Prudential Regulation in Egypt

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Abstract

The rapid liberalization of Egypt's financial sector demands maintaining the safety and stability of the banking system through prudential regulation. The justification for prudential regulation stems from the shortcomings of laissez-faire banking. Prudential policy generally seeks to prevent systemic risk, minimize financial instability, and ensure that financial intermediaries are adequately capitalized and professionally managed.

Revolutionary changes in banking services and practices have, however, revived concerns about the adequacy of prudential regulation. Juxtaposing the Egyptian situation with comparable world practice and experience brings to light the significant regulatory weaknesses of the Egyptian system. Understanding these weaknesses and their causes requires knowledge of the basic concepts underlying prudential measures, their classification, rationale and place in the changing world environment.

The authors clarify these points and address in particular the failure of Islamic Investment Companies (IICs) in Egypt in the 1980s, limits on the scope of bank activities, the regulation of multinational banking, capital adequacy and liquidity requirements, provisioning and information disclosure, the lender-of-last-resort function of the Central Bank of Egypt, and the deposit insurance scheme.

ملخص

يتطلب التحرير السريع للقطاع المالى فى مصر ضرورة المحافظة على سلامة وثبات واستقرار النظام المصرفى عن طريق لوائح وتشريعات حكيمة وحذرة. وينبع الاحتياج لمثل هذه اللوائح والتشريعات الحذرة من عيوب نظام الحرية المطلقة — Laissez-faire — للنظام المصرفى. والسياسة الحذرة تهدف بصفة عامة إلى منع حدوث المخاطر من ذات النظام، وتخفيض عدم الاستقرار المالى إلى الحد الأدنى، وضمان توفير رأس المال الكافى والإدارة الفنية لمؤسسات الوساطة المالية.

على أن التغيرات فى الخدمات والإجراءات المصرفية أدت إلى إثارة المخاوف حول مدى كفاية اللوائح والتشريعات الحذرة. وتؤدى مقارنة الوضع فى مصر بتجارب وخبرات الدول الأخرى إلى إظهار بعض جوانب الضعف التشريعية فى النظام المصرى. ويتطلب فهم هذه الجوانب الضعيفة وجود قدر من المعرفة بالمبادىء والأفكار الأساسية التى تقوم على أساسها هذه الإجراءات الحذرة، وتقسيماتها، والمنطق من وراءها، وموضعها فى البيئة الدولية التى تتغير باستمرار.

ويوضح مؤلفو الدراسة تلك النقاط، ويتناولون بشكل خاص بحث ظاهرة فشل شركات الاستثمار الإسلامية فى مصر فى خلال الثمانينيات، والحدود الموضوعة على مدى النشاط المصرفى، وتنظيم البنوك متعددة الجنسيات، وكفاية رأس المال ومتطلبات السيولة، وعمل المخصصات والإفصاح عن البيانات، ودور البنك المركزى المصرى كمقرض أخير، ونظام التأمين على الودائع.

I. Introduction

Prudential regulation is the broad term given to a wide range of supervisory measures which aim to reduce the risk of bank failure and maintain the safety and stability of the banking system. The importance of prudential regulation stems from the notion of 'systemic risk' — the fear that one particular bank's failure may affect the public's confidence in other banks, leading to widespread withdrawals and possibly to the collapse of the whole banking system (commonly termed as 'bank runs').[1]

Prudential regulation, through its impact on innovation, market practices and transaction costs has a far-reaching effect on the efficiency of the financial system. It differs from country to country depending on the overall legal structure, social background, political circumstances and economic system. But, in general, a prudential policy seeks to prevent systematic risk, minimize financial instability, and ensure that financial intermediaries are adequately capitalized and professionally managed.[2]

In financially repressed economies, prudential guidelines and the quality of supervision are at times sacrificed in order to channel loanable funds to priority projects and to fund fiscal deficit. In such circumstances, conflicting goals may impede prudential measures and the role of prudential policy may be ill defined which, in turn, impairs the safety and soundness of the banking system.[3] But as banking sectors all over the world are gradually moving towards liberalization and away from direct interference by regulatory authorities, prudential measures have acquired a particular and increasing prominence.

The justification of prudential regulation stems from the shortcomings associated with free banking. Laissez-faire banking[4] can not provide a stable monetary framework or a sound financial system. There are two arguments often given to justify the regulation of the financial sector in general and the banking system in particular.

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[1] On the economic aspects of prudential regulation, see Dewatripont and Tirole (1994).

[2] Polizatto (1990) p. 1 and World Bank (1992) p. 13.

[3] As indicated by Greenspan (1996), "The precise meaning of soundness has always been tenuous and ill-defined. This is why judgment has been, and will continue to be, a critical component of prudential supervision. " But he also accepts that the "technology and techniques which banks have developed, and are developing, allow us to greatly improve that judgment by constructing measures of soundness in probability terms. "

[4] On the case of central banks and their role, see Goodhart (1991).

First, it is argued that banks are inherently unstable and subject to interruption and failure.[5] Bank failures may generate externalities in the form of additional losses borne by the economic system as a whole. This requires either the intervention of the central bank as a lender of last resort or the establishment of a deposit insurance scheme, or both. Nevertheless, such intervention may encourage banks to get involved in riskier operations — the so-called moral hazard risk — which in turn requires further intervention through bank monitoring and the reduction of excessive risk.[6]

Second, the banking industry is based on the acquisition of greater knowledge in a way that enables bankers to know more about the markets in which they operate than do customers. In such cases of asymmetric information, conflicts of interest can frequently occur because separating the functions of bankers and customers is expensive due to the existence of high transaction costs. The customer has little power to assess the qualifications and monitor the performance of the professional banker. Regulatory control is therefore necessary.[7]

This paper deals with prudential regulation in Egypt by reviewing the classification of prudential measures and discussing certain theoretical considerations. It also discusses the financial rise of Egypt's Islamic companies in the 1980s, followed by a detailed discussion of the prudential regulation of banks in Egypt. In particular, the paper analyses the nature of prudential regulation, restrictions on the scope of banking activities, the regulation of multinational banks, capital adequacy and liquidity requirements, and provisioning and information disclosure. It reviews the lender-of-last-resort function of the Central Bank of Egypt and the deposit insurance scheme. The paper proceeds by highlighting certain problems and challenges that face banking regulators in Egypt. The concluding remarks emphasize the challenges associated with the potential increase in capital inflows.

II. Classification of Prudential Measures

The term 'prudential' is often used in a narrow sense, referring to a number of guidelines concerning a bank's capital adequacy and liquidity. Its meaning is expanded here to include all measures dealing with banking safety and stability and

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[5] Park (1991) pp. 334-335.

[6] Goodhart (1989) pp. 194-195 and pp. 203-204.

[7] Ibid., p. 195 and p. 207.

which are here classified as 'preventive' and 'protective' prudential measures.[8] According to this classification, preventive regulation encompasses a number of measures designed to reduce risk-taking by banks in order to minimize the possibility of crises. Protective measures, on the other hand, provide support and rescue to banks and depositors once a problem or a crisis has occurred, especially when such a crisis threatens to implicate other financial institutions and markets.

It is useful to note that preventive and protective measures are not completely independent of one another. The existence of protective measures may significantly strengthen depositors' confidence in the banking system and may act as a preventive consideration. On the other hand, the excessive comfort and moral hazard risk which results from generous protective measures may induce banks and depositors alike to take bigger risks, therefore increasing the need for tight preventive supervision. The following are some of the main prudential measures known to bank regulators around the world.

Preventive Measures

Restrictions on Scope of Activity

This prudential measure is concerned with whether banks should combine commercial banking and securities activities or whether the two roles should be performed by different institutions.[9] The debate has largely centered around the US 1933 Glass-Steagall Act which separated commercial and investment banks. But whereas such separation was adopted in the United States and to a lesser extent in Japan, European countries have tended to adopt the German model of universal banking. In Egypt, the system that currently exists may generally be described as one which is closer to the universal banking model, although not in its absolute form.

