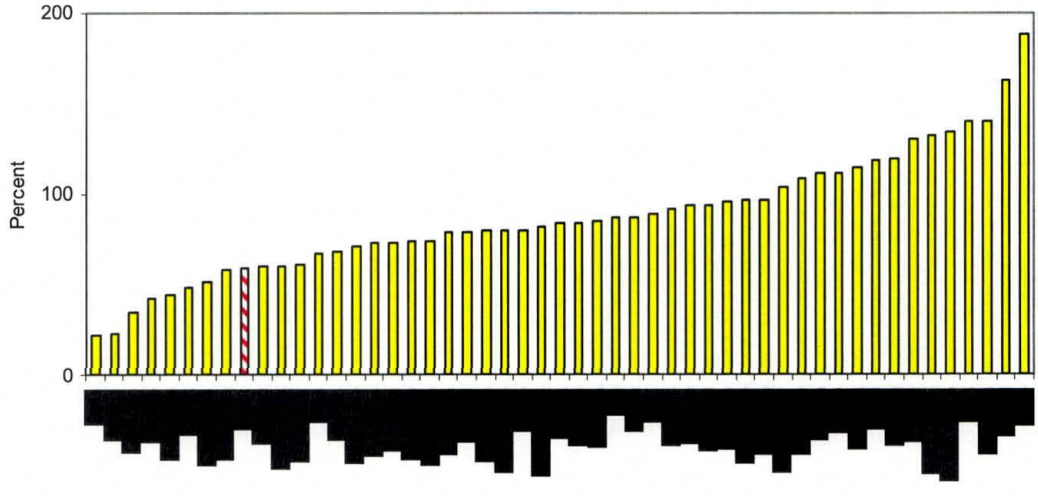
Banking plays a central role in Egypt, accounting for more than 60 percent of financial-system assets. There were 43 banks operating in Egypt as of June 2006, of which four are state-owned commercial banks,[1] 29 are private commercial banks and joint-venture banks, seven are branches of foreign banks, and three are state-owned specialized banks.[2] The intermediation by the banking system in Egypt, however, is weak by international standards. While savings are high and banks in Egypt collect many deposits, they actually lend little of these deposits—and have lent less over time—to the real sector. The quality of financial intermediation is also poor, reflected in high costs, non-performing loans, and limited access for households and small firms to financial services. Underlying these problems are issues of incentives and governance, and a still weakly developed institutional infrastructure for lending.

A. ACCESS TO BANK FINANCIAL SERVICES

1. Supply of Financial Services from the Banking Sector

Total bank deposits in Egypt amount to about 100 percent of its GDP, high by many developing countries' standards. Unfortunately, little of these deposits go to the real sector, as banks prefer to invest in government paper or other, non-loan assets. The loan-to-deposits ratio in Egypt is only 58 percent, well below the world average of 86 percent, and much less than the level of intermediation in many developed economies, where typically credit exceeds deposits (Figure 1).

Figure 1: Loans-to-Deposits Ratio in Egypt

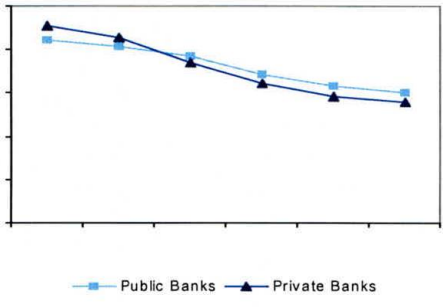


***Source*:** WorldBank database.

[1] Namely, National Bank of Egypt, Banque Misr, Banque du Caire, and Bank of Alexandria.

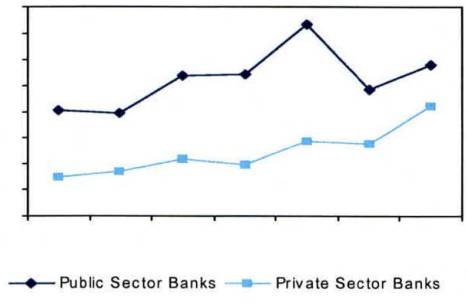
[2] Namely, Egyptian Arab Land Bank, Industrial Development Bank of Egypt, and Principal Bank for Development and Agricultural Credit.

Figure 2: Loan-to-Deposit Ratio in Egypt



Source: Central Bank of Egypt, 2006.

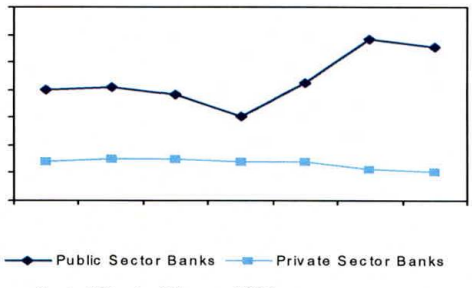
Figure 3: Treasury Bills-to-Total Assets in Egypt



Source: Central Bank of Egypt, 2006.

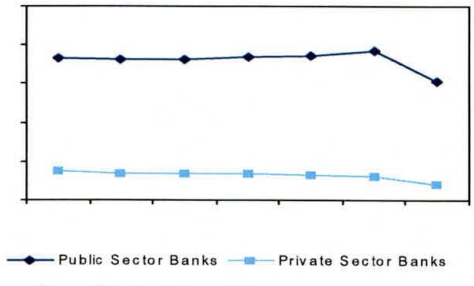
The loan-to-deposit ratio in Egypt has been declining over the last few years (Figure 2). Furthermore, only a small portion of the funds mobilized are lent to the productive sector, and even less to the private sector.[3] Banks are increasingly investing in treasury bills and government bonds (Figure 3). They held about 91 percent of outstanding treasury bills as of June 2006; public banks alone held 70 percent. This reflects banks' inefficiency in identifying profitable projects and their cautious investment policies, and the fact that treasury bill investment is not only risk-free, but exempt from taxes.[4] Direct lending to the public sector—both the Government and state-owned enterprises—has also increased in recent years: state-owned banks have increased such lending from 4 percent in 2000 to 5.5 percent in 2006 (Figure 4). Lending to SOEs remains high for state-owned banks compared to private banks: 15.2 percent versus 2 percent as of June 2006 (Figure 5).[5] In other words, banks finance the budget deficit and are not playing an active role in financial intermediation.

Figure 4: Government Sector Loans-to-Total Loans in Egypt



Source: Central Bank of Egypt, 2006.

Figure 5: State-Owned Enterprises Loans-to-Total Loans in Egypt



Source: Central Bank of Egypt, 2006.

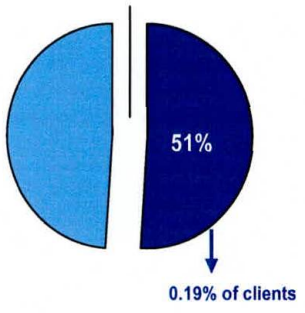
[3] Furthermore, not all the increase in credit advances to the private sector can be considered a net credit or an indication of fresh funding to the private sector, as there is an issue of rolling over or evergreening of loans. It is very hard to find information and data that differentiate between fresh funding and rolling over of credit.

[4] Although Law 5 of 1998 effectively removed this tax exemption, banks were still granted an exemption equal to 95 percent of income earned from investing in government securities. Under the new Tax Law 91 of 2005, banks are once again enjoying the full tax exemption. Another constraint is the high minimum limit for subscription, resulting in the exclusion of small savers as investors.

[5] Although in 1991 the Government eliminated banks' preferential treatment of loans granted to public enterprises, actual enforcement only happened in 2002 when state-owned commercial banks were no longer subject to government-directed lending policies and were no longer extending credit to public enterprises unable to service debt. Over the past four years, public-sector banks have extended few new loans or overdraft facilities to defaulted SOEs. Today, SOE loans on public-sector bank books are largely a stock of aged loans—current maturities rang from five to 10 years, having been largely committed between 1996 and 2001—with no meaningful transactions in overdraft facilities over the last four years.

At the same time, credit to the private sector has sharply decreased. Currently, it stands at 54 percent of GDP, similar to country comparators, yet half the OECD average of 110 percent. Furthermore, data from CBE show that the distribution of loans in Egypt is quite concentrated (Table 1). As of December 2005, 22 clients with loans of more than LE 1 billion accounted for some 11 percent of total credit outstanding. The next 47 clients, with loans between LE 500 million and LE 1 billion, accounted for some 10 percent of total credit outstanding, meaning that 69 clients accounted for almost one-quarter of total credit outstanding. Adding the next 486 clients means that more than 50 percent of total loans are represented by a scant 0.19 percent of all clients (Figure 6). Even when including loans less than LE 30,000, the average loan size is still as high as LE 159,906, which compares very unfavorably with other countries at similar income levels, and with other countries in the region, such as Lebanon and Iran.

