Lebanese Economic Crisis and Banking Restructuring: Some Preliminary Suggestions

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1. Introduction

Since the end of the Lebanese civil war in the very early 1990s, the Lebanese economy has been on a bumpy ride. Post-war recovery allowed the economy to grow by more than 6% annually by 1998; but then political bickering, assassinations, and the July 2006 war between Hizballah and Israel all contributed to slow down the economy to 2% per year during 1999-2006. However, paradoxically, the economy flourished during the Global Financial Crisis, driven by the real estate and financial sectors, and managed to register annual growth in excess of 8% by 2011. But bad luck struck again with the onset of the Syrian Civil War in 2012, to the extent that growth averaged close to 1% till 2018; and did much worse later on, falling by more than 6% in 2019 and 20% in 2020 due to the financial crisis and the deadlock in government formation.

There were primarily two good things that stood out during the above period (but later on proved to be somewhat highly problematic): the first was the fixed exchange rate regime, which brought about and ensured monetary stability; the second was the recapitalization of banks, who managed to prosper and recoup part of their old glories. In retrospect, however, those two achievements happened to be transitory if not porous: the exchange rate proved to be noticeably overvalued especially after 2011; and the banking system was structurally shaky as it became heavily exposed to the sovereign especially the Central Bank (BDL).

But that is not all. As important, there were at least two bad things that actually got even worse: the first was poor governance and corruption, almost throughout the public sector; the second, and in consequence, was a rising public debt that reached more than 175% of GDP by 2019 and stood at close to $92 billion, more than 36% of which in USD.

This constellation of disruptive forces came to a head in late 2019 and, perhaps unsurprisingly, brought down the Lebanese economy and its banking sector. What added insult to injury was the absence, to this day, of any corrective measures by a reforming new government. In this respect, what we aim to do in this note is to provide suggested measures/proposals on how to deal with one important consequence of the crisis: bank restructuring. The analysis is preliminary in nature and is intended to enrich the debate on this crucial topic, and its views are neither representative nor exclusive of any banking organization.

2. Lebanese Crisis vs Peers

For years, many analysts commended Lebanese banks on their good performance in an economy crippled by political and social instability. Today, however, scrutiny of banks' portfolios reveals that they are heavily exposed to the indebted government and the Central Bank, which could jeopardize their long-term viability. Banks were acting as a cushion and filling the financial performance gap with credit. In the short run, this was a viable solution yet risky, given the fact that they provided a short-term solution to a long-term problem.

In March 2020, the banking sector was rocked by the government's Eurobond default. This default had added to the complexities of the fiscal, external and banking crises. In addition, the wide social unrest and the Port of Beirut Explosion in August 2020, taken all together, have led to more uncertainty to the situation coupled with an extreme foreign reserves 'shortages and soaring inflation. In turn, Commercial banks' client loans and deposits have continuously declined while non-performing loans are significantly increasing putting pressure on the sector's liquidity and profitability.

For a meaningful comparison, we present briefly in the table below a summary of the causes of the financial crisis in peer countries in order to better devise a worthy bank restructuring plan for Lebanon. And these countries are those of Argentine, Greece, Cyprus and Egypt.

Countries	Argentina	Greece	Cyprus	Egypt
Causes	Overvalued exchange rate Large current account deficit Rising debt, consumer, Governmnet or Corporate Falling reserves Poor Regulation and erosion of policy credibility Unstable political and economic situation Bank run begins	Huge current account deficit Threatened State liquidity Fraudulent government and fiscal indiscipline with excessive expenditures spending Accumulated debt Tax evasion Insufficient risk assessmnet for Greek debt Reversal of Capital inflows loss of confidence Increasing Interest rate	Banking sector highly exposed to overleveraged local property companies Shutdown for some cypriot banks Fiscal mismanagement and failure monitoring for the finanial sector imprudent behavio by the cypriots authorities	Political, Social and economic uncertainty The egyptian revolution and its socio-economic impact Low foreign direct investments High budget deficit High debt , unemployment and poverty rate Fast growing population with constant growing State

Source: BLOMINVEST

In comparable terms, the root causes of the financial crisis in Lebanon can be summarized mainly as the following:

- Sovereign over-indebtedness
- Peg to the USD
- Twin deficits (current account and budget)
- Bank asset-liability mismatching
- Weak capital markets alternative to banks