Allocation of Regulatory Responsibility

The allocation of regulatory responsibility among international regulators is a prudential measure which seeks to reduce the risk of multinational banks using complex global corporate structures in order to avoid domestic regulation. It is a relatively recent area of prudential regulation, based on cooperation between regulators from different countries, and has been the consequence of the growth of

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[8] For details of the distinction between preventive and protective regulation, see Dale (1984) pp. 55-68.

[9] On the issue of universal versus segregated banking, see Dale (1992) and Benston (1990).

multinational banking over the last three decades.[10] The relation between the growth of multinational banking and the rising global concern and cooperation in the area of prudential regulation is due to two reasons. First, multinational banks by virtue of their complex structures represent a challenge to national regulators who may be able to conduct adequate local supervision but who have difficulty assessing the global position of such banks. Second, the imposition of tight prudential rules may have adverse effects on bank profitability, at least in the short term, and hence on the competitiveness of the market where such rules are imposed. National banking regulators are therefore reluctant to impose restrictions unless assured that competing banking centers around the world would follow suit. The so-called flight of banks to soft-regulated systems has become particularly important with the rise in number and importance of developing and emerging markets.

Since the early 1970s, the problems of regulating multinational banks were brought to the attention of world regulators by a series of banking crises which led to an unprecedented cooperation in international regulation. The 1973 Secondary Banking Crisis in the United Kingdom, followed by the 1974 Bankhaus Herstatt Crisis in Germany, were early signs of the interdependence of national banking and financial systems and the need to adopt a new outlook to international cooperation in banking regulation.[11] This culminated in the establishment of the Committee on Banking Regulations and Supervisory Practices in 1975 (more recently renamed the Basle Committee on Banking Supervision) by the G-10 countries under the administrative auspices of the Bank for International Settlements in Basle, Switzerland.

The Committee's work in this area produced two major documents: the 1975 and the 1983 Basle Concordats. Both Concordats were based on the following three principles: (a) the need for contact and cooperation between host and parent supervisory authorities; (b) the need to ensure that no foreign banking establishment escapes supervision; and (c) the need for adequate supervision, judged by the standards of both host and parent authorities. In promoting these broad principles, the report makes two distinctions: one between three types of foreign banking establishments — branches, subsidiaries and joint ventures — and the other between three areas of prudential supervision — liquidity, solvency and foreign currency

[10] Gardener (1991) p. 99.

[11] On the reasons and consequences of both crises, see Hall (1993) pp. 6-9 and Freeland (1994) pp. 231-240.

positions. The report then recommends an allocation of regulatory responsibilities based on these two distinctions.[12]

Capital Adequacy Requirements

Capital adequacy — once described as “the most important, single element within bank supervisory (or prudential regulatory) systems”[13] — is usually assessed as a ratio of capital to total assets, where the assets are weighted in terms of the risk they carry. It is a measure of the financial soundness of the bank, and its capacity to meet future, often unexpected, demands. The 1988 Basle Report is the main effort undertaken by international regulators in regulating capital standards. It was the corner stone of an effort to introduce international guidelines for prudent lending following the 1980s debt crisis. Its principal objective was to improve international banks’ capital strength, as well as the market perception about them, by setting minimum capital adequacy standards which member countries would gradually introduce, provided that they would fully implement them by 31 December 1992.

The core of the report’s recommendations is that bank regulators in countries which have adopted it should, by the end of 1992, impose a minimum risk asset ratio of 8 percent on all internationally active banks under their supervision. This ratio is derived by expressing the adjusted capital base as a percentage of the total weighted risk assets.[14]

Protective Measures

Protective prudential measures maintain the stability of a banking system by providing support and rescue to banks when a crisis occurs, especially if it is felt that the crisis may be contagious and threaten the stability of other institutions or of the whole banking system. There are two major protective prudential measures. The first is the lender-of-last-resort function of the central bank, which protects depositors by providing rescue funds, not to them directly but rather by rescuing the banks

[12] The report recommends that liquidity should be the concern of the host supervisory authority. Solvency, however, should be supervised by the host supervisory authority in the case of subsidiaries and joint ventures, but by the parent authority in the case of branches. Foreign currency positions, on the other hand, should follow the same rule as solvency if the purpose of such supervision is prudential. But if the foreign currency supervision is pertinent to economic policy considerations then it should be the concern of the host authority. It should be noted that this allocation of responsibility is based on which regulator would have the primary, but not the exclusive, responsibility, and therefore does not preclude cooperation between regulators.

[13] Gardener (1994) p. 193.

[14] Maximilian Hall (1993a) p. 188.

themselves. The second is the deposit insurance scheme which ensures depositors that their money will be refunded, either wholly or partially or up to a certain amount per depositor, if the bank where such funds are deposited fails to repay on demand. Both types of protective prudential measures raise serious considerations about how much they actually encourage moral hazard. As noted by Greenspan (1996), "deposit insurance, …by changing the terms under which banks deal with their creditors, distorts the signals and incentives that banks receive from the market, creating a substantial potential for excessive risk-taking by banks. In response, bank regulators have been forced to try to minimize this moral hazard that, in the absence of the safety net, the market itself would police."[15]

Table 1 compares implicit and explicit insurance schemes. Under implicit deposit insurance schemes, the government is not obliged by law to protect deposits and the extent of coverage is left to its discretion. It has been argued, however, that a "well-functioning 'explicit' deposit insurance scheme is likely to produce faster, smoother, and more predictable resolutions of failing bank situations than an implicit system."[16] It may therefore be appropriate to convert implicit deposit protection schemes to explicit schemes. But on the other hand, explicit insurance is more costly than the implicit scheme. Explicit insurance requires the establishment of a separate institution, with its own management and staff, thereby raising operating costs for monitoring banks and managing their funds. The explicit deposits insurance scheme may create a moral hazard problem[17] and banks might be involved in riskier operations, which require further monitoring. It may also discourage clients from trying to distinguish between a weak and a sound bank since both are covered by the same insurance scheme.[18]

An Egyptian Financial Crisis

Revolutionary changes in banking services and practices, associated with incidents such as Barings in England and Daiwa in Japan, have revived concerns about the adequacy of prudential regulation.[19] Even before these two individual incidents

[15] Greenspan (1996) p. 2.

[16] Mas and Talley (1990) p. 44.

[17] It has been argued that deposit insurance was largely responsible for the frequent collapses of the S&L Institutions in the United States where many seek to reform such schemes. See Jaff (1989) and White (1989).

[18] For further discussion of the problems of deposit insurance and possible solutions, see Dybvig (1993) and Flood (1993).

[19] Hoenig (1996) p. 5.

Table 1. A Comparison between Implicit and Explicit Insurance Schemes

Feature	Implicit Schemes	Explicit Schemes
Existence of governing rules and procedures	No	Yes
Obligation to protect depositors	No, at the discretion of the government	Yes, up to a certain limit
Amount of protection	Varies from no protection to full protection	Varies from limited protection to full protection
Contribution to initial capital of the scheme	No	Yes
Regular payments to the scheme	No	Yes

Source: Adapted from Talley and Mas (1992) p. 326, Table 11.2.

occurred, examples of recent system-wide problems in banking thrive from the Southern Cone to Scandinavia.[20] In Japan, the financial system was estimated to hold $500 billion in bad loans in 1992.[21] The United States in the 1980s witnessed 1300 commercial bank failures in addition to the Savings and Loans crisis which is presumed to cost $1,000 per inhabitant.[22]

Egypt's own most spectacular financial crisis occurred during the 1980s as a result of the collapse of Islamic Investment Companies. The so-called Islamic Investment Companies (IICs) grew in a spectacular manner during the 1980s.[23] The estimated number of these companies was 105 at the end of 1988. The exact number of these institutions, like the size of their deposits and the number of their depositors, has

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[20] For an account and discussion of bank insolvencies and crises, see Caprio and Klingebiel (1996) and Sundararajan and Balino (1991).

