

PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: AB2097

Operation Name	EG- FINANCIAL SECTOR REFORM
Region	MIDDLE EAST AND NORTH AFRICA
Sector	Banking (85%) and Insurance (15%)
Project ID	P088877
Borrower(s)	GOVERNMENT OF EGYPT
Implementing Agency	Ministry of Investment and Central Bank of Egypt
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1. Country and Sector Background

1. The financial sector in Egypt has been, over the past decade and a half, the subject of reform efforts mainly aimed at financial liberalization to develop more effective financial instruments, strengthen the financial system's infrastructure, and enhance competitiveness through increased private sector participation. Egypt, as a result, has modernized its financial system in a measurable way, and provided increased autonomy and power to the monetary and regulatory authorities. In particular, the government 1991 Economic Reform and Structural Adjustment Program (ERSAP) – supported by a World Bank adjustment operation – was designed to achieve macroeconomic stability of which an integral part was financial sector reform. That reform program foresaw two phases. The first focused on developing more effective monetary and financial instruments to control liquidity, and liberalizing interest rates and credit. The second phase focused on increasing competitiveness in the financial market by enhancing private participation in commercial banking, securities, and insurance. The objectives of the first phase were by and large met, while phase two of the program did not extend beyond the establishment of a legal framework for bank privatization, as the sale of joint-venture or state-owned commercial banks were thought by the government to be premature given concerns for lack of public support.

2. The financial sector, despite these positive steps, continues to face important challenges given the low levels of competition and financial intermediation (with large liquidity in the banking system), relatively high intermediation costs, limited innovation and dominance of state ownership. The banking system is burdened by high levels of non-performing loans, while the non-bank segment is characterized by underdeveloped bond, insurance, and mortgage markets, thin trading in equities, weak corporate governance, and weak infrastructure for effective payment systems.

3. The Egypt 2002 Financial Sector Assessment Program (FSAP) highlighted key priorities for financial sector reform, in banking and non-banking. A number of measures recommended in the FSAP were endorsed by the authorities – especially in what relates to strengthening the regulatory framework, addressing public bank loan portfolio problems, completing the privatization of joint venture banks, and restructuring the insurance industry to enhance its role

in resource mobilization. Some of the recommendations were implemented by the authorities,¹ notably in the context of the Banking Law 88 of 2003² introduced by the previous government.

4. The new reformist government that took office in June 2004 set a major agenda for macroeconomic and structural reform and modernization. As part of this agenda, it submitted a program of financial reforms that was formally endorsed by the President of Egypt in September 2004. Officially referred to as the “Financial Sector Reform Program”, it is to be implemented over 2005-08. The program represents the most far reaching, substantive and comprehensive drive towards financial sector strengthening to have been launched so far in Egypt – and indeed in any other country of the Middle-East North Africa region.

5. The program aims mainly at: (i) consolidating the banking system in reducing by nearly 2/3rd the number of institutions in an over-banked domestic market – including the landmark decision to merge the two public banks, Banque Misr and Banque du Caire, the country’s second and third largest; (ii) divesting fully public sector shares in some 20 joint-venture banks (de facto largely controlled by state-owned financial institutions), creating thus the core of a domestic private banking system that would account for 20 percent of system deposits; (iii) privatizing the state-owned fourth largest commercial bank (Bank of Alexandria with 7 percent of sector deposits); (iv) restructuring the remaining two public sector banks (National Bank of Egypt, and the merged Banque Misr-Banque du Caire) through an in-depth capacity building program to allow them to play their role on a commercially viable basis in increasingly open and competitive markets (the authorities have yet to commit to the opening up of the capital of these two state-owned banks); (iv) reforming the insurance sector both at regulatory and company levels, inter-alia in privatizing at least one of the three state-owned (direct) insurance companies, and assessing the need for a major overhaul of the others, with a possible reallocation of market sub-segment activities; and (v) seeking to develop a new system of mortgage finance for a more sustainable housing finance market.

6. Underpinning the whole program is a major effort at strengthening the regulatory capacity and supervisory apparatus. Lending further credence to the authorities’ determination to see the reforms through, sweeping executive measures – uncharacteristic of the consensus-driven Egyptian establishment – were taken with the appointment of a new central bank governor, new management at all supervisory and regulatory bodies, including the Egyptian Insurance Supervisory Authority, Capital Market Authority, Mortgage Finance Authority, and the Cairo and Alexandria Stock Exchange, and all four public sector insurance companies. In parallel, the newly established Ministry of Investment was given oversight for all non-bank financial institutions. To carry their program through, the authorities have sought financial and technical assistance from the USA, the European Union, the African Development Bank, the International Monetary Fund, and the World Bank, asking the latter, in addition, to coordinate potential support efforts.

¹ The authorities have already taken action in several of these priority areas, sometimes with technical and financial assistance from the World Bank, USAID, and European Union.

² Officially known as the Central Bank, Banking System, and Money Law 88 of 2003 includes 135 Articles.