Figure 6: Credit Extended to Private Sector* in Egypt



Source: CBE (2006).
* This covers only loans above LE 30,000 that are recorded at the Credit Registry at CBE.

Table 1: Frequency Distribution of Private Sector Credit in Egypt

Loan Description	Number of clients	Credit (*million LE*)	As a percent of total credit to the private sector	Average loan size (*million LE*)
Less than LE100 million	289,039	157,483	48	0.5
LE100 million and less than LE500 million	486	99,856	31	205
LE500 million and less than LE1 billion	47	31,835	10	677
LE1 billion and more	22	37,261	11	1,693
TOTAL	289,594	326,435	100	1.13

Source: Central Bank of Egypt, *General Department of Compilation of Credit Risk*. ***This does not include loans less than LE 30,000, which need not be reported to the CBE credit registry.***

Such a high fraction of loans to a limited number of borrowers means a heavy concentration of credit risk, although limits exist (according to Law 88 of 2003, credit facilities to an individual client can not to exceed 20 percent of banks' capital),[6] and a lack of diversification. Large corporate-sector loans are as much as 70 percent of total loans for many banks, with retail lending accounting for only 10 to 20 percent of total loans and SME lending only 20 to 22 percent.[7]

[6] Before this law, there was a 30 percent limit imposed in 1993 on all claims on individual clients, including equities, not just credit facilities. Previously, banks could have an equity investment in a company equal to 100 percent of the bank's capital and credit exposure of 25 percent of its capital (i.e., an exposure of 125 percent of its capital in a single client). The effectiveness of credit limits is also undermined by the lack of consolidated accounting standards. Despite the risk associated with credit concentration, the central bank supervisory body focuses mainly on ensuring that loans extended to an individual borrower by each bank separately are within the stipulated limits. Moreover, the central bank supervisory body estimates credit-concentration risk on the basis of loans extended to a specific company, rather than an individual borrower. To be of significance, limits should apply to groups of related companies on a consolidated basis. This is particularly important when dealing with customers who have multi-economic activities.

[7] Foreign bank branches and public specialized banks have reported higher lending to the SME and retail segments, but these banks do not have a large market share in the lending sphere.

2. Deposit Mobilization and Financial Services for Households

Banks have so far targeted a limited segment of households for deposit mobilization and other financial services. Incentives for households to use deposits and other financial services are poor. Minimum required deposit amounts[8] are too high to enable the poorer segments of the population to access the banking system and tend to discourage the unbanked population to save through formal channels. Although the commercial state-owned banks have relatively high branch density in both urban and rural areas (Figure 2.8), they do not extend many financial services to relatively disadvantaged segments of society. For example, only 3 percent of the savings accounts at state-owned banks have less than LE 5,000 in them (Table 2). By contrast, 42 percent of state-owned specialized bank accounts and 66 percent of foreign bank accounts have less than LE 5,000. Over 90 percent of the accounts at state-owned specialized and foreign banks have LE 500,000 or less. The public banks, which have an advantage in attracting small depositors due to their branch network, have instead focused on large depositors, with one-third of their accounts larger than LE 500,000 and 22 percent larger than LE 5,000,000.

Table 2: Share of Savings Accounts by Size of Deposits in Banks in Egypt *(percent)*

Deposit Size	Public Commercial Banks	State Specialized Banks	Private & JV Banks	Foreign
Less than LE 5,000	3	42	34	66
LE 5,000–LE 500,000	65	52	49	27
LE 500,001–LE 5 million	11	6	13	5
Over LE 5 million	22	0	4	3

Source: World Bank Survey of Banks in Egypt, (2006). The figures are for accounts denominated in Egyptian pounds. The size distribution of dollar-denominated accounts is very similar to the one presented here.

The lack of deposit mobilization from small savers is not due to financial repression. Interest rates on deposits are relatively high, about 6 percent for one-month time deposits in Egyptian pound, and 10 percent to 13 percent for deposits with maturities of one year and above, comparable to government bonds paying 9 percent to 11 percent for 15 years (Table 3). The interest rates for saving instruments vary from 6 percent to 13 percent depending on tenor and size. Foreign-currency deposit rates are in line with international market rates. Deposits are subject, however, to 14 percent liquidity and reserve requirements, which increase financial intermediation costs.

Table 3: Local Currency Deposit Interest Rates in Egypt

	Current A/C	Saving A/C	Time Deposits					
			7 Days	1 month	3 months	6 months	1 year	3 years+
State-owned banks	8.3	8.1	2.4	4.1	5.7	6.6	7.3	7.3
Public specialized banks	3	9.4	2.4	6	6.9	7.3	7.5	8.5
Foreign branch	4.75	6.4	2.6	5.7	6.2	6.45	6.36	9
Private and joint venture banks	3.33	7.54	3.1	5.9	6.6	6.8	7.1	8.25

Source: World Bank Individual Banks Survey (2006).

Banks, however, have been recently trying to catch up and cater to the lower segments for all types of financial services. As part of their retail efforts, banks have recently been actively

[8] For checking and current accounts LE 1000 in state-owned banks, LE 5,000 in private sector banks; for time deposits LE 5,000 on average for all the banks.

offering credit and debit cards, with public banks generally offering debit cards, and private and joint-venture banks offering credit cards (Table 4). The large and rapidly growing volume of card issuance helps capture salaries of public- and private-sector employees, thus enhancing low interest bearing current account volumes (credit-card usage limits are usually set to the amount of customers' time deposits).

Table 4: Number of Credit and Debit Cards Issued in Egypt during 2005

	Credit Cards	Debit Cards
State-Owned Commercial Banks	44,947	373,692
Foreign Bank Branches	20,875	-
Private and Joint Venture Banks	193,534	92,963

Source: World Bank Individual Banks Survey (2006).

B. FACTORS BEHIND WEAKNESSES IN SUPPLY OF BANKING SERVICES

Weaknesses in the supply of banking services, especially to small firms and poor households, arise from a number of factors. These include poor market structure, limited number of access points and branches, poor performance of banks, lack of skills (particularly assessing credit risk) and incentives, poor credit policies and practices, weak external and internal governance (especially in state-owned banks), and newly implemented and relatively untested regulations and supervision. Many of these weaknesses can be attributed to the dominance of state-owned banks, compounded by the ongoing process of institutional and operational restructuring. But the supporting institutional infrastructure is also poor. The judicial infrastructure is weak, with long backlogs, high processing costs to support collateral, and cumbersome foreclosure procedures. The credit-information base is weak and transaction costs are still high.

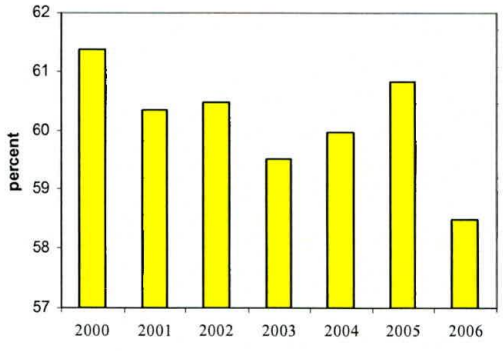
1. Market Structure

The banking sector is dominated by state ownership, in terms of assets and number of branches. Collectively, state-owned banks account for more than 60 percent of total assets, and 85 percent of branches as of June 2006. In addition to their extensive branch networks, state-owned banks hold equity capital and *de facto* governance sway in most joint-venture banks. Public-ownership stakes in these joint-venture banks has been at the root of unwelcome governance and conflict of interests issues. Indeed, although joint-venture banks are not, in principle, subject to centralized management control, their links to the large state-owned banks translate into weak governance, affecting overall competition and quality of financial intermediation. Effectively, the public sector's dominance in the banking system goes beyond the 60 percent level.

Although the legal preparation for privatizing the banking system started in 1998, ownership of the banking system has not changed as rapidly as was expected. While the share of state-owned banks declined in the late 1990s, an increase has occurred since 2000 (Figure 7). Despite the recent sale of some state-owned banks' shares in joint-venture banks, for many joint-venture banks majority public ownership is still maintained through ownership of insurance companies, NIB, and other public entities. With government majority control, minority shareholders' rights in joint-venture banks are highly restricted—in terms of board nominations, distribution of profits, auditing and access to information—and, although there is some private-sector board representation, the public sector dominates the decision-making process.

International experience and Egypt-specific evidence shows that banks that are partially privatized—especially those in which the state maintained a controlling ownership stake—perform worse than those that are majority privatized. This is important, since even with the successful implementation of the financial-sector reform program—the privatization of Bank of Alexandria,[9] the merger of the two commercial state-owned banks, and the full divestiture of state-owned bank shares in the joint-venture banks—public ownership in the Egyptian banking system is expected to remain as high as 48 percent. Furthermore, divestiture of state-owned banks' share in joint-venture banks by itself will not assure their total privatization when other non-bank public entities retain shares. For the near term, the banking system will remain dominated by two huge state-owned commercial banks: the National Bank of Egypt, and the merged Bank Misr-Banque du Caire.