[21] Tirole (1994) p. 470.

[22] Ibid., and Caprio and Klingebiel (1996) pp. 19-20.

[23] The first Islamic Investment Company was *Al-Sharif*. It was established in 1958 but did not go public until 1978, when it announced that it would open the door for the public to invest in the enlargement of the company's operations with promises of high returns in the form of dividends according to Islamic principles.

never been agreed upon. But with the official number of depositors at 502,826 and a dependency ratio in Egypt of 5.6, almost 3 million people were affected directly by the activities of the IICs. Total deposits held with the IICs are estimated at £E3.8 billion in 1988 — 7.8 percent of GDP, the equivalent of 17 percent of public commercial bank deposits and approximately 10 percent of total banking sector deposits.[24] Most of these deposits were collected in less than three years, from 1985 to 1988.

IICs emerged in a financially repressed environment with, effectively, a non-functioning capital market and a malfunctioning banking sector. Potential investors faced several bureaucratic, legislative, and regulatory difficulties when dealing with conventional institutions. In such circumstances, a significant number of potential savers and investors preferred to deal with these new companies due to the higher rates of return which they were offering in a seemingly placid way.

The experience of IICs revolves around two main arguments[25] which explain the reasons behind financial dualism and the existence of the informal financial sector. The first argument considers the informal financial sector a response to the imperfections and weaknesses of the repressed formal sector. The tight regulation of financial intermediaries and various restrictions imposed on their activities forced potential savers and investors to find other instruments of savings and sources of credit outside the formal sector.

The second argument states that the existence of the informal financial sector can be explained by an inherent dualism in the economic and social structure of the whole society. Regardless of the condition of the formal sector, the informal sector would flourish as long as a significant part of the population is still attached to traditional values and religious views — for example, opinions concerning *riba* or usury.[26]

The case of the IICs suggests a combination of these two arguments. On one hand, they support Goodhart's law[27] by being the unregulated substitute for a heavily

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[24] The figures of deposits and depositors are those published by the offices of the Attorney General and the Socialist Attorney after the collapse of the IICs in June 1988.

[25] See Germidis (1990) and Kitchen (1986).

[26] *Riba* is a generic term which stands literally for all kinds of excesses above the value of a thing. The technical meaning for *riba* is the premium, regardless how small or large, which must be paid by a borrower to a lender in addition to the principal as a condition for a loan or for an extension of its maturity. Generally speaking all forms of predetermined fixed return related to the size and length of a loan, regardless of its purpose, are considered by Muslim scholars as *riba* although this has been and continues to be a source of heated debate. See Choudhury and Malik (1992) and Chapra (1985).

[27] See Goodhart (1984) p. 96.

regulated formal financial sector. On the other hand, they appeared as institutions working according to the dominating religious and traditional values. This clearly supports the second argument — an argument largely neglected by conventional financial intermediaries and not utilized effectively by formal Islamic banks.

A question arises: What sort of activities enabled the IICs to pay their depositors 24 percent per annum on deposits in local and foreign currencies? A pyramid scheme[28] is the plausible explanation for the high rate of distributed profits of IICs.[29] O'Connell and Zeldes (1988) define a 'rational' pyramid scheme as "a sequence of loan market transactions with positive net present value to the borrower." According to the pyramid scheme, cash payments on debts (deposits) are met mainly by increasing the amount of outstanding debt through fresh borrowing. Debts are backed not by real assets but by future debts.[30]

Minsky (1986) argues that speculation and pyramid schemes are to a certain extent a recognized feature of the operations of many formal financial institutions. But speculation, in the words of Keynes (1949), may cause no damage like bubbles on a *steady* stream of enterprise. But the case of IICs was serious because they became "the bubble on a whirlpool of speculations."[31]

The recent history of financial fiascoes is full of examples of wide-scale pyramid schemes, from the Ponzi scandal in the early 1920s[32] in the United States, the MMM crash in Russia in 1994,[33] the Fortuna Alliance in the United States in 1996, to the Gjallica fund crisis in Albania in 1997.[34] In these incidents, as in the case of the IICs, there was misrepresentation and violation of implicit and explicit trust, using the expression of Kindleberger. In the three cases of Ponzi, MMM and IICs, there was heavy reliance on slick advertising campaigns, in which a seemingly genuine activity

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[28] Also known as Ponzi schemes, named after Charles Ponzi's financial ploy in 1919-20 in the United States. See Train (1985) pp. 11-16 for historical background.

[29] And indeed it is the explanation for the current high interest rate paid by the government on treasury bills in Egypt.

[30] See Minsky (1986) p. 206-214 and Kindleberger (1978) p. 79.

[31] Cited in Shafik (1989) p. 303.

[32] See Train (1985) pp. 11-16.

[33] On the MMM crisis, see the two issues of *The Economist*, dated 30/7/1994 and 10/9/1994.

[34] *The Economist* (30/1/1996) reported that the clients of this fund and other collapsing pyramid schemes were thought to number more than a third of the population of Albania. The Albanian president claimed that his government would compensate his compatriots but experts and western bankers said Albania could not afford to pay. The collapse of these funds resulted in riots and major political unrest.

appeared as a façade. In the case of Ponzi, it was arbitrage opportunities in international postal coupons; in the MMM case, it was the trade in privatization vouchers; and in case of the IICs, it was the establishment of holding companies involved in a variety of production and services activities which were used as a smoke screen.

The IICs enjoyed no supervision or regulation until the symptoms of problems appeared on the surface after immense losses of some IICs in speculating on gold and foreign currencies in the international markets in November 1986. This was followed by a series of similar problems and concluded with the international financial crisis on Black Monday in October 1987, marking the beginning of the fall of these companies. These problems along with others forced the government to intervene to regulate these companies.

The government, however, acted too late and did too little to reform the companies and help them adapt to the new rules. Its action might only have contributed to their early collapse as they were heavily regulated and effectively denied access to fresh capital. The case of the IICs accentuates the need for a prudential regulator and adequate supervision. It rejects the calls for complete deregulation of the financial system due to misunderstanding of liberalization or lenient monitoring under the notion of flexibility.

III. Bank Prudential Regulation in Egypt

The Nature of Regulation

Before discussing specific features of Egyptian bank regulation, it is necessary to analyze first the nature of the regulation undertaken by the Central Bank of Egypt (CBE) and its regulatory approach.

The CBE is vested with bank supervision, such as off-site monitoring and surveillance of bank performance, as well as on-site inspection of financial conditions. All operating banks are required to appoint two external auditors every financial year to examine the bank's accounts. Auditors report the degree of adequacy of the bank’s internal control system and the degree of adequacy of provisions to the CBE. The CBE may adopt a resolution to suspend the distribution of dividends to shareholders if any shortage in provisions is reported.[35]

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[35] Law No. 163 of 1957, Articles 25 and 26 as amended by Law No. 50 of 1984 and Law No. 37 of 1992.

State-owned banks are subject to further on-site monitoring by the Central Audit Organization (CAO) which coordinates its work with external auditors.[36] CBE's supervision is concerned with the degree of compliance with credit controls, tariff schedules, interest rate ceilings and, to a lesser extent, the assessment of bank solvency. CAO's supervision is more concerned with the compliance of the state-owned banks with the rules that govern the public sector as a whole, rather than with portfolio quality and related aspects of performance.