	2019				
	Number of Account	Amount in LBP	Amount in USD	Total	Dollarization rate
Less than 5M LBP	1,725,030	606	350	956	36.61%
5M-30M	481,602	2,139	2,317	4,456	52.00%
30M-75M	222,527	3,130	3,919	7,049	55.60%
75M-150M	140,684	3,960	5,801	9,761	59.43%
150M-300M	108,720	5,227	9,560	14,787	64.65%
300M-750M	82,704	6,979	17,921	24,900	71.97%
750M-1,500M	29,470	4,372	15,401	19,773	77.89%
Total 1	**2,790,737**	**26,413**	**55,269**	**81,682**	**67.66%**
1,500M-3,000M	13,336	3,115	14,414	17,529	82.23%
3,000M-4,500M	3,864	1,442	7,615	9,057	84.08%
4,500M-7,500M	2,582	1,441	8,144	9,585	84.97%
7,500M-15,000M	1,695	1,716	9,399	11,115	84.56%
15,000M-30,000M	679	1,283	7,608	8,891	85.57%
30,000M-75,000M	282	1,482	6,679	8,161	81.84%
75,000M-150,000M	42	641	2,172	2,813	77.21%
More than 150,000M	26	254	5,577	5,831	95.64%
Total 2	**22,506**	**11,374**	**61,608**	**72,982**	**84.42%**
TOTAL 1+2	**2,813,243**	**37,787**	**116,877**	**154,664**	**75.57%**

Source: BLOMINVEST

What also mark the Lebanese crisis are two features that are somewhat peculiar to its banking sector:

First is the large number of small depositors. As can be seen from the above table, out of around 2.8 million bank accounts in 2019, close to 1.7 million accounts held less than 3.3 thousand USD each, totaling $956 million out of total deposits equal to about $155 billion!. On the other hand, 22.5 thousand accounts between $1 million and more $100 million each, held deposits equal to $73 billion, close to half of total deposits. More generally, small deposits' accounts grasped the biggest share of total number of accounts in the banking sector and stood for about 99% yet held only $82 billion, while big depositors grasped 1% out of the total number of accounts and held the rest of the deposits.

Second is the heavy foreign currency (FCY) exposure to BDL. From the table below, we see banks' Eurobonds investments in May 2021 were only $8.2 billion while their loan portfolio (resident and non-resident) amounted to about $19 billion, but their placements at BDL stood at whopping $77 billion. From the same table, we also see BDL's net foreign reserves (exclusive of Eurobonds) were actually close negative to $64 billion. So it is fairly apparent that the main potential losses for banks arise from their deposits at BDL, which in turn represent the core of their customers' deposits.

NFA of BDL (usd M)	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21
Total Deposits in FC	111,821	111,407	111,143	109,886	109,398	108,759
Financial Sector Liabilities	6,583	6,460	6,456	5,952	5,381	5,273
Total Deposits in FC	**118,405**	**117,867**	**117,599**	**115,838**	**114,779**	**114,032**
Total Placements in FC	**40,640**	**40,531**	**40,662**	**38,655**	**37,432**	**37,056**
Deposits at other CBs	578	637	718	647	721	797
Loans to Residents in FC	18,788	18,515	18,599	17,814	17,144	16,793
Eurobonds held by banks	9,391	9,448	9,462	8,442	8,392	8,236
claims to non-Resident financial sector	4,716	4,822	4,924	4,889	4,317	4,881
Loans to Non-Resident Customers	2,573	2,530	2,391	2,333	2,287	2,272
Non-Resident Securities Portfolio	487	485	478	471	488	429
Other Foreign Assets	4,106	4,094	4,090	4,059	4,082	3,648
Total Reserves of CBs at BDL	***77,765***	***77,337***	***76,938***	***77,183***	***77,348***	***76,976***
Foreign currencies of BDL	**18,604**	**17,976**	**17,494**	**16,752**	**16,233**	**15,708**
Securities Portfolio	**5,494**	**5,501**	**5,406**	**5,413**	**5,419**	**5,404**
Foreign Liabilities including special LT liabilities	2,992	3,001	2,882	2,913	2,915	2,920
Net Assets in FC	**21,107**	**20,476**	**20,019**	**19,252**	**18,736**	**18,193**
Total Reserves of CBs at BDL	77,765	77,337	76,938	77,183	77,348	76,976
Eurobonds held by BDL	**5,030**	**5,030**	**5,030**	**5,030**	**5,030**	**5,030**
Net Foreign Reserves (deducting Eurobonds)	***(61,688)***	***(61,891)***	***(61,949)***	***(62,960)***	***(63,641)***	***(63,813)***

Source: BLOMINVEST

3. Suggestions for Banking Restructuring

So the banking sector in Lebanon must address its worsening portfolio to better play an active role in Lebanon's economic recovery. The resolution of the ongoing financial crisis is imperative to the restructuring of the banking system (BDL and Banks). In fact, the large exposure of the banking sector to the sovereign (primarily the Central Bank) implies the recognition of banking sector losses and the need for restructuring of the sector to obtain solvency.

