Egypt banks – Cabinet's approval of amendments to Income Tax Act: Market chatter suggests changes unlikely to be applied retrospectively; Active balance sheet key to absorb impact

The Egyptian Cabinet approved on 21 November amendments to the Income Tax Act, requiring financial institutions to separately book income from treasury instruments. According to the Cabinet's statement, the move would bring current accounting practices in line with international practices, allowing the government to tax earnings on yields in a fairer manner. The statement underlined that the amendments stipulate separating income from treasury instruments from other operating revenues, while excluding the possibility of any additional tax burdens applied on treasury instruments.

Income from treasuries will be separated from other revenues, whereby the former will continue to be taxed at source, at the withholding tax rate of 20% (as per the current treatment), and added to tax expenses from other lending activities, at 22.5% of the operating income (excluding income from treasuries), minus costs incurred/related to treasury holdings (no clarity/agreement on the calculation methodology). It was reported that the amendments would also entail assigning a percentage of costs to the treasury operations, in order to arrive at a more accurate calculation of the taxable income of the conventional business. This comes in contrast to the currently adopted taxation practice, where treasury income is taxed at 20% at source (with

no costs allocated to this part of the income), then compared to tax expenses calculated at the 22.5% corporate tax rate (the higher amount incurred is expensed as income taxes).

Our take: As per our conversations with key banking sources over the past couple of days, we understand that discussions are still ongoing between the MoF and the Federation of Egyptian Banks regarding the mechanism of applying the amendments. Nonetheless, market chatter suggests the outcome would unlikely entail applying the tax changes on banks' current portfolios retrospectively, and should impact new issuances after the amendments are officially put into effect. Thus, this would not affect current profitability, and make the implementation more feasible, in our view.

In terms of the costs assigned to banks' treasury operations, the Federation of Egyptian Banks proposed breaking down costs into: i) financing costs (total cost of funding/total funding base multiplied by treasury holdings) and ii) operational costs (total SG&A excluding depreciation/total revenues multiplied by total income from treasury securities). This should render a lower impact on banks, particularly the more efficient ones, in terms of an additional tax burden, as opposed to the MoF's initial proposal, where banks' total expense-to-income ratios are to be used to calculate treasury costs.

Given this backdrop, we believe that active balance sheet management is key to mitigate the potential impact of the tax amendments. In the event of the application, measures to be undertaken by banks would include: i) hiking asset yields in line with the potentially higher taxes, ii) enhance cost efficiency (interest and non-interest), and iii) gradually increase utilisation in private credit at the expense of government securities. This should be supported by a more favourable outlook for credit activity in 2019, in line with our expectation of the resumption of monetary easing. In our view, banks with strong lending foothold and franchise would fare better as compared to smaller banks with relatively lower capitalisation.

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