The authority of the CBE to regulate the banking sector in Egypt is derived from the explicit statement of banking legislation.[37] More specifically, the law states that the Board of Directors of the CBE has all powers and authority accorded to the Central Bank itself in accordance with the provisions of the law.[38] Furthermore, bank regulation laws stress that the CBE's Board of Directors has the authority to lay down rules for the regulation of commercial, specialized and investment banks.[39]

The Board of Directors of the CBE exercises this authority by issuing circulars either to individual banks or to all banks registered as the case may be. These circulars deal with issues which are neither dealt with by the bank regulation laws nor by their implementing decrees. But because these circulars derive their binding authority from the bank regulation laws and their accompanying decrees, they can neither contradict these laws and decrees nor legislate new rules which have no basis in them.

The legal provisions which are the basis for the binding force of these circulars and other forms of instructions issued by the CBE are the following: Article 34(a) of the 1957 law states that a bank may have its registration cancelled and its license withdrawn if it "... violated the provisions of this law [163 of 1957], the provisions of its implementing decree [currently 187 of 1993] or decisions taken by the Board of Directors of the Central Bank of Egypt.…"[40] Article 60(ii) of the same law further states that the Board of Directors may take other disciplinary action against the bank

[36] Law No. 144 of 1988.

[37] Law No. 163 of 1957, Article 1.

[38] Law No. 163 of 1957, Articles 2 and 6.

[39] Law No. 163 of 1957, Articles 40 and 44, Law No. 120 of 1975, Article 20, respectively.

[40] Law No. 163 of 1957, Article 34(a) as amended by Law No. 50 of 1984.

which violates the law, the implementing decree, or the decisions taken by the Board of Directors of the Central Bank of Egypt.[41]

The circulars issued by the CBE, which convey decisions taken by the Board of Directors, are therefore accorded the same legal force as the law itself and its implementing decree. On a practical level, circulars issued by the CBE have recently acquired an even greater importance because they have addressed some of the most crucial aspects of banking regulation, particularly prudential measures and guidelines. The following is an account of the major prudential measures in Egyptian banking law and practice. These are classified as broad preventive measures — measures which deal with the general regulatory environment in which banks operate; specific preventive measures — measures which form the core of a prudential safety net; and finally protective prudential measures.

Broad Preventive Measures

Scope of Banking Activities

Currently, the banking structure consists of 81 banks of which 28 are commercial banks; 32 are investment and business banks, of which 21 are branches of foreign banks. This is in addition to 21 specialized banks, which include one industrial bank, two real estate, and 18 agricultural banks based in governorates, including the Principal Bank for Development and Agricultural Credit. Three banks are not registered with the CBE.[42]

Accordingly, there exists in Egyptian law three types of banks: commercial, specialized and investment banks. Commercial banks are defined as institutions which habitually accept deposits payable on demand or after a period not exceeding one year.[43] They are also prohibited from undertaking certain activities, of which the most relevant are:

- Dealing in movable and immovable property, except if such property is used by the bank for the conduct of its ordinary business (such as the bank premises), or if it accrues to it in settlement of a debt. In this case, the bank has to dispose of the movable property within a year, and of the immovable property within five years

[41] Law No. 163 of 1957, Article 60(ii), as amended by Law No. 50 of 1984 and Law No. 37 of 1992.

[42] These three banks are Arab International Bank, Nasser Social Bank and Chemical Bank.

[43] Law No. 163 of 1957, Article 38.

from the date that it accrues, unless authorized by the CBE to keep it for a longer period of time.

- Dealing in, or owning, shares which constitute the bank's capital, unless in debt settlement.
- Owning shares in a joint-stock company in excess of 40 percent of the company's paid-up capital or owning shares in different companies whose aggregate value exceeds the nominal value of the bank's paid-up capital and reserves.

The last two limits set in the law may be exceeded with permission from the Minister of Finance and Economy, on the basis of advice from the governor of the CBE.[44] Specialized banks as defined by the law: "banks whose main business is the financing of real estate, agriculture or industry, while the acceptance of demand deposits is not one of their basic activities."[45] The CBE lays down the rules governing the activities of these specialized banks, including the conditions for establishing companies and for issuing bonds.[46]

The third and last type of bank was introduced in 1975, the investment and business banks (not to be confused with investment or merchant banks). They are defined as banks which "carry out operations related to the pooling and promotion of savings for the sake of investment, in accordance with the economic development plans and the policies envisaging the fostering of the national economy. In this respect, such banks may establish investment companies or other companies exercising various types of economic activity. They may also undertake financing of Egypt's foreign trade operations."[47] This type of bank is not permitted to accept deposits as a habitual activity, and is not bound by any limit on its equity holding in companies.

It is clear from the above that banking in Egypt is neither based on a total separation of commercial and investment banking, nor on an unlimited combination of activities under the roof of universal banks. The Egyptian banking system is, generally

[44] Law No. 163 of 1957, Article 39.

[45] Law No. 163 of 1957, Article 43.

[46] Law No. 163 of 1957, Article 44.

[47] Law No. 120 of 1975, Article 17.

speaking, closer to the universal or gross banking model, but with a limited distinction between commercial and other banks.

But if this system has until now gone largely unchallenged, it is not due to its proven effectiveness, but rather to the traditional domination of the few public sector banks over the whole of the banking system, and the fact that the securities markets remained, until fairly recently, practically inoperative. But with the current efforts undertaken by the Egyptian government to deregulate the banking system, privatize public sector companies and encourage capital markets, Egyptian bank regulators will be faced with a new situation where the relationship between commercial banks and capital markets will need reconsideration.

Even now, and in spite of the fact that restrictions on the scope of banking activities are a major element in bank regulation law, such limitations have been less strict in practice than in law. On one hand, this is largely due to the powers accorded to the CBE in exempting banks from some of these restrictions. For example, there are numerous cases of commercial banks holding higher than 40 percent equity in various companies with authorization from the CBE. On the other hand, with the gradual reactivation of the securities markets since the early 1990s, commercial banks have been able to become significantly — albeit indirectly — involved in these markets. For example, through the ownership of 40 percent of brokerage firms, fund management companies and other companies are active in the securities trading, and the establishment of investment funds, again with authorization from the CBE.[48]

Regulation of Multinational Banks in Egypt

The regulation of multinational banks in Egypt is an issue which has been dominated not by the rules for the allocation of regulatory responsibilities, but by whether foreign banks should be allowed to operate or not. Moreover, if they are allowed to operate, then what restrictions, if any, should be imposed on their activities. This is not unusual for a developing country which is more concerned with the activities of multinational banks in its territories than with the activities of its own banks abroad, which are very limited.

[48] Law No. 59 of 1992, Article 41.

Foreign banks returned to Egypt in accordance with the provisions of the 1974 investment legislation.[49] Their status was further clarified in the 1975 banking legislation.[50] According to these provisions, foreign banks are permitted to operate in Egypt under one of the three following regimes, each with its own restrictions.

The first is that the foreign bank can participate in the establishment of a joint-venture Egyptian bank. Foreign participation, which was limited to a maximum of 49 percent, is currently unrestricted.[51]

The second is that the foreign bank can establish a wholly owned branch in Egypt. Such branches were, until 1992, forbidden from undertaking local currency operations, but are now allowed to conduct such operations with the approval of the Ministry of Economy and the CBE.[52]

The third is to open a representative office of the foreign bank in Egypt, but which can neither conduct operations in local currency nor any banking operations at all. The office's permitted scope of activity is the representation of foreign parent banks in the strictest sense.

But in terms of allocation of regulatory responsibility, and in spite of the importance accorded to this issue by leading world regulators, it has not been sufficiently dealt with in Egyptian law. The current regulations state the following requirements for allowing a foreign bank's branch to operate:

1. The foreign bank's branch has to show that its main office holds the nationality of a specific foreign country.[53]
2. The branch has to show that its main office is subject to the monetary supervision of the country where the main office is located.[54]
3. The capital of the foreign bank's branch should not be less than US$15 million, or the equivalent in other currencies. This requirement has to be fulfilled within four

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[49] Law No. 43 of 1974.

[50] Law No. 120 of 1975.

[51] Law No. 97 of 1996.

