

The Financial Stability
of **Egyptian**
Banks




ANDERSEN

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Introduction

Financial institutions provide a wide range of financial products and services. They serve as intermediaries between providers and recipients of capital, facilitate asset and risk management, and execute transactions involving cash, securities, and other financial assets.

Given the diversity of financial services, it is unsurprising that numerous types of financial institutions exist. Types of financial institutions include deposit-taking, loan-making institutions, investment banks, credit card companies, brokers, dealers, exchanges, clearing houses, depositories, investment managers, financial advisers, and insurance companies. In many situations, overlap of services exists across types of institutions. For example, banks not only take deposits and make loans but also may undertake investment management and other securities-related activities and may offer such products as derivatives, which are effectively insurance against adverse effects of movements in the interest rate, equity, and foreign currency markets.

Banks accept from consumers and businesses and pay interest in return. Banks invest those funds in or extend loans to companies and. When the interest a bank earns from loans exceeds the interest paid on deposits, it generates income from the. Banks also earn interest from investing cash in short-term securities and from fees charged for their products and services such as wealth management advice, checking account fees, overdraft fees, ATM fees, interest, and credit cards.

Analyzing a Bank: The Camels Approach

“CAMELS” is an acronym for the six components of a widely used bank rating approach originally developed in the United States. The six components are Capital adequacy, Asset quality, Management capabilities, Earnings sufficiency, Liquidity position, and Sensitivity to market risk.

A bank examiner using the CAMELS approach to evaluate a bank conducts an analysis and assigns a numerical rating of 1 through 5 to each component. A rating of 1 represents the best rating, showing the best practices in risk management and performance and generating the least concern for regulators. A rating of 5 is the worst rating, showing the poorest performance and risk management practices and generating the highest degree of regulatory concern. After the components are rated, a composite rating for the entire bank is constructed from the component ratings.

This is not a simple arithmetic mean of the six component ratings: Each component is weighted by the examiner performing the study. The examiner’s judgment will affect the weighting accorded to each component’s rating. Two examiners could evaluate the same bank on a CAMELS basis and even assign the same ratings to each component and yet arrive at different composite ratings for the entire bank.

Although the CAMELS system was developed as a tool for bank examiners, it provides a useful framework for other purposes, such as equity or debt investment analysis of banks. The following sections discuss each component of the rating system.

Capital Adequacy

It is important for a bank (as with any company) to have adequate capital so that potential losses can be absorbed without causing the bank to become financially weak or even insolvent. Losses reduce the amount of a bank's retained earnings, which is one component of capital. Large enough losses could even result in insolvency. A strong capital position lowers the probability of insolvency and bolsters public confidence in the bank.

Capital adequacy for banks is described in terms of the proportion of the bank's assets funded with capital. For purposes of determining capital adequacy, a bank's assets are adjusted based on their risk, with riskier assets requiring a higher weighting. The risk weightings are specified by individual countries' regulators, and these regulators typically take Basel III into consideration. The risk adjustment results in an amount for risk-weighted assets to use when determining the amount of capital required to fund those assets. For example, cash has a risk weighting of zero, so cash is not included in the risk-weighted assets. As a result, no capital is required to fund cash.

Corporate loans have a risk weighting of 100%, and certain risky assets. Impact on P/B: The Price-to-Book (P/B) ratio compares a bank's market value to its book value (shareholders' equity). A higher capital adequacy rating often leads to a higher P/B ratio because investors are willing to pay a premium for a bank that appears financially stable and less risky.

Strong capital buffers suggest the bank is better equipped to weather downturns, which makes it more attractive to investors.

- **Capital Requirements:** Under Basel III, banks are required to maintain a higher quality of capital, particularly Common Equity Tier 1 (CET1) capital. The CBE has adopted these requirements, setting a minimum CET1 ratio and Total Capital Ratio, ensuring banks have enough cushion to absorb losses.
- **Capital Conservation Buffer (CCB):** The CBE mandates a capital conservation buffer on top of the minimum capital requirement. This buffer helps banks maintain a capital cushion in times of economic stress.
- **Counter-Cyclical Capital Buffer (CCyB):** The CBE has also implemented the counter-cyclical capital buffer to be applied in times of excessive credit growth, although its use is contingent on the economic environment.