Figure 7: State-Owned Banks' Share of the Banking System Total Assets in Egypt



Source: Central Bank of Egypt, 2006.

Through a series of acquisitions, mergers, and revoking of licenses of non-compliant banks, the number of banks and branches of foreign banks has declined from 57 in 2000 to 43 as of June 2006, and is expected to reach 34 by 2007.[10] The consolidation of the banking system—with the exit of small private and joint-venture banks and the entry of several strong foreign banks—is expected to enhance competition in the market, especially when accompanied by a strengthened regulatory framework and a healthier business environment.

2. Branch Network

Egyptian banks have few outlets for basic banking services. Egypt has fewer bank branches and automatic teller machines (ATMs) per capita than other countries within the region and other countries with similar per-capita income (Table 5). Relative to the developing world, Egypt's branch density is low, and its ATM coverage is less than one-seventh that of the typical developing country (1.8 versus 13.3 ATMs per 100,000 residents). Branch and ATM density is linked strongly to GDP per capita, making comparisons with higher-income countries in the region such as Bahrain and Kuwait potentially misleading. Even so, Egypt has fewer than half the number of branches of either Iran or Jordan, although their per-capita are incomes substantially less than double Egypt's.[11] Within the region, only the West Bank and Gaza has fewer bank branches, and Egypt trails all countries in Table 2.5, including those with similar

[9] Bank of Alexandria is only the smallest of the state-owned commercial banks, only accounting for some 7 percent of the system's assets.

[10] Transactions completed to date include: (i) September 2004 merger of Misr Exterior with Banque Misr; (ii) April 2005 merger of Crédit Agricole with Crédit Lyonnais under the new name of Calyon-Egypt; (iii) June 2005 merger of American Express with Egyptian American Bank; (iv) July 2005 merger of Arab African International Bank and Misr America Bank; (v) October 2005 merger of Mohandes Bank with National Bank of Egypt; and (vi) December 2005 merger of Bank of Commerce & Development with National Bank of Egypt.

[11] Data from a World Bank survey on access to and use of financial services (World Bank, *Measuring Banking Sector Outreach*, Indicators of Access to and Use of Financial Services across Countries, Thorsten Beck, Asli Demirguc-Kunt, and Maria Soledad Martinez Peria (2005).) The cross-country figures are for 2003, and thus may under-represent the current outreach of the Egyptian financial sector if the branch network has expanded in recent years.

income levels, in ATM density.[12]

Table 5: Branching and ATM Presence, Cross-Country Comparisons

Country	Branches *per 100,000 people*	ATMs *per 100,000 people*	GDP per Capita *(US $, 2003)*
Honduras	0.73	3.56	1,001
West Bank-Gaza	3.27	3.24	1,026
China	1.33	3.80	1,094
Egypt	**3.62**	**1.78**	**1,220**
Bosnia	3.86	5.36	1,682
Colombia	8.74	9.60	1,747
Belarus	4.79	5.06	1,770
Dominican Republic	6.00	15.08	1,821
Jordan	10.02	9.38	1,858
Albania	2.11	2.37	1,933
Kazakhstan	2.47	7.01	1,995
Iran	8.39	1.25	2,061
Lebanon	18.01	16.81	4,224
Chile	9.38	24.03	5,462
Mexico	7.63	16.63	5,968
Czech Republic	11.15	19.57	6,123
Argentina	10.01	14.91	7,483
Saudi Arabia	5.36	14.7	8,366
Bahrain	13.48	26.83	10,791
Kuwait	8.27	19.69	14,848
Israel	14.74	18.81	16,686
Sweden	21.79	29.56	28,858
Regional Average	9.46	12.5	6,787
Industrialized Average	35.31	73.54	28,983
Other Developing (average)	6.89	13.3	2,748

Source: World Bank, *Measuring Banking Sector Outreach*, Indicators of Access to and Use of Financial Services across Countries, Thorsten Beck, Asli Demirguc-Kunt, and Maria Soledad Martinez Peria (2005).

By bank type, state-owned specialized banks have 1,236 branches, state-owned commercial banks have 969 branches, private and joint-venture banks have 657 branches, and foreign banks have 42 branches. In general, banks tend to concentrate on the urban population, with branch networks concentrated in Cairo and Alexandria; the number of branches per 100,000 people is about 80 percent higher for urban areas than rural. Urban and rural bank-branch density varies significantly, though, by type of bank (Figure 8). State-owned banks have the most balanced branch network overall, though their presence is still greater in urban than in rural areas (three versus one branch per 100,000 people). Private and joint-venture banks have three urban branches per 100,000 residents, but much less rural coverage, 0.5 branches per 100,000. State-owned specialized banks are the only bank type for which rural branch density is higher than urban, roughly five times as high. With only 42 branches, foreign banks have little physical presence in either urban or rural areas.

[12] For the country as a whole, the CBE figures imply 4.3 branches per 100,000 residents. The figure for the rural areas is consistent with that of the cross-country data in Table 2.5; however, the figure for urban areas is higher. A part of the under-count for Egypt in Table 2.5 is likely due to new branch creation, but it also seems likely that the cross-country calculations do not contain information on all banks operating within a country. To the extent that branch density is under-represented similarly in all countries in the World Bank survey, the comparisons across countries in Table 2.5 are valid. In any event, the figures from the CBE also indicate that branch density is not high, even by the standards of developing countries.

Box 1: Egypt Post Offices

Egypt Post is present in 218 cities and 4,500 villages throughout Egypt. With 47,000 employees, 3,600 post offices and 6,500 licensed postal agents (franchised post offices through private-public partnerships), Egypt Post serves 15 million customers, including 13 million savings-account holders. In the Upper Egypt and Delta regions, where there are very few bank branches, there are 2,800 postal outlets, placing Egypt Post in a unique position to improve access to finance in these regions.

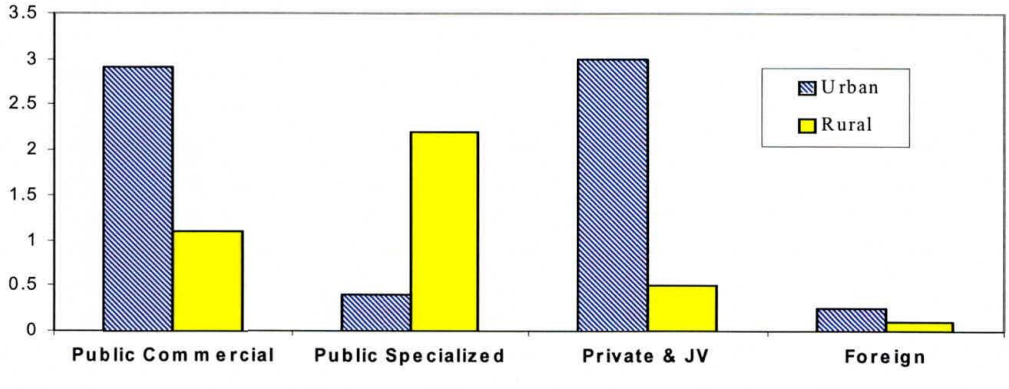
Postal financial services: strong growth and anchorage within the middle and low-income households. In the past four years (2002-2005), 40 to 60 percent of Egypt Post's annual revenues have been generated through postal financial services: savings accounts, transfers of funds, pension payments, postal cheques, and e-payments and services offered as intermediary (car insurance, investment account with the Faisal Islamic Bank, bill payments for Egypt Telecom). Revenues from savings have increased by 150 percent over the past four years. Domestic money transfers have also shown strong growth (131 percent), while international money orders have decreased (down 49 percent). Pension payments have grown by 58 percent. According to official figures, Egypt Post has about 10 percent of market share in the savings segment (estimated at around LE 34 billions), and 20 percent in the money transfers. In view of the average deposit per account, middle- and low-income households represent the bulk of Egypt Post customers.

Preparing for a strategic turn around. Egypt Post used to transfer postal financial deposits to the NIB for 0.5 percent, while savings books carried an interest rate of about 12 percent. Since early 2006, a new regulation has allowed Egypt Post to invest the postal savings in the financial markets, an opportunity to rebalance interest yields.

Egypt Post has also invested intensively in its network in the last few years (computerization and interconnection of post offices), and further capacity-building is planned, at both the infrastructure and system levels (management and information systems, back office systems, and operational systems). Information and Communication Technologies-based financial services are a prerequisite to better-managed financial services.

Figure 8: Urban and Rural Branch Density by Bank Type in Egypt

(Branches per 100,000 people)



Source: Central Bank of Egypt (2006). Urban governorates include Alexandria, Cairo, Port-Said, and Suez.

