ERF Policy Brief

Public Banks and Development in Egypt: Overview, Issues and the Way Forward?

Jasmin Fouad, Moheb Said, Wesam Sherif and Chahir Zaki

About the authors

Jasmin Fouad is a Professor, Faculty of Economics and Political Science, Cairo University and American University in Cairo.

Moheb Said is an independent researcher..

Wesam Sherif is a Researcher, American University in Cairo.

Chahir Zaki is a Professor, Faculty of Economics and Political Science, Cairo University and ERF Research Fellow

In a nutshell

- *Public Development Banks (PDB), like any other bank, serve as a financial intermediary, yet with a strong developmental role. This brief provides an overview of PDBs in Egypt. The latter is of particular interest for two reasons.*
- *First, while PDBs have a long history in the Egyptian economy, their role and the intervention are rather limited. This applies to banks that were created during the socialist era of Nasser.*
- *Second, the largest share of the PDBs-related projects implemented in Egypt is undertaken by government-owned commercial banks, namely National Bank of Egypt, Banque Misr and Banque du Caire.*
- *Thus, the objective of this brief is twofold: first, to analyze how and why the role of PDBs can be played by public banks; second, to highlight the lessons that can be learned from the resilience of the Egyptian financial systems to the succession of crisis/disruptions.*

On the development role of banks

While a Public Development Bank (PDB) like any other bank serves as a financial intermediary, its main goal is to promote development. Indeed, many development banks focus on a limited specific number of sectors of the economy according to the needs of the country, such as agriculture, industry, housing, health or education. In this case, the development bank will be specialized in one sector and hence entirely dedicated to its development. At the global level, such banks represent 10% of global financial flows.

Development banking will always be a risky initiative but, with efficient and proper management, it can help achieve development objectives (Janine Thorne & Charlotte du Toit, 2009). The most celebrated role of PDB since the outbreak of the global financial crises has been their countercyclical function. During the crises PDBs were able to provide liquidity to financial markets, which enabled them to avoid the downtrend. The financial sector operates pro-cyclically, so private banks' behavior tends to aggravate crises by decreasing the flow of liquidity to the system when it is most necessary (Minsky, 1986). It is therefore crucial that PDB play this proactive role to protect the economy and correct market failure (Wray, 2009). This is the main argument that justifies public intervention in the credit market. PDBs can play this important role through various channels (Mazzucato and Penna, 2015): (1) ensuring the security and soundness of the financial system through managing liquidity in times of crises, (2) creating an information base to combat the negative effects of asymmetric information on the financial market, (3) financing of socially important projects; and (4) promoting financial development (Stiglitz, 1994). This is very important in developing countries where markets' imperfections or failures exist, such as asymmetry of information, imperfect competition and underdeveloped fragile capital market. In this context and when private banks are not able to achieve these objectives, then public banks emerge as the second-best alternative (Feijo, Horn, and Feil, 2020).

Why the Egyptian case?

The Egyptian case is of particular interest for several reasons. First, while PDBs have a long history in the Egyptian economy, their role and the intervention are rather limited. This applies to banks that were created during the socialist era of Nasser. The decreasing role of these banks can be explained by four main reasons. On the one hand, Moheildin and Nasr (2003) argue that with the Egyptianization and nationalization measures in the 1950 and 1960s, the banking sector became highly concentrated with the application of sectoral and functional specialization making the system a sector-based mono-bank one (with mandatory public ownership/governance). This led to less competition and less innovation. On the other hand, most of these banks were always backed up and sponsored by the government. Yet, with the lack of incentives, political interference, poor governance, complicated bureaucratic procedures for loans processing, and overstaffing, their performance deteriorated and their profits decreased. This affected their interventions and financing capabilities. Moreover, with the privatization of the banking sector that took early 2000s, most of the banks that remained public were the largest commercial ones only.

Second, the lion share of the development project implemented in Egypt is undertaken by government-owned commercial banks, namely National Bank of Egypt (NBE), Banque Misr and Banque du Caire (BdC). These three banks are of interest for three reasons. First, generally, their mission statement is aligned with the concept of development bank. For instance, NBE's one refers to *"NBE believes that it has a significant role to play in improving the quality of life of Egyptians. Such contributions were vigorously engaged in supporting healthcare, education, slums development, combating poverty, alleviating the distress of imprisoned indebted persons, and empowering people with disabilities, as well as supporting culture and maintaining heritage"*. In the case of Banque Misr, "Banque Misr was established in 1920 by the pioneer economist and financial expert Mohamed Talaat Harb Pasha, who spearheaded the concept of investing in national savings and directing them towards economic and social development". Moreover, BdC operates as a subsidiary of Banque Misr and is largely known for its comparative advantage in microfinance, which is highly correlated to development activities. The third reason in choosing these three banks is their large market share. In fact, while NBE has the highest market share (total assets accounted for 31.5% of Egyptian banks' total assets in 2020), Banque Misr's market share is EGP 967.3 billion and Banque du Caire EGP 211billion.