Asset Quality

Asset quality pertains to the amount of existing and potential credit risk associated with a bank's assets, focusing primarily on financial assets. The concept of asset quality extends beyond the composition of a bank's assets and encompasses the strength of the overall risk management processes by which the assets are generated and managed. Loans typically constitute the largest portion of a bank's assets. Asset quality for loans reported on the balance sheet depends on the creditworthiness of the borrowers and the corresponding adequacy of adjustments for expected loan losses. Loans are measured at amortized cost and are shown on the balance sheet net of allowances for loan losses.

Impact on ROE: The Return on Equity (ROE) measures how efficiently a bank generates profits from its equity capital. If a bank has high asset quality and manages NPLs well, it will likely experience lower provisioning for loan losses and higher profitability, boosting its ROE. In contrast, a bank with poor asset quality may have a lower ROE because it needs to allocate more capital to cover potential loan defaults, thereby reducing net income.

Management Capabilities

Many of the attributes of effective management of financial institutions are the same as those for other types of entities. Effective management involves successfully identifying and exploiting appropriate profit opportunities while simultaneously managing risk.

For financial institutions, a particularly important aspect of management capability is the ability to identify and control risk, including credit risk, market risk, operating risk, legal risk, and other risks. Directors of banks set overall guidance on risk exposure levels and appropriate implementation policies and provide oversight of bank management. Banks' senior managers must develop and implement effective procedures for measuring and monitoring risks consistent with that guidance.

The CBE requires banks to implement robust risk management frameworks in line with Basel III principles, covering credit, market, and operational risks.

Resolution Planning and Recovery Framework Following Basel III guidelines, the CBE has implemented rules requiring banks to develop recovery and resolution plans. These plans outline how banks can recover from financial stress or be orderly resolved without threatening the broader financial system.

Impact on ROE: Strong management leads to better strategic decisions that can improve profitability. A well-run bank is likely to generate higher returns

on equity as it efficiently allocates resources, manages risks, and controls operational costs.

Earnings

Financial institutions should ideally generate an amount of earnings to provide an adequate return on capital to their capital providers and specifically to reward their stockholders through capital appreciation and/or distribution of the earnings. Further, all companies' earnings should ideally be high quality and trending upward. In general, high-quality earnings mean that accounting estimates are unbiased and the earnings are derived from sustainable rather than non-recurring items. For banks, one important area involving significant estimates is loan impairment allowances. In estimating losses on the loan portfolio collectively, statistical analysis of historical loan losses can provide a basis for an estimation, but statistical analysis based on past data must be supplemented with management judgement about the potential for deviation in future. In estimating losses on individual loans, assessments are required concerning the likelihood of the borrower's default or bankruptcy and the value of any collateral.

Many of the factors have a high degree of interdependency and there is no single factor to which our loan impairment allowances as a whole are sensitive.”²⁰ Banks also must use estimates in valuing some financial assets and liabilities that must be measured at fair value. When fair value of an investment is based on observable market prices, valuation requires little judgment. However, when fair values cannot be based on observable market prices, judgment is required. Under both IFRS and US GAAP, fair value measurements of financial assets and liabilities are categorized on the basis of the type of inputs used to establish the fair value. Both sets of standards use the concept of a fair value hierarchy.

Fair Value Hierarchy

The three “levels” of the fair value hierarchy pertain to the observability of the inputs used to establish the fair value.

- **Level 1** inputs are quoted prices for identical financial assets or liabilities in active markets.
- **Level 2** inputs are observable but are not the quoted prices for identical financial instruments in active markets. Level 2 inputs include quoted prices for similar financial instruments in active markets, quoted prices for identical financial instruments in markets that are not active, and observable data such as interest rates, yield curves, credit spreads, and implied volatility. The inputs are used in a model to determine the fair value of the financial instrument.
- **Level 3** inputs are unobservable. The fair value of a financial instrument is based on a model (or models) and unobservable inputs. Financial modeling, by its very nature, contains subjective estimates that are unobservable and will differ from one modeler to another. For example, a financial instrument’s value might be based on an option-pricing model employing an unobservable and subjective estimate of the instrument’s market volatility.