Branch-density figures do not reflect the postal system and its potential contribution to improved access to financial services, especially in rural areas (Box 1). There are currently 3,600 postal branches, though only 600 are connected via DSL lines, and many do not offer a full range of financial services.[13] A major effort is underway to assess and train staff in financial-service provision, and restrictions on how post deposits are invested have recently been lifted. Thus, there is an opportunity to enhance postal payments and savings products, while at the same time using this distribution and IT infrastructure for credit extension.

Box 2: Status of Islamic Finance in Egypt

Islamic financial services (IFS) are expanding worldwide. More than 200 Islamic financial institutions reportedly have in excess of $200 billion in total assets. Some expect Islamic finance to attract 40 percent of the total savings of the Muslim population worldwide. Currently Islamic financial services have a significant presence—in addition to GCC countries—in Malaysia, Indonesia, and Pakistan, and are emerging in a number of non-Muslim countries. To capitalize on the potential, a number of global financial institutions—including Citibank, HSBC, Goldman Sachs, BNP-Paribas and UBS—have established *Shariah*-compatible services. Capital market instruments are also developing, mainly in the form of *Sukuks,* with outstanding issues of about $40 billion; and insurance products in the form of *Takaful* are gaining ground.

Egypt pioneered Islamic finance with the 1963 establishment of Mitghamr Savings Association. Notwithstanding its early start and Egypt's large, predominantly Muslim population, Islamic financial services have limited penetration, with only three major fully Islamic financial institutions (IFI) and some Islamic windows at conventional banks. Assets of full fledged IFIs were about 3 percent of total banking assets at the end of 2004. The limited penetration of IFIs is in part due to the collapse of Islamic Investment Companies (IIC) in the 1980s, which contributed to skepticism towards institutions operating with an Islamic finance label and led depositors to shift their accounts to Islamic windows of conventional banks.[1]

Faysal Islamic Bank is the largest Islamic bank in Egypt today, followed by the Islamic International Bank of Investment and Development and the Egyptian Saudi Finance Bank. These banks have formal Shariah Boards to assess *Shariah* compliance. Islamic banks are under the same regulatory framework as conventional banks—with requisite adjustments made for reporting and compliance requirements—and are under the purview of the Central Bank of Egypt.

In general, like most IFIs elsewhere, assets are predominantly allocated to financing trade and services activities, as these provide generally higher returns and have short maturities. The share of agriculture and industrial sectors is small.[2] Hard data on Islamic activities of conventional banks are less readily available. Bank Misr was the first conventional bank to set up an Islamic branch, and has a dominant position in deposit mobilization. At the end of the 1990s, there were some 62 Islamic branches of 23 conventional banks. It is estimated that the Islamic banking sections of the four largest state banks account for more than 10 percent of total deposits.[3]

Despite a growing network of branches, the local Islamic finance sector still lags behind regional and international growth because of the underdeveloped services they offer. This is especially so in the capital markets and insurance sectors. Hermes EFG and Faisal Islamic bank launched the first, and still only, Egyptian Islamic fund in October 2004, which only invests in *Shariah*-compliant companies. *Shariah*-compliant insurance services are not commonly available, with the exception of the Islamic Arab Insurance Company, which offers its services in Egypt through its local subsidiary Saudi Insurance House. *Sukuk* (Islamic) bonds have not yet made a noticeable appearance in Egypt's financial markets.

[1] IIC grew spectacularly, accumulating billions of dollars in deposits. Dividends distributed by IIC were more than double those offered by conventional banks. IICs were not subject to supervision or regulation until some IICs' large losses gold and foreign-currency speculation became known.

[2] Mahmoud Mohieldin (1997), p. 13.

[3] Islamic branches do not have a board of religious scholars to verify the banks' operations and assure their compliance with Islamic law in

[13] 2,400 postal outlets have indirect electronic access via phone line, and 600 are not connected at all.

3. Performance of Banks

Compared to their private counterparts, state-owned banks lag in efficiency and in performance generally, as evident in their financial indicators.[14] State-owned banks are undercapitalized (Figure 9), and suffer from poor asset quality and high non-performing loans (NPLs). The incentive for these banks to identify and resolve problem loans before they become non-performing, maximize profits, or even minimize losses barely exists, as reflected in their relatively low profit margins, high operating costs, and inadequate risk-management systems. Being backed by the Government and protected from closure on constitutional grounds, they are not subject to the same level of strict banking supervision, making them more inclined to roll over and "evergreen" loans.

State-owned banks have also been slow to modernize and innovate. The volume and scope of products and services these banks offer to the market has been limited. Past heavy public-sector control and restriction of competition has led to lethargy among these banks. In the past, most lending was toward a few large private corporations and large public-sector projects. Lending to the private sector was based on "relationship" or "name" lending, and mostly to major suppliers or contractors for the public sector. This type of lending has led to substantial NPLs and has hindered resource-allocation efficiency. State-owned banks have been trying to adjust their operations and become profitable and efficient business entities in a short period. However, the restructuring of non-performing assets is distracting management from lending.

Analyzing banks by performance and differences in capital adequacy, asset quality, NPLs, management soundness indicators, earnings, and profitability sheds light on which banks have been able to increase their loans in a sustainable manner. Analysis (Box 3) shows that Egyptian banks with more focus and more capital are more profitable, and that private banks outperform state-owned banks. Analysis which compares the size of banks' loan portfolios to their funding capacity, shows large private and foreign banks are best able to increase lending to the private sector in a sustainable manner in Egypt.

a. Capital adequacy

The average capital adequacy ratio of banks in Egypt is low compared to other developing countries facing similar risks. Capital is vital for ensuring soundness for a banking system, since it acts as a cushion against shocks, allowing banks to absorb losses and continue honoring claims. The amount of capital that a bank should hold depends primarily on the riskiness of its assets. Hence, banks with unsophisticated risk-management systems should maintain much higher capitalization levels.

The Central Bank, Banking and Money Law 88, issued in 2003, significantly raised minimum capital requirements.[15] As a result, there have been several mergers, acquisitions, and revoking

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[14] There are two main limitations regarding the data used. First, available data is not very accurate, as some banks indulge in practices such as "window dressing". Second, aggregation of bank data can potentially conceal problems by offsetting positive and negative signals from individual banks. Deterioration in individual banks may not be apparent in aggregate data. Still, despite limitations associated with data quality and aggregation, these micro-prudential ratios can give a rough indication of areas of vulnerabilities and weaknesses in the banking system .

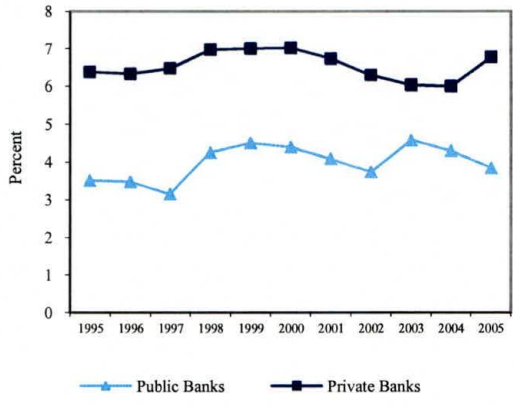
[15] Minimum capital requirement increased from LE 100 million for domestic banks and US$ 15 million for branches of foreign banks to LE 500 million and US$ 50 million respectively. Banks were supposed to meet these requirements within one year, which was extended to a maximum of three years at the discretion of the central bank.

of licenses of non-compliant private and foreign banks. However, state-owned banks in Egypt still suffer from a low capital adequacy. The equity-to-assets ratio—a proxy for capital adequacy—shows that state-owned banks averaged at 4 percent in 2006, as opposed to 7 percent for private banks, indicating that the former are undercapitalized and less resilient to shocks (Figure 2.9).

b. Asset quality

The quality of banking-system assets is adversely affected by the substantial NPLs from previous periods. The NPLs-to-total loans ratio rose from 11.7 percent in 1999 to 16 percent in 2003, and to 22 percent in 2005.[16] Were strict past-due and loan-classification criteria applied and rolling-over of loans taken into account, NPLs would be even higher.[17] It is estimated that around 63 percent of NPLs are to SOEs.

Figure 9: Equity-to-Assets Ratios of Banks in Egypt



This large volume of NPLs is the result of previous directed lending to loss-making SOEs, government-led initiatives (including mega projects), and connected lending to private enterprises. Although many SOEs were highly leveraged and over indebted,[18] state-owned banks continued to extend loans; more than 91 percent of claims on SOEs are owed to state-owned banks. Private-sector NPLs were mainly generated during the credit boom of the mid-1990s, when many loans were allocated to connected and well-known business executives. Rapid credit expansion stretched the capacity of banks to carefully screen borrowers, especially as credit officers were not well equipped to analyze the feasibility and viability of the proposed projects. The situation was aggravated by the deteriorating macroeconomic environment of the late 1990s, which led to an increase in the number of companies declaring bankruptcy. Many private-sector defaulters fled the country, leaving behind large bank loans that went unpaid.

