OECD OCDE

MENA-OECD Investment Programme

May 17, 2006

Egypt National Investment Reform Agenda Workshop

Privatisation Session: Reforming State Owned Banks

Draft Background Document

This document is designed to provide a context for discussion of the National Reform Agenda Item 'Privatisation of State Owned Banks and Divesting Public Shares in Joint Venture Banks'. It highlights Egypt's history of privatisation, along with recent efforts of the Egyptian government to reduce its ownership in the banking sector, and the key challenges it faces in doing so.

I. Issue Background

1. Egypt's privatisation program started with the passage of Law 203 in June 1991. This law created a new structure for the public sector by removing State Owned Enterprises (SOEs) from control of the sectoral ministries and placing them under the supervision of holding companies designed to manage them with greater autonomy. In 1992, a list of candidate firms was made public – 20 of them were to scheduled to be privatised in 1991-1992, 25 in 1992-1993 and 49 in the following year.

2. The progress of implementation of this plan over the years has been ambiguous. Egypt had planned to have all its public enterprises privatised by February 2002, but the Ministry of Public Enterprises continued to own 181 companies by the end of 2002. Since 2000, the process slowed down due partly to valuation problems and partly to the restructuring of companies before privatisation. By the end of June 2002, the government had completed 132 major and 57 partial privatisations out of 314 public enterprises scheduled for privatisation, gathering revenue of EP 14.4 billion.

3. These transactions included the sale of majority stakes in 38 companies and minority stakes in 16 companies through a public offering, the liquidation of unviable companies, as well as other means. As a result, the public enterprises' share of total employment has been reduced from 7% in 1991 to 2.5% by mid-2002. The privatisation process has gained momentum after the 2004 with the Cabinet restructuring and change of Central Bank management. The process has accelerated markedly during the last 2 years, with the total revenue from the sale of public companies reaching $947 million last year, which is more than double than in the previous four years combined. During the first 12 months of Office of the new Cabinet (the year to June 2005), the government has sold about EP 5.6 billion of state assets, including a 20% stake in Telecom Egypt.

4. Privatisation of the banking sector has been slower than the overall progress of the privatisation process. The sale of state-owned banks was first forecast for 1998, when the banking industry was dominated by four state-owned banks, which accounted for 80% of commercial deposits in the country. The privatisation objectives related to the banking sector have not been realised as quickly as originally envisioned. More than 60% of the market was controlled by the State as of 2005, through direct ownership or participation. When the government of Ahmed Nazif was appointed in July 2004, it came with a plan to sell one of four state owned banks privatise 38 joint venture banks and force the country's weak banks to be overtaken by stronger institutions. Since 2005, the government has been engaged in an ambitious programme to privatise state owned banks. To date, State's shareholdings in 12 of the 17 joint venture banks have been sold, including 33.8% in Egyptian American Bank (EAB), and a sale of MIBank. The Bank of Alexandria is the first wholly government owned institution set for sell off, which is indicative of the seriousness of the ongoing reform of the financial sector.

5. Currently, the banking sector is at the centre of the new government's reform agenda and is expected to become more privatised and deregulated, in particular against the backdrop of a five year reform plan for the banking industry. This overhaul of the banking industry is due to the fact that it is not performing as efficiently as it could. Profitability has been about 0.5% on assets over the last years; nonperforming loans officially exceeded 20% of total loans in 2004 and less than 2/3 was provisioned.

6. The banking sector currently represents around 80%-90% of the total Egyptian financial sector. It is comprised of four public sector banks (Banque Misr, Bank of Alexandria and Banque Du Caire, and the National Bank of Egypt), as well as three specialized public sector banks such as the Egyptian Arab Land

Bank. There are also 11 private-sector joint ventures banks, which are classified as business and investment banks, and 14 foreign bank branches.