[52] Law No. 101 of 1993.

[53] Law No. 163 of 1957 for Banks and Credit, Article 21-1-c, as amended by Law No. 37 of 1992.

[54] Law No. 163 of 1957 for Banks and Credit, Article 21-1-c and Article 21(ii), as amended by Law No. 37 of 1992.

years from the date the 1992 legislation became operative — prior to 5 June 1996 — and in accordance with a schedule issued by the CBE.[55]

4. The branch of the foreign bank has to submit to the CBE a statement issued from its head office indicating its acceptance of any responsibilities pertaining to deposits made with the branch, to creditors' rights regarding that branch, and generally to any of the branch's other current or future obligations. The same statement should also include an undertaking by the head office to compensate the branch for any losses shown in the year's accounts within one month from the date that such accounts are approved by the branch's auditors.[56]

Thus the current banking legislation attempts to follow a combined approach whereby general supervision of the branch would remain the host country's responsibility. But the responsibility of maintaining its liquidity and safeguarding the rights of depositors is shifted to the parent country.

Regarding subsidiaries of foreign banks, the law is silent as to what rules will apply to such subsidiaries in terms of allocation of regulatory responsibility. The implication is that foreign subsidiaries are treated like any other Egyptian incorporated bank, with no special regard to their relationship with multinational banking groups. Finally, joint-venture banks are also considered to be ordinary banks incorporated in Egypt and registered with the CBE, thus subject to ordinary rules and regulations.

Specific Preventive Measures

Table 2 outlines the specific prudential measures instructed by the CBE since the start of the financial reform program in 1990/91.

Capital Adequacy

In most less developed countries (LDCs), banks are undercapitalized. Their capital therefore insufficiently meets actual and potential unusual losses.[57] There are two aspects of capital adequacy in the Egyptian case. First, the minimum capital volume required from banks to start business, and second, the minimum capital ratio required

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[55] Law No. 163 of 1957 for Banks and Credit, Article 21-3, as amended by Law No. 37 of 1992. It is worth noting here that the same law states that the authorized capital of Egyptian banks should not be less than £E100 million (about US$30 million), and the paid-up capital not less than £E50 million (about US$15 million).

[56] Presidential Decree No. 187 of 1993, for The Implementing Regulations of the Banks and Credit Law (No. 163 of 1957), Article 13.

[57] Polizatto (1990), op. cit., p. 4.

to support given levels of operations.[58] Regarding the first requirement normally referred to as the ‘entry requirement,’ the CBE imposes an initial capital requirement of £E100 million on banks as criteria for their authorization. This is considered

[58] See Morris (1990) p. 65.

Table 2. Specific Prudential Measures Adopted in Egypt

Prudential measure	**Description**	**Date of issuance of instructions**
Capital adequacy	In accordance with the Basle Accord, all banks operating in Egypt, except branches of foreign banks, are required to keep a risk ratio of 8 percent as a minimum.	January 1991
Liquidity requirements	Banks are required to maintain a liquidity ratio of 20 percent for local currency and 25 percent for foreign currencies.	December 1990
Asset classification and provisioning	Follows World Bank suggested guidelines concerning assets and contingent liability classifications and provisioning.	September 1991
Concentration limits (domestic)	A bank is prohibited from having claims against one client either in the form of credit facilities or ownership in the capital that exceed in total 30 percent of the bank's capital base.	April 1993
Concentration limits (international)	All banks operating in Egypt, except branches of foreign banks, are prohibited from depositing more than 40 percent of capital base or 10 percent of total investments abroad with one foreign correspondent.	November 1992
Foreign currency exposure limits	All banks are not allowed to maintain more than 10 percent of the capital base of a short and/or long-term position of any single currency. Also, the total short and/or long-term position of all currencies, including domestic currency, should not exceed 20 percent of the capital base.	September 1993

Source: Adapted from The Central Bank of Egypt's circulars and annual reports and World Bank (1993) pp. 12-25.

sufficient and comparable with international standards of US$15-30 million (approximately £E50-£E100 million). Considering the second requirement, Egyptian banks maintained capital adequacy ratios ranging between 6 and 7 percent of total assets — less than the Basle Committee standard (in 1988) of 8 percent of risk adjusted assets.

Following the implementation of the financial reform program in the early 1990s, the CBE issued a circular dated 31 January 1991. It informed banks under its supervision that they were to abide by the following capital adequacy timetable. Banks, which at the end of December 1990 already maintained the 8 percent ratio, were to keep it from then onwards. Banks with a ratio from 7 to 8 percent were to reach the required 8 percent ratio by 31 December 1992. Banks with a ratio from 6 to 7 percent were to reach it by 31 December 1993, and those below 6 percent were to reach it by end of December 1995.[59] Furthermore, the circular also provided banks with a method for calculating the capital adequacy ratio, including definitions of Tier I and Tier II capital,[60] risk assessment and other explanatory matters.

But in spite of this ambitious schedule designed to bring all banks within the 8 percent limit within five years, the delay until 1995 was deemed unacceptable because of its deviation from the Basle timetable. In April 1991, a new circular stated that banks below the ratio of 6 percent were now required to reach the 8 percent target ratio by end December 1993 rather than 1995, so that all Egyptian banks would reach the 8 percent limit by that date.[61] It has been recently announced that the ratio for the whole banking system is 10 percent for the end of June 1996, but this does not necessarily mean that all operating banks have complied with the capital adequacy rule.

Liquidity and Reserve Requirements

Banks in Egypt are required to hold a minimum of government securities as one of the components of the compulsory liquidity ratio. The liquidity ratio of 30 percent,

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[59] The Central Bank of Egypt, Circular No. 311 dated 31 January 1991, conveying a decision taken by the Board of Directors of The Central Bank of Egypt on 17 January 1991.

[60] Tier I capital includes stock issues and disclosed reserves without any limit. Tier II or supplementary capital includes perpetual securities, undisclosed reserves subordinated debt and redeemable shares at the option of the issuer. For further details, see Dewatripont and Tirole (1994) p. 50 and for a critical analysis and discussion of the prerequisites of application, see Dziobek, Frecaut and Nieto (1995).

[61] The Central Bank of Egypt, Circular No. 317 dated 21 April 1991, conveying a decision by the board of directors of the Central Bank of Egypt, dated 11 April 1991.

imposed on domestic and foreign currency deposits, was introduced in 1958 and did not change until 1991 when it was reduced to 20 percent as part of the reform program. Although the minimum liquidity ratio did not change over the 1960-1990 period and remained at 30 percent, the actual spread was highly variable and its average was 48.7 percent — there was an average of 18.7 percent excess liquidity during the last three decades. In some years, the actual liquidity was even more than double the minimum liquidity ratio.[62]

Excess liquidity in Egypt[63] can be attributed to several factors that support the arguments of the financial repression school regarding the adverse effects of government intervention on the competitiveness of the banking system. First, government securities and bonds are included in the components of the liquidity ratio, to the extent that they become major items in bank portfolios. Second, the rising usage of treasury bills by the government to finance its budget deficit especially when the foreign credit market became more restrictive. Banks are normally attracted to the risk-free treasury bills as they offer high, tax-free interest rates. Third, like high resort requirements, high liquidity ratios may reflect the monetary authority's concern over the low capitalization and insolvency of some of the operating banks. Authorities wish to return to this simple method, which in fact penalizes the solvent banks instead of requiring insolvent banks to improve their capital requirements and keep adequate provisions.[64] Fourth, excess liquidity in bank portfolios can be a reflection of an unstable economic environment and increasing perceived risk on the part of investors and banks. Fifth, excess liquidity may also reveal inefficiencies in the intermediation process that force banks to hold relatively high proportions of liquid assets.