The Government is making efforts to address the state-owned banks' NPLs. A scheme was outlined in late 2005, with resources from privatization proceeds earmarked to this effect.[19] Under Law 88 of 2003, state-owned banks are requested to follow stringent lending policies, and since 2002, state-owned banks have stopped lending to non-viable and defaulting SOEs. Accordingly, new NPLs at state-owned banks should be much reduced.

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[16] These figures are from the General Department for the Compilation of the Banking Credit Risk, as of the end of the fiscal year (June 30th).

[17] The actual level of NPLs is expected to be higher if strict loan classification criteria were applied, and if rolling-over of loans is taken into account. A large portion of the loans is in the form of overdraft facilities that are not categorized as nonperforming, and hence the past-due classification has not accurately captured NPLs. It is also worth noting that a sizable number of NPLs have been restructured, some of which under very concessional terms. These may represent hidden weaknesses in the banks' portfolios.

[18] SOEs' indebtedness increased from around LE 24.9 billion in 2002 to LE 28.6 billion in 2005.

[19] Within that framework, all of Bank of Alexandria SOEs' NPLs, amounting to LE 6.9 billion, were settled in cash in February 2006. Settlement agreements of 46 percent of private-sector NPLs in state-owned banks have been developed; with total collection amounting to 12 percent of these NPLs.

Box 3: Bank Performance Analysis by Size and Ownership

Financial data for a bank can tell a great deal about its efficiency in financial intermediation. Because most banks in Egypt are not listed, accounting data must be used to measure bank performance; specifically the ratio of operating income-to-total assets. Analysis controls for the diversity of income streams (fees versus non-fee income) and includes several other bank-specific variables, including bank-specific measures of bank ownership. All bank-specific data are from Bankscope, a commercial database of financial information on most large banks around the world. Analysis for this study uses data for the period 2001 to 2004.

One basic conclusion is that banks in Egypt with more focus are more profitable, controlling for the fact that banks that generate more interest income tend to be more profitable. This is consistent with the notion that agency conflicts from engaging in multiple activities destroy value. Banks should focus on their area of expertise, be it making loans or underwriting securities. Also, more highly capitalized banks (as measured by the ratio of equity to total assets) are more profitable; this is consistent with the notion that higher-quality banks are both able to amass more capital over time and generate higher profits. This also suggests that some banks with relatively low levels of capital may be taking excessive risks that are not paying off in higher profits.

In terms of the effects of ownership and type of specialization on bank performance, foreign-owned banks outperform domestically owned private banks, and both types outperform state banks. This suggests that opening the market to foreign entry could increase bank performance by increasing competition and improving incentives, consistent with the findings of a large cross-country empirical literature on this topic. Data do not indicate any difference in performance across different types of banks, such as commercial banks, investment banks, Islamic banks, or specialized government credit banks. Bigger banks, as measured by total operating income, and more highly capitalized banks, however, do extend relatively more loans. This suggests that there are economies of scale, arguing for increased consolidation of the banking sector in Egypt. At the same time, banks with relatively more deposits, which tend to be the cheapest source of funding for banks, extend relatively fewer loans, independent of bank ownership, suggesting that not having to compete for deposits creates incentives for easy forms of financial intermediation, such as lending to the Government and large corporations, leaving smaller borrowers without access to lending.

The portfolio of private banks today is, on aggregate, of better quality compared to state-owned banks, as shown by the lower ratio of NPLs and the smaller share of lending to loss-making SOEs. Reflecting their better credit-screening mechanisms, private banks have been mainly involved with viable public-sector institutions and large national and multinational corporations. They have also adjusted faster to the tighter regulations; in fact, most of them were already following prudent lending policies.

b. Management soundness indicators and staffing

Management indicators, such as expense ratios and earnings per employee, show that on aggregate the banking system is not operating efficiently, as it suffers from high operating costs and low earnings. This is largely due to a distorted incentive system, poor governance structure, and the dominance of state ownership. State-owned banks are, in general, characterized by weak internal governance, overstaffing, and lack of performance incentives. Employees of state-owned banks are treated as civil servants in terms of job guarantee and salary scale, which reduces their performance incentives and leads to overstaffing. Managers of state-owned banks have few incentives to innovate or to identify problem loans at an early stage.

Disparities between private and state-owned banks in Egypt due to variations in management performance show up in performance measures. Inefficiency from overstaffing in state-owned

banks shows in the relatively low (and declining) earnings-per-employee ratio (Table 6). Private banks offer their staff better compensation packages. Although this increases staff costs, leading to a higher expense ratio for private banks compared to state-owned banks in some recent years, (Table 7), private banks have also been investing more in innovation and introducing new financial instruments. The higher revenues and larger profits that result from these investments tend to offset higher staff costs. With the 2002 launch of banking-sector reform and the change in management, especially of state-owned banks, there has been a declining trend for expense ratios of both state-owned banks and private banks, reflecting higher efficiency levels.

Table 6: Earnings per Employee of Banks in Egypt *(LE million)*

	State-Owned Banks	Private Banks
1998	16.32	22.79
1999	18.35	25.21
2000	20.82	28.49
2001	20.45	28.98
2002	19.81	29.14
2003	18.98	29.87
2004	18.91	29.87
2005	18.88	29.97

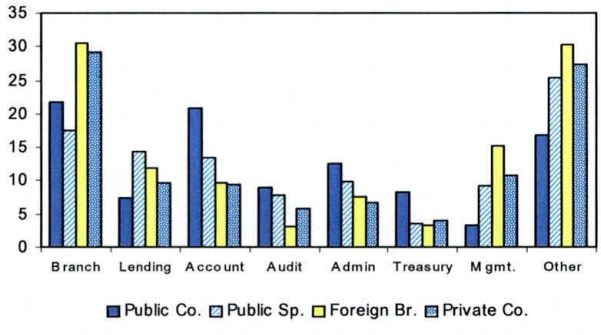
Table 7: Expense Ratio* of Banks in Egypt *(in percent)*

	State-Owned Banks	Private Banks
1998	75.99	67.41
1999	78.78	73.72
2000	82.99	81.78
2001	84.02	87.65
2002	86.23	89.66
2003	83.31	87.43
2004	81.88	80.32
2005	77.16	78.70

* Calculated as the ratio of expenses-to-total revenue.
Source: CBE, Supervision Department.

More than 75 percent of the banking sector's income comes from interest earned, compared to 50 percent for the average bank in a developing country. While new products are being introduced, most loan products are quite basic, generally straight lending with fixed interest rates.[20] Fees and commissions and treasury earnings are not significant sources of revenues, primarily because of a lack of diversification in products (hedging, forwards, factoring or export receivables, discounting under letters of credits, structured investment banking products are not being offered) and limited other services. Recent increases in ATMs and credit/debit cards as well as retail lending suggest, however, that banks will see an increase in income from fees and commissions in the future.

Figure 10: Distribution of Staff in the Egyptian Banking System



Source: World Bank Individual Banks Survey (2006).

While there have been recent efforts to improve efficiency through increased automation, staff breakdown (Figure 10) shows that public banks have more staff in back-office activities than private and foreign banks, as their accounting is not fully automated, lowering efficiency. Moreover, the lack of skills and sophistication in the banking sector, especially in

[20] All banks provide trade-finance facilities, letters of guarantees, notes discounting, overdrafts, syndications, club deals, project finance and local- and foreign-currency loans. Forwards on foreign exchange are limited to specific trade transactions by the regulations of the CBE.

state-owned banks, has led to a narrow range of products and services. While all banks indicate that they are active in credit marketing through the use of media and staff, most banks (16 of the 35) say they will not recruit new staff in the credit and lending areas.[21] Thus the retooling of banks' staff will take considerable time.

d. Profitability indicators

Figure 11: Return on Assets of Egyptian Banks

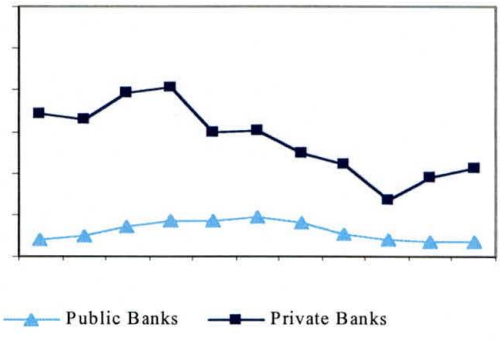
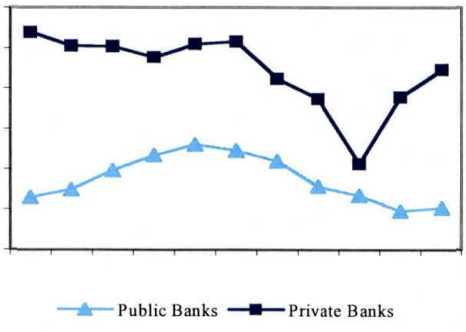


Figure 12: Return on Equity of Egyptian Banks



Profitability indicators put banks operating in Egypt at a modest level compared to other developing countries. This is largely due to the poor performance of state-owned banks; returns-on-assets and returns-on-equity are much higher for private banks (Figure 11 and 12).[22] To a large extent, the poor performance of state-owned banks can be attributed to sizable additions in recent years to loan-loss provisions. But it also reflects their continued inefficient allocation of funds and weak financial intermediation.