2. Operation Objectives

7. The main development objective of the government financial sector reform program, and of the proposed World Bank operation, is to build a more resilient financial sector with a sound banking system and insurance industry that could contribute better, in the medium-term, to the provision of modern and effective financial services. The World Bank supports the government reform proposals, which in many areas are consistent with the World Bank assistance strategy for Egypt to support economic growth. The proposed operation would help achieve this objective by strengthening the enabling environment for financial intermediation and risk management, and increasing private sector participation in the provision of financial services. To this effect, World Bank assistance would seek to: (i) strengthen the regulatory and supervisory framework for banks and non-bank financial institutions to ensure compliance with international standards and effective enforcement; (ii) reform the banking system through consolidation, privatization of state-owned and joint-venture banks, and restructuring of the remaining public sector banks; and (iii) restructure the insurance industry to develop and deepen the financial sector (World Bank assistance in the areas of public pension and mortgage markets is being provided separately).

3. Rationale for Bank Involvement

8. World Bank involvement in support of Egypt's financial sector reform program would build upon the policy dialogue the World Bank has been conducting with the authorities over the recent years, particularly in the context of, and as a follow up to, the FSAP. The experience that the World Bank has gathered in development policy lending in the financial sector is highly valued by the authorities, as it would be brought to bear on, and guide the design and implementation of, the program. The authorities take further comfort from the long-term involvement of the World Bank in, and the comprehensiveness of its approach to, financial sector reform and development in Egypt. The perception thus that the World Bank is prepared to remain engaged and support the authorities in moving with their reforms beyond the time-frame of the proposed loan – in a way congruent with the 2005-08 medium-term framework within which the government program is cast – makes of the World Bank a privileged partner. Moreover, the World Bank is expected to coordinate efforts of all bilateral and multilateral donors in a concerted way that would smooth the implementation of what is an ambitious and tall agenda.

4. Financing

9. The proposed loan in an amount of US\$500 million equivalent is a single tranche, Development Policy Loan (DPL) to support the authorities' in the priority areas and earlier phase of their financial sector reform program to be implemented over the period 2005-08. The reform program could be supported by follow-up operations, is a comprehensive, far-reaching effort to address salient financial sector weaknesses and enhance the system's capacity for financial intermediation and the provision of financial services. The proposed DPL would be disbursed upon effectiveness, once a specific set of conditions is met.

5. Institutional and Implementation Arrangements

10. The Ministry of Investment and the Central Bank of Egypt will be the two entities responsible for overall implementation of the proposed operation and for reporting progress and coordinating actions among other concerned agencies (insurance regulator and capital market authority). As mentioned in relation to the outcomes of the policy reforms, the World Bank will monitor actions and review progress of the implementation of the proposed operation. At the same time, the overall status of the government's program will be monitored during supervision to ensure that the reform program is well on track. In addition, supervision missions will allow the Bank to continue the policy dialogue with the institutions involved in the implementation of the program of reform, and also ensure the deployment of staff and consultants able to advise the government in all of the policy and technical areas pertaining to the reforms.

6. Benefits and Risks

11. Benefits would result from addressing major impediments to a more efficient functioning of the financial system within a potentially stronger regulatory environment and enhanced role for the private sector in financial services. Resolution of the large stock of non-performing loans – a salient weakness of the banking sector – would strengthen in the medium-term the system's capacity for financial intermediation, efficiency in mobilization of savings, and capacity to shoulder corporate sector activities and enhance growth.

12. The main risks could be a slowdown of the reform momentum to a path that would not allow for a genuine change towards market-based, risk-taking business patterns in the public financial institutions (moral hazard issue). This relates particularly to the government's commitment to and decisiveness in restructuring the remaining two large public sector banks – and until such time as their capital can be open to private sector entry, instilling the governance, culture and incentives that would weed out past business practices – the government ability to manage the related fiscal implications, and the capacity to build an independent and credible regulatory apparatus.

7. Poverty and Social Impacts and Environment Aspects

13. The operation's objectives to improve the efficiency of the financial sector will have overall positive long-term economic impact, although bank restructuring would normally be associated in the short term with staff redeployment resulting from optimization of labor input and skill upgrading. In the context of the restructuring process, voluntary severance packages have been offered to employees who wish to avail themselves of early retirement schemes. Training programs are also offered to staff whose positions at their level of expertise may be eliminated. The proposed operation concerns broad strategic reform decisions and would therefore not include a social protection component, but this would be included in follow-up operations as these will include the implementation of the operational audit findings which will have a direct staff redeployment impact and which will need to be addressed (para. 98). The preparation of the proposed operation has so far entailed broad discussions with market participants from all pillars of the financial sector.

14. The policies supported by the proposed adjustment development policy loan are not likely to have any significant direct effects on the environment and natural resources. In addition, the indirect impacts that the DPL is likely to have on the environment are difficult to predict but are expected to be marginal.

8. Contact point

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