Another example is that a financial instrument’s value might be based on estimated future cash flows, discounted to a present value. Neither the estimated future cash flows nor the discount rate can be observed objectively, because they depend on the determinations made by the modeler

Impact on NIM: Net Interest Margin (NIM)

is a key metric that measures the difference between the interest income a bank earns on its assets (like loans) and the interest it pays on its liabilities (like deposits), relative to its assets. A higher **Earnings** rating from the CAMELS framework generally reflects strong and stable interest income generation. Banks with strong earnings will typically have a higher NIM because they can effectively manage the spread between lending and deposit rates. Moreover, they can improve asset quality and reduce bad debt, which enhances their profitability.

Liquidity Position

Adequate liquidity is essential for any type of entity. Banks' systemic importance increases the importance of adequate liquidity. If a non-bank entity's insufficient liquidity prevents it from paying a current liability, the impact would primarily affect the entity's own supply chain. In contrast, because deposits constitute the primary component of a bank's current liabilities, the impact of a bank's failure to honor a current liability could affect an entire economy. Deposits in most banks are insured up to some specified amount by government insurers; thus, liquidity is a key focus of regulators. The Basel III Regulatory Framework²² cites the sudden illiquidity accompanying the financial crisis of 2008 as a main motivation for the introduction of a global liquidity standard. Because of the sudden pressures on liquidity at the inception of the financial crisis, some banks experienced difficulties, despite having an adequate capital base.

Basel III thus introduced two minimum liquidity standards, both to be phased in over subsequent years.

The Liquidity Coverage Ratio (LCR) is expressed as the minimum percentage of a bank's expected cash outflows that must be held in highly liquid assets. For this ratio, the expected cash outflows (the denominator) are the bank's anticipated one-month liquidity needs in a stress scenario, and the highly liquid assets (the numerator) include only those that are easily convertible into cash. The standards set a target minimum of 100%.

The Net Stable Funding Ratio (NSFR) is expressed as the minimum percentage of a bank's required stable funding that must be sourced from available stable funding. For this ratio, required stable funding (the denominator) is a function of the composition and maturity of a bank's asset base, whereas available stable funding (the numerator) is a function of the composition and maturity of a bank's funding sources (i.e., capital and deposits and other liabilities).

Impact on NIM: While liquidity itself doesn't directly affect NIM, a bank with strong liquidity can afford to take on higher-yielding assets (such as loans to creditworthy customers) without risking liquidity problems. This allows the bank to maintain a strong interest margin, as it isn't forced to hold large amounts of low-yielding liquid assets that drag down NIM.

Sensitivity to Market Risk

Almost every entity has some exposure to changes in interest rates, exchange rates, equity prices, or commodity prices. The nature of banks' operations generally makes sensitivity of earnings to market risks a particularly important consideration for analysts. Mismatches in the maturity, repricing frequency, reference rates, or currency of banks' loans and deposits create exposure to market movements. Further, exposure to risk arises not only from loans and deposits on a bank's balance sheet but also from off-balance-sheet exposures, including, for example, guarantees or derivatives positions linked to interest rates, exchange rates, equities, or commodities.

It is important to understand how an adverse change in any of these markets would affect a bank's earnings. It is also important to evaluate the strength of a bank's ability to manage market risks.

Impact on P/B, ROE, NIM: High sensitivity to market risk can negatively affect a bank's valuation and profitability. If a bank faces significant exposure to interest rate changes or foreign currency fluctuations, its earnings and ROE might be more volatile, leading to lower investor confidence and a lower P/B ratio. Similarly, market risk can affect a bank's NIM if it is heavily exposed to fluctuating interest rates or foreign exchange rates.

Banking-Specific Analytical Considerations Not Addressed by CAMELS

The following bank attributes are either unaddressed or not fully addressed by a CAMELS analysis:

- **Government Support:** Government agencies monitor the health of banks in the entire system and will close banks that might fail or will arrange mergers with healthy ones able to absorb them.
- **Government Ownership:** Public ownership of banks may include a strong ownership representation by the government of their home country.
- **Mission of Banking Entity:** Not all banks share the same mission.
- **Corporate Culture:** A bank's culture may be very risk averse and cautious and make only loans perceived to be low risk, or alternatively, it may be risk seeking and willing to take risk in pursuit of high returns on investment.

Local Rules Affecting Banks in Egypt

- **Egyptian Banking Law:** In addition to Basel III, banks in Egypt are governed by the Egyptian Banking Law, which sets out the regulatory framework for banking operations, corporate governance, and compliance.
- **Anti-Money Laundering (AML) & Counter-Terrorism Financing (CTF):** The CBE enforces regulations that align with international standards, requiring banks to implement strong AML and CTF measures.