The third reason is related to their public ownership making them more likely to implement the development agenda of the government. Finally, it is important to note that the law 88-2003 of the Central Bank of Egypt (CBE) did not include a particular definition of development banks. This partially explains why commercial banks were able to have a developmental role given that the latter was neither limited nor exclusive to banks specialized in development. Thus, the objective of this report is twofold: first, to analyze why and how public banks can play the PDB role; and second, to highlight the lessons that can be learned from the resilience of the Egyptian financial systems to the succession of crisis/ disruptions.

Against this background, *Agence Française du Développement (AFD)* co-organized the first edition of the "Finance in Common" Summit in November 2020. Its objective is to boost commitment of all PDBs to support a more sustainable financial trajectory and to help the governments respond to the crisis. This is particularly important with the COVID-19 pandemic and its subsequent socio-economic crisis that negatively affected the global economy. Indeed, with the increase of firms and households' vulnerabilities, the role of PDB has to be reconsidered in order to make their intervention more effective and curb the negative effects of the pandemic. Hence, the second summit will chiefly focus on the Egyptian case in order to examine the determinants of their resilience and analyze why commercial (public) banks have substituted classic PDBs.

Public banks' framework of operations, policies, and governance in Egypt

Methodology

Building on the determinants of development banks listed by Kovachev (2013) and the definition of PDBs adopted by Xu et al. (2021) and the Finance in Common definition of PDBs, a survey of 25 questions has been formulated and distributed on public banks. The main objective of the survey is to determine to what degree public banks in Egypt can qualify as development banks in light of their actual market presence and dominance in government's development projects. The survey questions cover three aspects namely; legal status independence and autonomy, role of the government, and clarity of the public mandate. The first two aspects tackle the independence of the banks from the government in their sources of finance as well as their financing decisions. The third examines whether these banks are obliged by their mandates or the government to support the development process in the economy. The survey also addresses the bank's role during economic crises; one of the main roles of development banks and their main argument for existence. In addition, the survey also addresses the efficiency and governance of operations of these banks in light of best practices. All survey questions are short answer questions to be answered with either yes, no, or n/a to be filled by representatives from the banks. The survey questions were sent to representatives from the public banks by email and zoom meetings with the representatives were then conducted to follow up with discussing the questions and the main objective of the survey. The discussions were fruitful in adding more illustrations and details to further elaborate the short answers to the survey questions. The discussions were also important to ensure the proper understanding of the underlying questions and their goal and avoid mis-interpretation of the questions. The analysis has been focused on the two main public banks with the largest market shares namely; the National Bank of Egypt and Banque Misr.

Survey Results

Our findings suggest that National Bank of Egypt, Bank Misr and Banque de Caire are the important stabilizers to maintain economic stability. They played an important role in mitigating the negative repercussions of COVID-19 on the economy. Their financial resilience is based on high capital adequacy ratios and liquidity. The three banks also contribute to development through their pivotal role in promoting SMEs and various projects in the economy. The banks also play a prominent role in enhancing financial inclusion through digitalization and the application of innovative tools. These three main roles in terms of maintaining financial stability, promoting SMEs and enhancing financial inclusion allow for the characterization of the public commercial banks as public development banks.

The Way Forward

From a policy perspective, several recommendations are worthy to be mentioned.

1. Development banks can only play their important role if they have independence, flexibility and expertise. The mandate of development banks is of lesser importance.
2. It is important to understand the factors that has contributed to the different outcomes of COVID-19 on the different banks. The variables include capital, liquidity and the legal and regulatory framework.
3. Stress testing is an important tool to mitigate risk. The introduction of stress testing since 2011 has enabled the Egyptian banks to react to several shocks including COVID-19. After the pandemic stress testing can focus on the effects of political challenges, economic fluctuations and natural disasters.

4. COVID-19 has accelerated the complete adoption of digitalization. It is important in that context to have the regulatory frameworks to protect banks and customers from various cyber threats. While the Financial Regulatory Authority (FRA) has drafted a law to regulate non-banking fintech operations such as nano-finance, consumer tech and insurance tech, the Central Bank of Egypt has not taken visible steps in this direction for the banking sector.
5. Financial resilience is crucial to protect banks and the banking system. Building capital is not an option but a necessity. Liquidity is also of utmost importance, yet the optimal level of liquidity must be determined in order not to suffer from idle money and to avoid credit crunches.
6. The application of a flexible prudential regulation framework to allow banks to operate freely and still maintain high levels of financial resilience.
7. Banks need to apply cost-cutting programs without negatively affecting their relations with their customers.
8. The application of Basel IV principles is a further step in the right direction
9. The future of banking sector will be different and all banks have to equip themselves with all the requirements of the new era, which requires technological infrastructure and knowledge of fintech and sufficient training on all the new financial tools.

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Contact Information

ERF Office
Address: 21 Al-Sad Al-Aaly St. Dokki, Giza, Egypt
PO Box 12311
Tel: +202 333 18 600 - 603
Fax: +202 333 18 604
Email: erf@erf.org.eg
Website: http://www.erf.org.eg

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