The magnitude of reserve requirements indicates whether they are used for prudential purposes and as an instrument of monetary policy, or for generating income for the budget. In developed economies, the ratios of required reserves are much less than LDCs. For example, in the United States, on the first $42.2 million the reserve requirement is 3 percent. For amounts in excess of $42.2 the ratio is 10 percent. For Canadian chartered banks, the reserve requirement is 10 percent on demand deposits, though the monetary authority has been considering a policy to phase out reserve

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[62] CBE Annual Reports.

[63] For a discussion of the problem of excess liquidity in other LDCs, see Nissanke (1993).

[64] See World Bank (1992) p. 13.

requirements.[65] In the United Kingdom, the Bank of England imposes a reserve requirement ratio as low as 0.35 percent of deposits to finance its operations.[66]

The use of reserve requirements in Egypt against banks liabilities goes beyond their traditional role as a monetary instrument and a prudential measure. Reserve requirements were imposed on both local and foreign currency deposits in the form of reserve balances with the CBE. While required reserves on the former are not remunerated, on the latter they are at LIBOR. The required reserve ratio was set by the CBE at a relatively low level in 1960 at 12.5 percent. In 1962, it was increased to 17.5 percent of deposits. During the period between 1966 and 1978, it became 20 percent and reached its highest level of 25 percent during the period between 1979 and 1990. Under the financial reform program, it was reduced to 15 percent.

Reserve requirements have been used to control the quantity of money and credit, affect the liquidity of the banking system, tax financial intermediaries, and most importantly generate revenues to finance budget deficit.[67] High reserve requirements decrease loanable funds available for investment by reducing the fraction of given volumes of deposits and by reducing the equilibrium volume of deposits through decreasing the profit-maximizing deposit rate.[68] They are therefore considered a leakage in the intermediation process.[69] Depending on the elasticities of the demand for deposits and for loans, the bank can pass part, or all, of the tax burden to depositors and borrowers in the form of a bigger spread between rates of deposit and lending.

Loan Provisioning

Provisioning creates discipline in bank operations and helps reflect their true financial conditions. There are two forms of provisions: general provisions and specific provisions. Under general provisions it is assumed that even the highest quality loans in the bank's portfolio may incur some loss, hence a small percentage of total loans is held by the bank. Specific provisions can be classified into four categories: current,

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[65] Champ and Freeman (1994) p. 121.

[66] See Hardy (1993) p. 10.

[67] See Morris et al. (1990) pp. 44-45.

[68] See Fry (1988) p. 108 and Courakis (1987) p. 150.

[69] Only under special characteristics of the demand and supply for assets and liabilities of banks, as shown in Courakis's (1984) partial equilibrium model, the adverse effect of reserve requirements on the volume of deposits may not hold.

substandard, doubtful and lost loans. Accordingly, specific provisions range between zero percent in the case of current loans to 100 percent in the case of lost loans.[70]

Banks in most LDCs fail to make realistic provisions to cover possible losses according to the classification of loans. As a result, their balance sheets do not reflect their actual positions, and profits are exaggerated and their solvency may be at stake.[71] It is difficult in the case of Egypt to know how serious the issue of solvency is, since information on the non-performing loans and soundness of loan portfolios are not published.

Until 1992, banks did not apply international standards on their loan classification, possibly to avoid provisioning for public sector non-performing loans. The application of adequate classification and provisioning of loans still needs to be accompanied by an improvement in the functioning of the legal framework concerning bankruptcy procedures, liquidation of collateral and debt recovery.[72]

Information Disclosure

Publishing an adequate level of information is necessary for depositors and borrowers to distinguish between bank performance and facilitate their scrutiny by relevant authorities and bodies, such as rating agencies. Egyptian banks are generally reluctant to disclose information beyond what they supply in their annual reports. Such reports are not uniform in the information they provide, which makes comparisons difficult.

Some banks publish only balance sheets without income statements, which makes it difficult to determine their financial condition and whether they incurred a profit or a loss. Banks faced with difficulties delay the publication of their annual reports and/or hide essential information in fear that the disclosure of unfavorable information might lead to a deposit run and/or may deny them the ability to raise fresh funds.

If banks are to work according to market forces and competition, then their actual and potential clients should be able to choose rationally between them. This necessitates disclosure of adequate information on their activities.[73] Bank reports in Egypt do not fulfill this objective and hence require extensive modification on the following basis:

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[70] See Morris (1990) p. 60.

[71] Polizatto (1990) p. 6.

[72] See World Bank (1992) p. 36.

[73] See Morris, op. cit., p. 67.

1. Bank reports have to be published quarterly or, at least, twice a year to ensure an up-to-date flow of information.
2. It is normally expected to find in banks' reports information on the quality of bank portfolios, adequacy of provisions and detailed outcome. In practice, such essential information is hardly to be found in these reports. Instead, such reports devote significant space to cover the so-called current developments in the world, regional and domestic economies which can be found, in a more rigorous and extensive form, in specialized sources. The CBE should provide some guidelines for the information published in these reports and ensure their comparability.
3. Arrangements should be made to prevent, or at least minimize, the problem of window dressing, defined as the manipulation of published information by banks to give a better picture than the reality of their condition.[74]

Protective Prudential Measures

The Egyptian banking system currently features two protective prudential measures: the lender-of-last-resort function of the CBE and a deposit insurance scheme.

Lender of Last Resort

The lender of last resort is an early feature of Egyptian banking regulation legislation. Since the 1957 Banks and Credit Law, the CBE was stated to be responsible for providing emergency funds to banks in trouble. A 1992 amendment to the banking regulation legislation gave the CBE additional powers when conducting a rescue operation.[75]

Deposit Insurance Fund

The deposit insurance scheme is a relatively new addition to the Egyptian prudential structure. It was introduced in a 1992 amendment to the Banks and Credit Law. It is stated in the law to have an independent legal personality and to be subject to the supervision of the CBE.[76] Despite the introduction of an explicit insurance scheme in Egyptian banking legislation, this scheme remains to be implemented. This is due to

[74] See Allen (1992) for a theoretical and empirical analysis of bank window dressing.

[75] Law No. 157 of 1963, Article 50 and Article 30-II as amended by Law No. 37 of 1992.

[76] Law No. 163 of 1957, Article 31-II as amended by Law No. 37 of 1992.

the reluctance of the operating banks to participate in it since they find it costly compared with the ‘free’ implicit scheme which is still in operation. Under the implicit scheme, the depositors of the collapsed Bank of Credit and Commerce Misr (BCCM) were fully protected, as detailed below.

BCCM was an Egyptian private sector, joint-venture commercial bank, 49 percent owned by the Bank of Credit and Commerce International (BCCI). When, in 1992, BCCI’s operations were brought to an abrupt end in major world financial markets, BCCM faced a crisis due to the fact that its major shareholder was BCCI and that it had large deposits with BCCI worldwide, primarily in London. The Egyptian authorities, however, fearing a general loss of confidence in the banking sector intervened to safeguard the depositors and to protect the financial system’s stability and integrity.

The rescue operation consisted of an agreement between the CBE and one of the four state-owned banks — Bank Misr. Registered banks were asked to contribute 0.5 percent of their deposits towards the funding of this operation in addition to an interest-free loan of £E1 billion to Bank Misr. This is supposed to be repaid over a 10-year period in exchange for Bank Misr taking over all of BCCM’s assets as well as its liabilities. Depositors with BCCM thereby became creditors to Bank Misr in amounts equal to their original deposits.

Further Problems and Challenges

Preferential Treatment of State-owned Banks

In principal, all banks in Egypt are treated equally as they are governed by the same regulations, and supervised by the same authority. In practice, there have been various aspects of preferential treatment of state-owned banks, including:

1. Branch authorization during the 1970s and 1980s favored the public sector. When the CBE in the late 1980s adopted a strict policy to control the number of branches, the number of branches per state-owned bank was significantly higher than that of other banks.[77]
2. State-owned banks had close relations with public sector enterprises in the form of equity stakes and membership of managing boards. Regulations in some public authorities and government institutions did not allow the

[77] World Bank (1992) pp. 33-34.

depositing of funds — such as pension and employees' funds — with non-state-owned banks.