- **Consumer Protection Regulations:** The CBE has also introduced various consumer protection regulations to safeguard the interests of customers, enhancing transparency in banking practices.
- **Leverage Ratio:** The CBE has adopted Basel III's leverage ratio framework, which acts as a backstop to the risk-based capital requirements. This ratio limits the build-up of excessive leverage within the banking sector, ensuring banks do not become overly reliant on debt.

Impact of Inflation, Currency Fluctuations, and Government Policies on Banking Operations in Egypt

Inflation, currency changes, and government policies have a big impact on how banks operate in Egypt. Inflation affects interest rates, the value of bank assets, and people's saving habits, which forces banks to adjust their strategies. Currency fluctuations create risks, especially for banks holding foreign currency, and can also lead to rising costs. Government policies, like changes in interest rates or economic stimulus programs, play a key role in shaping the banking sector by influencing lending conditions and economic growth. While high inflation and a weaker currency can increase the risk of loan defaults and reduce demand for credit, government initiatives can encourage more banking activity. Banks need to carefully manage these factors to stay profitable and stable.

Asset Quality and Market Risks Affect a Bank's Credit Rating and Valuation

Asset Quality:

Asset quality refers to the strength and stability of a bank's loan portfolio and other assets, assessing the risk of defaults and potential losses. This is often evaluated using metrics like non-performing loans (NPLs), loan loss provisions, and the overall creditworthiness of borrowers.

Impact on Credit Rating:

- Higher NPLs and lower asset quality signal increased credit risk, which can lower a bank's credit rating. A high proportion of bad loans or defaults suggests that the bank may struggle to recover its investments, leading to higher credit risk.
- A strong asset quality, on the other hand, indicates that the bank is managing its loan portfolio well, has a low default rate, and is less likely to face large losses, leading to a higher credit rating.

Impact on Valuation:

- Poor asset quality lowers the value of the bank, as it implies greater risk of loan defaults and higher potential for financial loss. This can lead to a reduction in the bank's profitability and future earnings potential, directly affecting its valuation.
- Good asset quality supports higher valuation because it suggests steady income streams, fewer write-offs, and strong future profitability.

2. Market Risks:

Market risks refer to the potential losses a bank might incur due to fluctuations in the financial markets, such as changes in interest rates, foreign exchange rates, commodity prices, and equity markets. For banks, managing these risks is crucial for maintaining financial stability.

Impact on Credit Rating:

- High market risk exposure (e.g., large fluctuations in the bank's trading book or heavy reliance on volatile market conditions) can negatively affect the credit rating. If market risks are not properly managed, they could lead to significant financial losses that would affect the bank's ability to meet its obligations.
- Low market risk exposure reflects better risk management practices and a more stable financial position, which is favorable for the credit rating.

Impact on Valuation:

- Banks that are exposed to high levels of market risk may have a lower valuation, as investors perceive them to be riskier, and their earnings may become more volatile.
- Banks that manage market risk effectively, with strategies to hedge against interest rate changes or currency fluctuations, will be viewed as more stable and may have a higher valuation due to their consistent performance and reduced risk exposure.

Conclusion

the CAMEL approach provides a comprehensive framework for assessing the financial health of banks in Egypt, focusing on key areas such as capital adequacy, asset quality, management quality, earnings, and liquidity. When applied to Egyptian banks, this approach helps to identify both strengths and potential vulnerabilities in the banking sector.

Local regulations play a crucial role in shaping the operational environment for banks in Egypt. Regulations and compliance requirements influence the level of risk exposure, capital buffers, and overall stability of the financial system. In addition, inflation, currency fluctuations, and government policies significantly impact banking operations. Inflation erodes the purchasing power of consumers, affecting the demand for credit, while currency fluctuations introduce foreign exchange risks for banks with international exposure. Furthermore, government policies—whether monetary or fiscal—can either stabilize or destabilize the market, depending on how effectively they are implemented.

Therefore, it is essential for banks in Egypt to adopt prudent risk management strategies and stay adaptable to the evolving macroeconomic conditions, ensuring that they remain resilient amidst these challenges. By combining strong regulatory adherence with efficient operational practices, Egyptian banks can better navigate the complexities posed by inflation, currency volatility, and shifting government policies.



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