Overall, the indicators demonstrate that private banks perform better than state-owned banks. Data reveal several areas of deficiencies in state-owned banks, including a relatively low capital-adequacy ratio, poor quality of banks' assets, high ratio of non-performing loans, and modest earnings and profitability.

4. Poor Credit Policies and Practices

Many banks in Egypt are accustomed to lending to select state-owned enterprises or private corporations on a relationship basis, with little regard for credit policies and procedures. The stock of NPLs shows that many banks have done a poor job in lending to the public sector and other large corporations. Data also show that banks have not been very active in allocating resources to retail clients and SMEs (Table 8). This is especially so for state-owned banks, although they are better suited to lend to SMEs given their large and low-cost deposit bases and their extensive branch networks. The big four state banks mainly lend to large corporations, while the smaller, specialized state-owned banks, followed by foreign banks, are more active in

[21] Two out of the four public commercial banks have indicated a need for credit officers, which could be due to their privatization plans.

[22] Return-on-assets of the four state-owned banks ranged between 0.5 percent and 0.2 percent during the period 2000 to 2005, while that for private and joint-venture banks ranged between 1.1 percent and 1.5 percent. Similarly, state-owned banks' return-on-equity ranged between 9.8 percent and 4.0 percent, against 20.6 percent and 17.8 percent for state-owned banks (Annex, Table A.8 and A.9).

lending to SMEs. Foreign banks also reach out more than other types of banks to retail clients, possibly taking advantage of their superior credit-scoring skills.

A further sign of weak credit skills is that most banks consider the standard CBE credit guidelines to be sufficient, with only a few banks requiring additional information from borrowers. Furthermore, no bank has internal exposure limits by sector or type of borrower. Another sign of weak skills is that despite complaints about the poor quality of financial information provided, very few banks—public or private—require periodic financial statements (in addition to the required annual ones) from borrowers. And three out of the four state-owned banks and several joint-venture banks do not conduct an independent annual risk asset review.

Also, most banks price loans on a client-by-client basis, suggesting lack of standard products and poorly functioning asset-liability management and internal pricing mechanisms. Nearly all banks have centralized credit decision-making structures, partly as a reaction to past problem-loan experiences, but presumably also due to a lack of branch staff skills—although banks did not indicate a need for skill-building. Few banks conduct sufficient market and sector analysis to establish a solid growth strategy and target new markets.

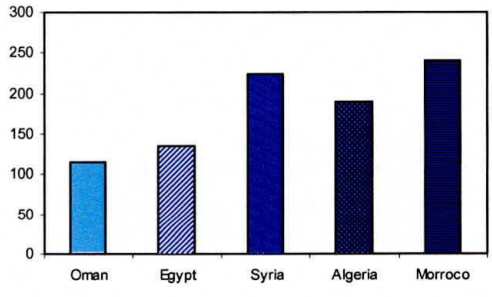
Table 8: Main Reasons for not Lending to SMEs* in Egypt

	Public Commercial Banks.	Public Specialized Banks	Foreign Branches	Joint venture banks & Private Banks	Total
Lack of proper financials	3	4.67	4.57	4.56	5
Poor audit quality of financials	3	4.5	4.05	4.06	4.5
Low banking experience of the SMEs	3	2.5	3.09	3.03	3.5
Poor financial skills of SME management	3.67	3.67	3.45	3.57	4
Preference of SMEs to use supplier credit	2	1.83	2.38	2.29	2.75
Lack of collateral	4	3	3.73	3.71	4.5
Unwillingness to provide collateral	4	2.67	4.18	3.89	4
Poor quality of collateral	3.67	2.67	3.64	3.57	4.5
Non-liquid collateral	3	2.5	3.64	3.4	3.5
Your bank's internal exposure limits	2.5	2.67	3.41	3.03	2.5
Your bank's lack of experience in SME lending	2	2.67	2.5	2.4	2
High cost of SME loan portfolio processing	1.5	2.5	2.9	2.59	1.75
High cost of registering collateral	1.5	2.83	3.14	2.94	1.5
Limited branch network of bank to reach SMEs	1.5	2.67	2.14	2.17	1.5

*Rank is 5-Most important, 4-Important, 3-Good to have, 2-Not important, 1-Not an issue.
Source: World Bank Individual Banks Survey, (2006).

Another sign of Egypt's poorly functioning credit market is unfavorable lending terms: collateral requirements are very high (an average of 123 percent of the loan value; even higher for SMEs). Collateral requirements as a percentage of loan value are as high as most other MENA countries (Figure 13), but above those observed in many developing countries. Usually banks resort to over-collateralizing when there are problems associated with foreclosure and loan recovery procedures. Moreover, since banks in Egypt have been operating under directed lending for some years, they are not

Figure 13: Collateral Requirements as a Percent of Loan Values



Source: Egypt, ICA (2005).

trained to base their credit decision on cash-flows, and require more collateral.

Another sign of weak operational efficiency is the response time to set up credit lines for a new borrower meeting all requirements. This varies from 20 to 24 days for corporate borrowers, 17 days for SMEs, and 10 days for individuals. These response times—excluding setting up collateral requirements and registering the collateral—suggest low internal credit-approval limits, lack of competition, and overall inefficiency. Response time is particularly high for the large four public banks, which have the weakest skills.

Lending is not limited by pricing, as rates vary greatly according to "what the market bears". Corporate-sector loans to the top 400 corporations in Egypt are charged 9 to 11 percent per year, whereas middle-market borrowers pay around 14 to 16 percent, and SMEs around 22 to 28 percent (Table 8). In addition to lending rates, private commercial banks and foreign branches charge between 1 and 5 percent for fees on loans, plus around 0.3 to 1 percent on collateral value for evaluation.[23] While interest rates follow government borrowing costs as a benchmark, there is not a proper yield curve to help price risks in the longer market. And the lack of foreign-currency hedging instruments leads banks to being overly cautious and charging high margins in foreign-currency lending.

Spreads between lending and deposit interest rates are consequently high, up to 10 percentage points. These spreads reflect the need for high provisioning as well as inefficiency in the banking sector, due to overstaffing and the required return on shareholders' equity. The high spreads also reflect that the lending market is supply-driven: banks take advantage of the lack of competition or collude in keeping spreads high. Only in lending to large corporations do all banks indicate much competition.

Table 9: Lending Rates for Local Currency of Banks Operating in Egypt *(percent)*

	15 Days	Short Term	Medium Term	Long Term
Public Sector				
Median	12	12.25	12.25	13
Maximum	12	13	13	14
Foreign Branch				
Median	6	12	14	15
Maximum	12	19.6	17.70	17
Private and Joint Venture Banks				
Median	13.5	13	13.5	13.75
Maximum	18	18.05	18.05	19

Source: World Bank, Individual Banks Survey, (2006).

5. Corporate Governance in the State-Owned Banks

Certain corporate-governance practices in state-owned banks deviate from internationally accepted good practice in several important respects (Box 4). The deviations mainly involve the fragmentation of the ownership function and the

[23] There is also a 1 percent registration charge for mortgages.

Box 4: Weaknesses in Corporate Governance in Egyptian State-Owned Banks

First, with respect to ***ownership***, the principal deviations are that responsibility for the conduct of the ownership function is fragmented, resulting in a loss of accountability. In particular, since the General Assembly does not have the power to appoint or dismiss board members, its ability to hold the board accountable is significantly diminished. (Moreover, it is unclear to whom, in practice, the General Assembly is accountable.) This lack of clear accountability, and the corollary potential inability of the fragmented ownership function to hold the board (and, indirectly, executive management) accountable, are a significant impediment to effectively exercising the Government's ownership rights, particularly when the Government wishes to assert its ownership rights for the purpose, for example, of pursuing its access agenda.