3. Payment of interest on current accounts was prohibited, benefiting public sector banks in two ways. First, they did not bear any costs for keeping such deposits which mainly belonged to public sector enterprises. Second, private banks were not able to compete for such accounts by offering higher interest rates to depositors. In 1991, state-owned banks had an average of more than 25 percent of total deposits in the form of current account, whereas the ratio in the Delta Bank, a joint-venture bank, was less than 10 percent.[78]

Entry and Exit Rules

It is argued that contestable markets and the freedom of entry for potential firms promote efficiency, encourage innovation and give highly favorable welfare outcomes.[79] For a market to be contestable, there should not be any significant entry barriers. Large economies of scale and high sunk costs, in addition to other entry costs, are examples of such barriers.[80] But in the case of banking, government regulations through permits and licenses are far more important than these other barriers. The Egyptian banking system has suffered from the use of restrictive regulations that prevented new entry and made the incumbent banks far from being contestable.

The banking system, after a series of Egyptianization and nationalization measures in the 1950s and 1960s, was left with four state-owned commercial banks and five specialized banks. The market was highly concentrated, and competition was further limited by the application of sectoral and functional specialization which made the system a sectoral based mono-bank.

The introduction of the partial liberalization policy in the mid-1970s and the establishment of a large number of private and joint-venture banks resulted in an increase in the number of banking units without a significant decrease in market concentration. State-owned banks used to have majority stakes in joint-venture

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[78] Annual reports of the NBE and the Delta Bank (1991).

[79] For an analysis of contestable markets, see Baumol, Panzar and Willig (1982).

[80] On entry barriers, see Bain (1956) and Tirole (1989) Chapter 8.

banks.[81] The domination of state-owned banks in a highly concentrated market resulted in frail competition and limited innovation.

The main reasons that have been put forward to justify restrictive regulations regarding entry can be summarized as follows:

- *Concerns about "cream skimming" by private and foreign banks*. But whether high profits resulted from cream skimming or more efficient banking is debatable and requires evidence which cannot be obtained from bank reports.
- *Fear of acquiring dominant positions in the domestic market*. This is a usual concern raised for political reasons and can be justified on these grounds. Preventing banks from entering the market, however, is not a suitable solution, while applying anti-trust measures may be a better approach to this problem.
- *Concern about hit and run activities*. Foreign and, to some extent, private banks are accused of a lack of commitment and of withdrawing their activities at the first sight of trouble. The withdrawal of large international banks from the market may be unjustifiably taken as a sign of problems and instability in the domestic market as a whole which in turn may have a devastating impact on the banking environment. The negative expectations and apprehension that followed the recent withdrawal of some American and European banks from the market lends support to this argument. In reality, it is the problems in the home markets of the foreign banks which are often behind their withdrawal rather than the difficulties in the Egyptian market.[82]
- *Protecting the interests of the incumbent banks, especially the public ones*. Unlike other arguments, this one is hard to defend. Response to competition can not be through protecting inefficient banks but rather by improving their efficiency and eliminating the restrictive intervention of the CBE in their decision making and activities.

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[81] See World Bank (1992) Vol. 2, p. 4. It is worth noting that under the financial reform program state-owned banks have been encouraged to sell their holdings in joint-venture banks. It is anticipated that by the end of 1997 significant portions of state-owned banks' equities in joint-venture banks will have been sold.

[82] Example of sudden withdrawal of foreign banks is that of Chase Manhattan Bank in the mid-1980s and Bank of America in 1994.

- *Concerns about allocating most of the domestically mobilized funds abroad*. This argument is a widespread complaint in LDCs against foreign banks.[83] In the case of Egypt, however, state-owned banks are not significantly different from foreign banks regarding the geographic allocation of resources. In 1990, 60 percent of foreign currency deposits in the banking system were allocated abroad, while in 1992 the ratio was as high as 77 percent.[84] This finding does not defend foreign banks as much as it criticizes the pattern of allocation of funds by the banking system as a whole including the CBE.[85] Again, prohibiting entry into the market is not a remedy for this problem which requires, among other things, improvement of investment opportunities in the domestic market and an enhancement of its stability.

It is worth noting that an international commitment to eliminate and reduce such barriers to the banking services industry, whatever the reason behind them, was reached under the General Agreement of Trade in Services (GATS). Although Egypt presented more comprehensive offers than those presented by an average developing country, the sectoral coverage of commitments has been low. Furthermore, due to the relatively more restrictive measures which apply to foreign commercial presence and natural persons in the covered sectors, a commitment to significant service liberalization is not clear. For effective liberalization of trade in services, harmonization of national regulatory systems and agreements to recognize the standards of partner countries may be essential.[86]

Although it is important to remove barriers to entry, it is also crucial to maintain a reliable exit mechanism. Such arrangements are required along with the establishment of satisfactory prudential measures to improve the efficiency and the soundness of the Egyptian banking system. An efficient market can not be achieved in the absence of an adequate exit mechanism.

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[83] For a discussion of the advantages and disadvantages of the role of foreign banks, see Drake (1980) pp. 158-165.

[84] See the CBE annual reports 1990 and 1992 and Al-Antary (1994) p. 13.

[85] The CBE relies on the Federal Reserve Bank of New York to manage a significant part of its international reserves. Most of these reserves are in US T-bills. The World Bank (1992) Vol. 1, pp. 80-81.

[86] Hoekman and Sauvè (1994) pp. 1-3 and Mohieldin (1996) pp. 5-7.

In Egypt, banks are not allowed to fail. This policy has come into effect not through prudential policy or measures that enhance the efficiency of banks. Instead, weak banks were allowed to continue in business with the support of the CBE and the rest of the banking system. While at some point recapitalization may be a necessary action to prevent financial instability, the fiscal impact of the bailout — one of capitalization's explicit costs — must be confronted. While figures for recapitalization costs are not available for Egypt, they can be significant. For example, estimated costs of recapitalization in Finland (1991-1993) amounted to 8 percent of GDP and in Spain (1977-1985) they reached 16.8 percent of GNP.[87] Another form of government support to ailing banks was the relaxation of certain prudential measures including the waiver of the reserve and liquidity requirements.[88]

Fear of a public misunderstanding that one bank failure may imply that others will follow in the future made the banking system adopt a form of collective self-preservation. According to this approach, insolvent banks were left to operate with the support of the banking system, while adequate measures like restructuring, merging or liquidation were not applied.

This policy resulted in the encouragement of inefficient banks to continue their violation of credit standards by indulging in high risk lending and bidding for deposits. Even under the application of interest ceilings, a bank like the infamous BCCM was paying a higher interest rate on deposits than other banks by 0.5-1 percentage points until its collapse. In a system which forces sound banks to subsidize ailing ones, this policy also resulted in the failure of bank customers to distinguish between efficient and inefficient banks.

Quality of Supervision

Financial supervision is a delicate task as it should be undertaken in a way that promotes the soundness and stability of the banking system without hindering the efficiency and the managerial autonomy of banks.[89] In terms of quality, bank supervision in Egypt suffers from various limitations.

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[87] See Caprio and Klingebiel (1996) pp. 18-19.

[88] Such a confession was made by Mr. T. A. Ismail, Chairman of the then troubled Daqahlyiah Bank, in an interview published in *Al-Ahram* newspaper on 9 September 1995.

[89] On the role of prudential supervision in banking, see Pecchioli (1987).