II. Current Reforms

7. In the history of bank privatisation in Egypt, the planned sale of the currently wholly owned Bank of Alexandria is perhaps the most significant. The Bank of Alexandria (BOA) is the forth largest commercial bank in Egypt with assets of 6.51 billion. Interest in this sale is expected to be significant from both domestic and foreign institutions, particularly given the positive recent performance of the BOA. The bank's performance has been boosted as a result of government repayment of $1.2 billion in loans that were owned by public sector companies and a reduction of its investments in other local banks, notably the Egyptian American Bank.

8. The privatisation process is now well advanced, the bid end period being April 2006. The privatisation is scheduled to take place by end of 2006 through government divestment of 75-80% of the banks' share capital through a structured sale process. The Ministry of Investment intends to make shares representing up to 5% of Bank of Alexandria's share capital available to the bank's employees and the residual shareholding (15-20%) will to be sold through an IPO on the Cairo and Alexandria Stock Exchange. The Egyptian Government has sourced on the expertise of the Citigroup who will be screening the bids in against predefined criteria for a 'Qualified Purchaser'.[1]

9. In addition to the privatisation of the BOA, a plan has been initiated to restructure the main public banks, including the National Bank of Egypt and Banque Misr. To do so, the government (and the Ministry of Investment specifically) has already implemented measures to reduce the non performing loans in the public sector. In January, the Ministry of Investment announced that the non-performing loans of public sector enterprises were sold to the National Investment Bank (the government's investment arm) for EP 6.9 bn. Recently, a new scheme was introduced to address bad loan problems.

10. The government has also decided to continue reducing its ownership in joint venture banks by selling related outstanding public shares. Together, the privatisation of the Bank of Alexandria and the divestiture of public shares in Joint Venture Banks are scheduled to be completed before the end of 2006 and are expected to reduce overall state ownership from 58% to 40%.

11. Other recent and relevant reforms of the banking sector included:

- The introduction and enforcement of a new minimum capital requirement in July 2005. This has encouraged consolidation in the sector reducing the total number of banks operating in Egypt from 57 in September 2004 to 43 currently.
- The appointment of international accountancy firms to conduct full audit reviews of the four public sector banks in accordance with International Financial Reporting Standards. The audit review of the Bank of Alexandria was finalised in 2005 by the KPMG Hazem Hassanand the audits of the other three banks are scheduled for completion by June 2006.

[1] A prospective purchaser must be an established and reputable financial institution, possessing a commercial banking license and having sufficient resources to ensure that Bank of Alexandria is financially and commercially strong after the privatisation.

- The launch of a resolution plan for the four public sector banks' portfolios on public enterprise non-performing loans.
- The creation of a non-performing loan unit at the Central Bank of Egypt to expedite non performing loan resolution and monitor the establishment of banks' non performing loan functions in order to improve loan work out policies. Settlements representing 46% of non performing loans have been made.
- The upgrading the Central Bank of Egypt's banking supervision unit to enable the banking sector to be supervised in accordance with international best practices (under a 2.5 year programme signed with the European Central Bank). The CBE is working with banks to comply with Basle II standards by 2006.

III. Key Challenges

12. Despite the accelerated speed of banking sector reform and privatisation, the Egyptian financial sector still suffers from insufficient private sector participation. While the need to privatise remaining SOEs and joint venture banks is clear, several obstacles in the process will need to be addressed in the near future if this project is to succeed:

- The state owned banks will need to continue improving their performance with respect to non-performing loans if they are to become a lucrative investment in case of privatisation. This hinges on the extent to which Egyptian government will be prepared to absorb the burden of bad debts in the banking system.
- Communication to affected domestic constituencies will be necessary to ensure that they are aware of and understand the need for reform. This represents a challenge given that commercial bank services are not largely used[2] and that public sector employees see bank privatisations (as other privatisations) as threatening to employment.
- Defining appropriate corporate governance practices for privatised banks and monitoring the privatisation process to ensure banks remain adequately supervised.

[2] Currently, 25% of Egypt's population collects regular salaries and it is estimated that 10% of the population has a bank account. As a result, 97% of transactions involve hard currency.