Second, the current arrangements impose ***significant potential conflicts of interest*** on the CBE (the monetary authority and bank regulator). With the Governor of the CBE chairing the banks' General Assemblies, and the Bank Restructuring Unit (BRU) within the CBE guiding the restructuring of the banks, the CBE is exercising considerable ownership functions (and, to some extent, board functions). This creates potentially serious conflicts of interest with respect to CBE's bank-regulation and monetary-policy responsibilities. For example, the ability of bank regulators to effectively exercise their responsibilities is undermined when their superior, the Governor, plays an ownership role for a regulated bank.[24]

Third, the deviations with respect to the ***board***—although less not to public banks and Egypt—relate mainly to the potential dominance of the board by executive management.[25] The principal concern is that executive management may dominate the boards, which undermines their ability to evaluate management performance and hold management accountable. This concern is exacerbated by the fact that the top executive managers are, in effect, appointed by the Prime Minister. A consequence commonly seen in state banks in other countries is that management is able to function in a relatively autonomous manner. In Egypt this may further diminish the ability for the Government to guide the banks to incorporate access-related objectives into their business strategies.

potential for dominance of the board by executive management, both of which undermine the ability of the Government to hold the board and executive management accountable. The deviations also involve a failure to separate government ownership from government regulatory functions, which creates conflicts of interest that can undermine the effectiveness of both functions. While these deviations may be expedient in the current situation and will likely persist over time (for example, as incumbents change), they impede the ability of the Government to effectively exercise its ownership rights.

6. Constraints on Household Access to Financial Services

As in other countries, demand-side factors—such as education—tend to dominate in explaining the use of financial services. Yet analysis also suggests that use is driven by supply-side factors. The importance of supply factors can be easily summarized through the importance of proximity to a bank or postal branch for access.[26] Urban households located within 15 minutes of a bank

[24] It can also give rise to claims of an unfair environment with respect to the regulation of private banks.

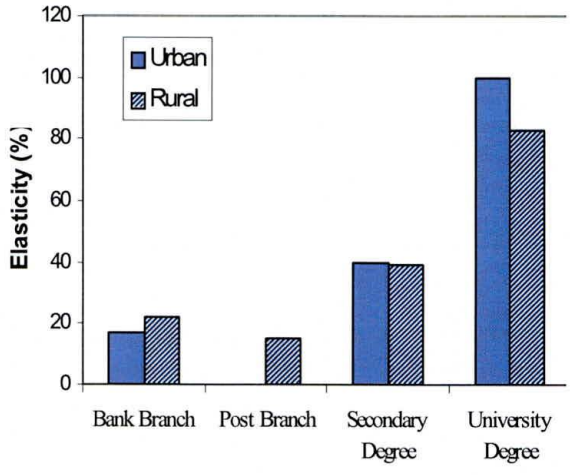
[25] In general terms, the principal responsibilities of a board of a state bank are i) to help formulate, approve, and monitor the bank's strategy, in the context of objectives defined by the owner; ii) to approve key policies; iii) to ensure a functioning system of internal financial and operational controls; iv) to establish performance indicators and benchmarks; v) to monitor disclosure and public communications processes to ensure that financial statements and other disclosures fairly present the bank's performance, financial condition, business, and risks; vi) to evaluate executive-management performance and hold management accountable; and vii) to develop a succession plan for executive managers.

[26] We acknowledge that these associations are not necessarily causal, and thus can be taken as an upper bound on the effects of expanding branch networks to unserved areas.

branch are 14 percent more likely to have formal savings or investments (Figure 14). The effects for rural households are even larger, with those located close to a bank ranch being 22 percent more likely to have access to financing, and those close to a postal branch being 10 percent more likely.

At the same time, the analysis confirms the importance of demand factors, including education, income, and gender. The effects of supply factors are dwarfed by those for demand-side variables, particularly education. Households headed by an individual with a primary or secondary school degree are almost 40 percent more likely to use financial services than those headed by individuals with no formal degree (Figure 2.13). Those headed by someone with a university or graduate degree are 99 percent more likely to use formal financial services in urban areas and 80 percent more likely in rural areas.

Figure 14: Marginal Effects of Branching and Education on Access to Financial Services in Egypt



Source: Egyptian Household Survey of Income and Expenditure (2005).

C. Access to Microfinancial Services[27]

Besides the many households with unmet demand for financial services, a conservative estimate suggests there were at least 2 million microenterprises in Egypt in 2006, accounting for 93.7 percent of establishments. In principle, microfinance offers a means of addressing the demand of households' and small firms' access to financial services. Microfinance institutions, however, often do not have the necessary scale. While no formal aggregate estimates are available, it is estimated that the outreach of the microfinance industry in Egypt covers only about 10 percent of potential borrowers.[28]

1. Main Players in Microfinance in Egypt

A few banks have been active in providing microfinance in Egypt, with some banks having established microfinance units within their institutions over the past decade (Box 2.6). There are four main banks engaged in microfinance, which extend credit using their own resources, or in their capacity as loan-managers either on behalf of donors or, more typically, on behalf of the Social fund for Development (SFD). While state-owned banks are engaged in microfinance, most private banks still do not make funds available to microenterprises, as they tend to perceive microfinance as too risky or as a developmental function that should be reserved to the

[27] Microfinance services aim at providing support to low-income groups operating small-scale income-generation projects and businesses by overcoming one of the main obstacles faced by poor people around the world: insufficient access to credit and other financial services. The formal financial system often perceives the poor as "un-bankable", due to their lack of collateral, small loan sizes, and low potential for repayment. Without access to formal financial services, the poor must often resort to borrowing from moneylenders at exorbitant interest rates; or participate in local rotating savings and credit circles. These informal financial services are often very costly, risky, and inconvenient.

[28] UNDP (2006).

Government, SFD, and non-governmental organizations (NGOs) (Box 6). The formal financial sector in general lacks familiarity with the specificity of microfinance and the particular needs of clients seeking microfinance.

Box 5: State Owned Banks Actively Involved in Microfinance in Egypt

National Bank for Development (NBD) is a private commercial bank that started the first microfinance unit in Egypt in 1987 from donors' grants. This unit became profitable and contributed approximately 25 percent of NBD's annual profit. Since 1997, it has relied on its own resources. It had an outstanding balance by 2000 of about LE 70 million, serving about 23,000 clients. Over the life of the program about 300,000 clients have been served, with total loans of LE 800 million. In addition to microfinance units in all of its 44 branches, NBD has mobile lending units to reach remote areas. Until 2000, the maximum loan size was LE 10,000, which was reduced to LE 3,000 in June 2003. For loans between LE 250 and LE 3,000 and for tenor of two months to one year, no collateral is required other than the presentation of an identity card. Credit decisions are based on the viability of the enterprise and its cash flow. NBD only provides credit to existing firms, not start-ups. Clients qualifying for amounts exceeding LE 3,000 are referred to NBD's corporate branches. NBD charges a flat interest rate of 16 percent plus a number of administrative and insurance fees, which can increase the total charges up to 30 percent. Moreover, NBD requires the borrower to deposit an amount equal to 10 percent of the loan in a savings account with accrued interest of 8 percent, which may be used for early loan repayment. Loan officers are paid in accordance with a performance-based reward system. The repayment rate is 96 percent. NBD's success can be attributed to careful evaluation of clients, close monitoring with on-site visits, weakly collection of installments, monetary incentive schemes for loan officers, and in-house enforcement units.

Banque du Caire and Banque Misr are the second- and third-largest state-owned commercial banks, with a network of 400 branches and 120 branches respectively. In 2001, Banque du Caire embarked on a strategy to downscale its institution-building to service small and microenterprises, capitalizing on the outreach of its large branch network. More than 107 of its braches have a microfinance unit. Banque du Caire is drawing on a trust fund of US$ 8.2 million at the Credit Guarantee Corporation (CGC) for the purpose of full credit-risk coverage of small and micro borrowers. The lending policy follows the graduation principle, whereby micro borrowers would initially be granted a loan of LE 1,000 and, subject to proper loan servicing, receive increased loan amounts of up to LE 3,000. The lending rate is 16 percent, flat amounting to around 30 percent. Banque du Caire has established best-practice microfinance standards within its institution. The outstanding loan portfolio stands at LE 270 million as of June 2006, and there are 117,000 active borrowers. Banque Misr, which began microlending in September of 2003 with microfinance units in 13 of its branches, had 17,000 active borrowers as of June 2006. The decision to merge Banque du Caire with Bank Misr would leave the merged bank with 120 branches with microfinance units, and 117,000 active borrowers.

Principal Bank for Development and Agricultural Credit (PBDAC) was established in 1930 as a specialized bank for rural finance. Today PBDAC covers the country with its extensive branch network in the form of 18 governorate banks, 1,016 village banks, and 312 satellite offices. PBDAC provides micro loans from LE 500 to LE 3,000, with terms from one to five years. Loans targeting agriculture are collateralized by land. PBDAC has a decentralized system for loan approval; the director of the village bank has the authority to extend loans up to LE 100,000. The director of the branch may approve loans up to LE 300,000. More than 90 percent of the loan portfolio is loans below LE 100,000. Repayment rates, however, have been below 90 percent.