First, the CBE is stated in the law to be an autonomous legal entity, to have an independent budget, and to be exempt from administrative rules governing the public sector. In practice, however, its real position is closer to that of any ministry or government bureaucracy. According to Egyptian law, the appointment of the governor of the CBE as well as of the other members of its Board of Directors is determined in accordance with the absolute discretion of the President and of the Prime Minister. Their remuneration is also subject to the same discretion. The representatives of the ministries of economy and of finance have a particularly strong role in the meetings of its board of directors. The board decisions are stated to be within the framework of the general policy of the state as determined by the government.[90]

Second, the significant increase in the number of operating banks, from 7 in 1974 to 81 in 1996, and the increase in the number of branches exceeding 2,250 units,[91] has not been matched by a corresponding increase either in the staff number (approximately 220 employees) of the Bank Control Department of the CBE or its resources. As a result, on-site monitoring of several banks was not undertaken and the CBE was content with the periodic reports of such banks on their activities.[92] These reports were not necessarily adequate in terms of the quantity and quality of information provided in them. Some of the operating banks, especially foreign ones, were adopting some new banking techniques and computerized transactions which due to lack of training were not fully grasped by the staff of the competent authorities.

Third, in many cases the effective supervision of banks, especially the public ones, was compromised by political pressure. Loans to insolvent and ailing public sector companies were allowed under the pressure of their concerned ministries. This, for instance, occurred following the Egyptian pound devaluation in 1985 which resulted in considerable foreign exchange losses amongst companies which were confronted with critical financial difficulties. “The Egyptian banks knew that they did not have the capacity to handle widespread bankruptcy, and also knew that the legal procedures for bankruptcy were unsatisfactory.… Hence, their management decision...was to provide additional credit facilities to keep distressed companies alive..., the outcome

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[90] Law No. 120 of 1975, Articles 6 and 7.

[91] See CBE, annual report 1994/95, p. 122.

[92] Ibid., p. 11.

was a substantially weaker financial sector."[93] It is therefore not surprising that the Egyptian banking system has suffered from a high ratio of non-performing loans, accumulated over the years due to similar practices. Exact figures for these loans are not available but their estimates are relatively high.[94]

State-owned banks in Egypt, as in other LDCs, were more prone to government interference in credit and planning decisions than private banks. They consequently had relatively high levels of non-performing loans, most of them government-guaranteed. Incentives to maximize profits, or even to minimize losses, barely exist in state-owned banks. In the words of Flemming (1993), "If losses will be covered [..] why should management minimize them? If loss-making enterprises will be bailed out in the end, why should a bank manager discriminate on his lending between good and bad risks?"[95] Non-performing loans and bad debts were therefore accumulated to the extent that it became difficult to clean up the balance sheets of such banks.

Fourth, privileged private sector borrowers were also allowed to borrow despite their poor financial condition and insufficient collateral. In 1989, the so-called sick balances reached 26 percent of total advances to private and investment sectors. Of these, 56.4 percent belonged to only 3 percent of the total number of defaulters.[96] Many defaulters fled the country to avoid legal action, while others managed to delay legal action against them for a long time.

In order to improve bank supervision, the regulatory framework should be clearly defined, the CBE must be more independent, its supervisory teams should acquire necessary knowledge and be empowered with sufficient resources. Improvement in bank supervision should not be achieved at the expense of the reasonable autonomy of banking units or interference with their decisions. Parallel reforms in accounting and auditing practices, and enforcement of the law in the case of default are also required.

Certain conditions are required to achieve a sufficient quality of supervision. Supervisors must acquire adequate training and have adequate resources, including adequate remuneration. Supervisors should also have sufficient autonomy from

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[93] Roe and Popiel (1987) p. 24.

[94] The estimate of the World Bank (1992) is 30 percent; the current estimate, however, is said to be lower than 15 percent on average.

[95] See Flemming (1993) p. 9.

[96] NBE (1989) pp. 142-143.

political interference and bureaucratic pressures. The supervisory body must also have enough power to enforce its decisions without the need to refer to higher authorities.[97]

IV. Concluding Remarks

This paper has dealt with the subject of prudential regulation in Egypt by discussing first some basic theoretical concepts regarding the definition of prudential measures, their classification, rationale, and place in the changing world environment. It then discussed the failure of Islamic Investment Companies in Egypt in the 1980s.

The paper analyzes in some detail the existing prudential measures in Egypt. The analysis seeks to compare the Egyptian situation with comparable world practice and experience, and to emphasize what may be considered significant weaknesses in the Egyptian banking prudential system. The argument dealt with the nature of prudential regulation in the context of Egyptian law, various prudential measures, limits on the scope of bank activities, the regulation of multinational banking, capital adequacy, liquidity and reserve requirements, loan provisioning, information disclosure, the lender-of-last-resort function, and the deposit insurance scheme. It also discusses certain problematic features of Egyptian banking regulation, specifically the preferential treatment of state-owned banks, entry and exit conditions as well as the quality of supervision.

Certain regulatory weaknesses were identified, which may be grouped under one of the following three categories which occasionally overlap. The first set of weaknesses is caused by lack of adequate rules, whether in the form of laws, decrees, or other binding enactments. This, for instance, is the case regarding the lack of sufficient clarity concerning the allocation of regulatory responsibility for multinational banks, and formal guidelines for information disclosure.

The second set of regulatory weaknesses may be attributed not to the lack of formal rules, but rather to the fact that such rules are, in practice, either entirely neglected or significantly relaxed. This is the case regarding, for example, the limitations over the scope of banking activities, the deposit insurance scheme, loan concentration and liquidity requirements.

The third, and last, set of weaknesses is what may be generally described as pertaining to the overall legal, economic and political environment in which banks and

[97] For example, supervisors should be able to impose, for example, fines, restrict dividend payments, request administrative action and force provisions. On this issue of quality of supervision, see Morris (1990) pp. 54-57.

bank regulators operate. This set of issues includes the difficulty in assessing the adequacy of loan provisioning in view of the legal system's own weaknesses, the unsuitability of the exit and entry rules, the bias in favor of state-owned banks and the chronic lack of resources and training from which the various regulatory agencies are suffering.

Although it would be difficult to deny the progress that has been made over the last few years in improving the quality of banking supervision in Egypt and in tightening the prudential structure, the persistence of the weaknesses referred to in this paper points out the fact that further improvements are needed. There is, in fact, more than ever before an urgency to introduce improvements and close the gaps caused by the persistence of regulatory weaknesses.

This is due to the fact that the banking scene in Egypt has been changing rapidly over the last few years — particularly since launching the economic reform program — and such change is expected to accelerate in the near future. Three aspects of change are particularly important. The first is the effect of globalization and innovation in the world financial markets on the Egyptian banking system which raises new and renewable challenges to regulators. The fast technological change, the expansion of financial competition, and the recent changes in the banking environment force regulators to continually revise their framework and update their procedures.

The second challenge is the increasing role played by private capital in the Egyptian banking system which necessarily requires a more sophisticated, perhaps even more aggressive, regulatory approach based entirely on arms-length considerations.

The third challenge is the expected growth in capital inflows, especially after the favorable sovereign rating that Egypt has received.[98] Since sterilization is considered costly, and capital controls harmful, it is argued that prudential regulation is the suitable device for containing the flow of capital and channeling it into preferred forms. As indicated by Garber (1995), under modern banking and liberalization of capital flows it is not difficult for a risk-taking bank to avoid prudential measures, which on paper are similar to, or the same as, international standards. Banks can go offshore or engage in off-balance-sheet activities which may violate certain prudential

[98] In January 1997, Standard and Poor's assigned Egypt 'BBB-' long-term and 'A3' short-term foreign currency credit ratings. It also assigned Egypt 'A-' long-term and short-term local currency credit ratings.

regulations. Preventing this from happening requires a stringent, politically-supported regulatory environment that enables ‘qualified’ supervisors to cover all bank activities in question and its affiliates onshore and offshore.

It may also be worth emphasizing that it is not the existence of formal prudential measures per se which determine whether a bank is efficient. It is rather the economic environment and mechanisms according to which banks operate that accentuate the negative effects of inefficiency and hinder competition.

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