Financial Development and Inclusive Growth

Executive Summary

Attaining Shared and Sustainable Prosperity in Egypt

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Middle East and North Africa
Finance and Private Sector Development

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A Study Led By Sahar Nasr

THE WORLD BANK

Forward

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

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

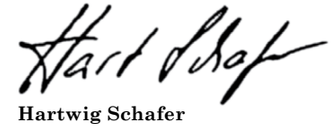
effectively seek out the best investments, efficiently mobilize resources to fund those investments, and carefully scrutinize the use of those funds by firms and individuals, this tends to accelerate economic development, alleviate poverty, and reduce income inequality. The greater the degree that financial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

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

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

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

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



Hartwig Schafer

Country Director
Egypt, Yemen and Djibouti
The World Bank Group

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The Egypt Financial Development and Inclusive Growth report was prepared by a team led by Sahar Nasr, Program Leader; and comprised of Asli Demirgüç-Kunt, Director, Development Economics and Chief Economist (Financial Development); Santiago Herrera, Lead Economist; Ahmed Kouchouk, Senior Economist; Karim Badr, Financial Economist (Macroeconomic Stability); Erik Feyen, Lead Financial Sector Economist (Financial Development); Ross Levine, Wilis H. Booth Chair in Banking and Finance, Haas School of Business (Financial Development); Catiana Garcia-Kilroy, Lead Securities Market Specialist (Non-Bank Financial Institutions); Anderson Caputo Silva, Lead Securities Market Specialist; Simon Walley, Housing Finance Program Coordinator (Egypt's Mortgage Market); James Hanson, Visiting Professor of Economics, Center for Development Economics, Williams College, Williamstown Mass (Banks Economic Growth); Thorsten Beck, Professor of Economics, Tilburg University, and Founding Chair of European Banking Center (Banks Economic Growth); Jonathan Katz, former Secretary of the U. S. Securities and Exchange Commission (Capital Market Regulation and Economic Growth); Nabil Hashad, Former Chair, Arab Center for Financial and Banking Studies and Consulting (Islamic Finance); Monal Abdel Baki, Research Professor, Durban University of Technology; Rodney Lester, Insurance Sector Expert (Insurance and Pensions); Bahaa Ali El Dean, Attorney-at-Law, Arab Legal Consultants (Financial Sector Integrity); Henri Lorie, Financial Economist (Legal Framework); Hoda Youssef, Research Fellow, Woodrow Wilson School of International and Public Affairs of Princeton University (Macroeconomic Stability); Laila

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Executive Summary

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

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

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

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

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

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

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

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

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

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

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

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

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

Egypt's fiscal situation has been deteriorating sharply since 2010 due to weak real growth, adoption of populist measures, and the lack of corrective actions. The overall budget deficit reached 13.7 percent of GDP in 2013, up from 11 percent a year earlier. However, fiscal aggregates are likely to temporarily improve in 2014, mainly due to the exceptional Gulf aid packages, and the one-off transfer of government deposit worth Egyptian Pounds (LE) 30 billion from the Central Bank of Egypt (CBE) to the Treasury. Actual figures for the first nine months of 2014 indicate a lower overall deficit of 7 percent of the year's projected GDP compared to a deficit worth 10 percent a year earlier.

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

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

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The Financial Sector Reform Program

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

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

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The Egyptian authorities launched in 2004, a two-phase financial sector reform program aiming at enhancing the stability and soundness of the system, which would be increasingly private sector-led, able to contribute more effectively to Egypt's growth performance. Phase I (2004–2008) focused mainly on reforming the banking sector, restructuring the insurance and pension systems; strengthening the capital markets, developing the almost non-existent mortgage finance market, as well as, strengthening the regulatory and supervisory frameworks governing the financial sector. Phase II (2009–2012) focused more on enhancing access to finance, and building a more inclusive and competitive system. It aimed at improving financial intermediation after achieving stability under the previous phase. The ambitious reform program of the financial sector launched in 2004 witnessed smooth implementation driven by the benign international economic conditions in addition to commitment from the Egyptian authorities, and the relative political stability witnessed during those years as opposed to Phase II of the reform program, which was interrupted significantly at its early stages with the January 25th, 2011 revolution.

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

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

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

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

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

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

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

Developments and Challenges in the Banking Sector

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

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

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

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

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

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

Development of the Non-bank Financial Sector

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

Equity Market. On the non-bank front, and in specific for the capital markets, the authorities established two funds (i) Investor Protection Fund, which insures investors against any illegal activity by brokerage companies such as fraud, trading without investors consent; however, it does not cover any losses arising from normal trading activities; and (ii) the Settlement Guarantee Fund that ensures the timely settlement for any transaction conducted through the Egyptian Exchange (EGX) in case any party defaulted on the transaction. This ensured less defaults for any stock market transaction and timely settlement of all transactions however, neither greater financial system credit to investment in the private sector nor greater access to finance occurred.

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

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

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

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

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

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

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

Although certain regulatory hurdles could be improved, limited market development has been caused by two structural bottlenecks: the dominance of banks as the main funding source at relatively low rates because of excess liquidity, and the need to consolidate government bond markets as a price reference in the long end of the yield curve.

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

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

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

Although the Egyptian insurance sector was opened to foreign competition in 1998, it did not include the necessary supervisory capacity building; development of the necessary supporting infrastructure; and the installation of management in the state owned insurers capable of operating in a competitive market place.

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

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

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

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

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

The mortgage market remains relatively underdevelopment, mainly due to the

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

Despite the financial leasing industry's relative cumulative growth and the favorable developments in the market since the issuance of Law 95 of 1995, leasing remains relatively small and underutilized in Egypt.

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

In order for the leasing industry to reach its potential and develop further, a number of short-term measures need to be considered.

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

In order for the leasing industry to reach its potential and develop further, a number of short-term measures need to be considered.

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

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

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

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

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

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

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

Financial Sector Integrity and Economic Growth

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

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

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

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

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

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Financial Institutional Infrastructure

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

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

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

The prevailing legal framework constrains the cost and terms of finance. Some laws are poorly written, especially those regarding secured transactions, bankruptcy, and settlement of disputes
The prevailing legal framework constrains the cost and terms of finance. Some laws are poorly written, especially those regarding secured transactions, bankruptcy, and settlement of disputes.

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

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

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

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

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

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

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

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

Macroeconomic and Financial Stability

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

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

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

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

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

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