SFD was established in the early 1990s to combat the adverse consequences of economic restructuring and liberalization. It is the largest national program, accounting for some 74 percent of total government credit programs aimed at small and micro firms. Its funds are mainly channeled through NGOs and banks, which earn a spread over the rate paid to SDF. The average loan size is about LE 1,500, the average maturity is one year, and the cost of loans to NGOs varies from 5 to 7 percent. Loans do not require collateral, but some group-lending

programs require group guarantees. Micro-loans extended over the last 10 years total about LE 121 million to 92,000 borrowers; there are currently about 70,000 outstanding borrowers.

The SFD manages a separate microfinance and SME unit, the Small Enterprise Development Organization (SEDO). SEDO is the largest division of the SFD and distributed about LE 1.5 billion in loans by 2000. SEDO extends loans to banks at fixed low interest rates, and banks are allowed to charge a spread of about 3 to 4 percent. The ceiling imposed on the spread tends to undermine the sustainability of this model and slows its growth. Banks get around this problem by imposing miscellaneous additional charges. Still, this program is not sustainable without government and donor inflows. In June 2004, with the issuance of the Small and Medium Enterprise Law 141, the SFD was assigned the responsibility of overall coordinator of micro and SME finance, and in setting the development strategy of the small and microenterprise sector in Egypt. This law also gave the SFD the mandate to provide low-cost financing using its own funds, government appropriations, and donor grants. Consequently, the SFD provides loan capital and operational subsidies to a variety of finance institutions, primarily banks that retail credit to end borrowers. MicroStart Project was initiated by UNDP in partnership with the SFD under its job-creation program. Micro-Start aims to improve access to appropriate services offered by local organizations to enhance the poor's informal economic activities, increase their revenues, and create employment. MicroStart provides grants to three microfinance NGOs in the El Fayoum Governorate, and the NGOs in turn charge their borrowers between 8 and 16 percent. The objective is to build these NGOs up into viable financial institutions.

Box 6: NGOs Are Key Players in Microfinance in Egypt

A large number of NGOs use grants and donations, and act as financial intermediaries for micro and small enterprises. The main funding sources of NGOs are donors including USAID, Swiss Fund, CIDA, Danida, GTZ, the Ford Foundation, Catholic Relief Services, UNICEF, UNFPA, and the ILO, amounting to more than 71 percent of the total. Credit programs, which started as an activity of NGOs in the late 1980s, have increased considerably and have become an important activity of community-based organizations in the 1990s in both rural and urban-poor communities. In addition to extending credit, programs provide technical training related to loan activity, upgrading existing businesses, starting new businesses, or improving the living environment, with the objective of alleviating poverty. The Egyptian Swiss Development Fund (ESDF) provides funds to income- and employment-generating projects, including microfinance projects. ESDF deals only with NGOs, which adopt their own interest-rate policy as long as they can prove their sustainability and participate by 10 percent of the total value of the project from their own or community resources. Organizations with focused small and/or micro credit programs are few, but include the Alexandria Business Association; the Association for the Development & Enhancement of Women; Street Food Vendors Associations; and the Ford Foundation. Both the NGO Support Center and CARE support microfinance programs through community based organizations in various governorates, in addition to providing technical assistance to community organizations and business associations.

CGC is a joint-stock company established by nine major banks to provide credit guarantees to SMEs without the collateral to obtain loans from banks. By guaranteeing a portion of loans made by banks, CGC effectively reduces required collateral, one of the main impediments to SMEs' access to finance. The CGC has an agreement with more than 55 banks to provide guarantees, and loans guaranteed range from LE 20,000 to LE 14 million. Total loans guaranteed amount to about LE 1 billion, for 19,000 clients. The CGC guarantees up to 100

percent of the loan amount for a fee of 0.5 percent of the amount up to LE 100,000, and 1 percent for larger loans. CGC also has several microfinance programs. Banks must approve potential borrowers before CGC issues a guarantee. In case of default, CGC covers any guaranteed funds after banks attempt all possible legal actions against the defaulting customer. To date, only about 8 percent of the total guarantees on defaulted loans have been partially or fully paid by CGC. This low percentage is in part due to lengthy court proceedings, because banks are required to take all possible legal actions before guaranteed funds can be released. Of course, this scheme also creates a disincentive for banks to collect on loans.

The Cooperative Insurance Society for Small Enterprises (CIS) is another organization that offers guarantee facilities. It was established by the SFD in 1999, and serves as a credit insurance facility to small and microenterprises.

2. Challenges Facing the Microfinance Industry

The large unmet demand for microfinance is due to both demand and supply problems. On the demand side, potential clients do not know what services are available and which are appropriate to their needs. On the supply side, microfinance units within banks and NGOs operate within defined loan brackets, catering to specific segments. Microfinance products and services are limited to conventional forms (individual and solidarity group lending), while alternative credit and savings products remain largely unused. Although many NGOs have successfully addressed some of the credit needs of microenterprises and poor households, they lack the institutional capacity to expand beyond their local communities. There is also a lack of skills among credit officers and NGOs in extending loans to microenterprises.[29] Furthermore, most micro-lending activities are largely donor-dependent, as they extend credit at subsidized interest rates and are not based on cost-recovery.

Although state-owned and private banks offer savings accounts, the National Postal Authority remains the dominant provider of micro-savings due to its extensive outreach, and its low-cost, simple application procedures. State-owned companies remain the main providers of insurance services. While some of their products are affordable for microenterprises and micro-consumers, in general products are neither designed nor marketed to meet the needs of the micro sector.

The development of the microfinance industry also lacks a supportive regulatory and legal framework, access to reliable information, adequate geographic coverage, and coordination among various stakeholders. Legal, regulatory, and institutional barriers include the conflicting policies and measures adopted by the line ministries and governorates engaged in microfinance, and the general absence of a common and shared understanding of the sector. The absence of information on creditworthiness and credit history is one of the main impediments facing the industry. The credit registry at CBE has a floor of LE 30,000, on current credits, and any loan below is not recorded (a planned private credit bureau is expected to address this deficiency). There is a sub-database of accounts more than 90 days past due and/or with legal proceedings initiated. The large majority of MFI lending occurs in the non-bank sector, which means most MFI loans are not reported to the CBE Registry.

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[29] Recently, CGAP, in cooperation with the regional network for microfinance institutions (SANABEL), has started offering training on some microfinance management and operational topics, including operational risk management, financial analyses, accounting, and product development.

Another legal constraint is that NGOs are not allowed to collect deposits under Law 84 of 2002 and cannot access commercial funds from banks and/or private investors.[30] At the same time, they cannot meet the capital requirements to establish themselves as banks, curtailing their ability to develop and introduce innovative approaches. Furthermore, NGOs experience significant delays when seeking obligatory approvals from the Ministry of Insurance and Social Affairs for the use of grant funds and loans from donor agencies and international organizations.

Until recently, there has been a lack of coordination among various stakeholders (government, non-government and donor organizations), minimizing benefits to the industry. There have been instances of duplication of efforts by various microfinance institutions in the same governorates. In some governorates, little is done to encourage microfinance-institution interventions, despite unmet demand. In other governorates there has been a too-strong bias towards urban areas. Although Law 141 of 2004 addresses this lack of coordination, it is still not fully enforced.

3. The National Strategy for Microfinance

The National Strategy for Microfinance, endorsed in December 2005, attempts to address these legal, regulatory, and institutional barriers hindering NGO microfinance activities. The strategy is based on the premise that the commercialization of the microfinance industry promotes competitiveness and continued innovation, thus redirecting the sector's trajectory from subsidy-based to market-induced. It aims to build an inclusive financial system that provides all the types of financial services needed by the poor. The banking system in Egypt will play a crucial role in this strategy, particularly through its large branch network. However, microfinance is considered a high-risk activity.[31] As a consequence, to date there is segmentation, with loans above LE 500,000 usually provided by the banking sector, and those below often provided through NGOs. Still, experiences in Egypt and elsewhere show that microfinance can be scaled up and made effective through the banking system.

CONCLUDING REMARKS

The financial-sector reform program and changes in the business environment have rejuvenated banks in recent years. Banks are improving credit policies and procedures while provisioning for past problem loans; upgrading their banking services; widening available lending products to the non-corporate sector; and diversifying products as the regulatory framework adjusts to the new environment. Banks are being privatized and the banking system is consolidating rapidly; this is leading to opportunities for greater economies of scale, which can lower the cost of financial intermediation.

However, the sector as a whole is still underperforming: the quality of financial intermediation is poor, costs are high, non-performing loans remain large, and access for households and small firms to financial services is limited. These deficiencies are primarily due to limited competition and a reluctance to change the status quo of significant state-ownership, leading to weak incentives and poor governance. Underlying these problems is a still weakly developed and tested institutional infrastructure for lending and financial intermediation.

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[30] NGOs are regulated by the Ministry of Insurance and Social Affairs, and governed under Law 84 of 2002.
[31] Kheir El-Din, El-Leithy and Tabbala (1999).

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