No doubt that the debt restructuring plan will result in losses to the Lebanese banks and thus would form a variable in the financial sector restructuring strategy. The strategy should ensure the recapitalization of solvent banks, whereas insolvent banks should exit the market or subject to merger or acquisition by other stable bank. Most importantly, the aforementioned losses must be equally distributed among all concerned parties in a way that it won't paralyze banks' functioning process.

In this context, we present two banking sector restructuring proposals or suggestions. The first proposal is more detailed whereas the second one is brief, but both (especially the first proposal) share the following objectives:

- to distribute the aforementioned losses in a fair and equitable way among all stakeholders
- To protect small and medium depositors who will recover up to 95% of their deposits in FCY
- To preserve a decent percentage of total deposits in FCY; remaining amounts are to be released as bank shares (deposit to equity swap) and Lirafication at a predetermined rate (could be at the current applied rate of BDL's circular 151)
- To restore trust in the Lebanese banking sector
- To reduce the gap of foreign currency reserves for the Central Bank while rationalize the size of banking sector to more sustainable levels according to the economy

It is very interesting to note that Lebanese banks are experiencing several changes through multiple BDL' s circular in addition to self-adaptation to the current situation. However, these changes are not enough and do not have strong and far-reaching drastic effects on the banking sector, and accordingly banks should undergo a well-defined restructuring plan that should be part of comprehensive reforms. We present below two separate bank restructuring proposals as components of such a plan.

Restructuring Proposal 1

This proposal rests on the idea that Lebanese banks should find a reasonable solution for all FCY deposits. As such, the losses that occurred to the Lebanese banking system from their placements at BDL should form the basis for bank restructuring, and is calculated after taking into consideration banks' required reserves at BDL i.e. an amount close to $63B (= $77B - $14B).

In more details, this proposal is similar in spirit to the monograph "Banking Sector Restructuring Proposal" (L'Orient-Le Jour, June 19, 2021). It aims to protect small to medium depositors by guaranteeing all foreign deposits $50,000 (LBP 75M), which is in line with the current law guaranteeing deposit of LBP 75M. It constitutes the following features as also outlined in the table below:

a- In foreign currency:
   i. $50,000.
   ii. 30% of the remaining foreign currency deposits above the mentioned amount to remain in FCY

b- 35% of the remaining amounts in LBP at a rate of 1,500 or at the BDL's circular 151 rate to better monitor the hyperinflation and this will be called the Lirafication amount process. The lirafied amount will be blocked for 5 years with restriction of the withdrawal limits.

c- 35% of the remaining amounts in banks 'equity to recapitalize the banking sector; this is called deposit to equity swap (D-E swap).

d- For the account exceeding $2 million will be granted as a perpetual dollar bond by BDL that will be against a part of the protected amount. This will be reducing the size of the banking sector after the restructuring plan.
   i. Perpetual Bond or Bond with long term maturity
   ii. Bond secured by one of BDL assets such as MEA or Casino Du Liban.

Proposal 1 Table

		Proposal 1	
Secured amount for all depositors		**50,000 usd**	
Account size		**< $2 M**	**>$2 M**
Actions towards amounts	**granted**	30%	20%
	Perpetual Bond	--	10%
	Lirafication amount	35%	35%
	D-E swap	35%	35%
Remaining deposits in FCY		**$ 45 B**	
Recovery of Deposits		**43% in FCY**	

Source: BLOMINVEST

On the other hand, and quite crucially, this proposal must include the corresponding adjustment to BDL' s balance sheet so as to reflect the changes that occurred to the commercial banks' balance sheet as predicated by the mechanics of the proposal. This ensures the consistency of the consolidated accounts, and the homogeneous impact of the proposal on both accounts.

Lastly, a very important question is what role do bank shareholders play in the restructuring process? In this proposal, we suggest that shareholders fill in all the capital requirements after the D-E swap is completed by depositors. This spreads the burden of restructuring and adjustment to the main stakeholders in the banking sector.
In order to apply this proposal, a quantitative analysis should be made to ensure the fairness of this step. However, we present below the pros and cons of this proposal:

	Pros	Cons
Proposal 1	a) 85% of the accounts will be granted with 100% of their dollar deposits b) Banking sector will be minimized to levels that can be sustained by the economy c) Bank recapitalization with contribution from stakeholders	a) 43% of all deposits will be in foreign currency b) Only small depositors with less than $50,000 will grant full recovery c) Large Lebanese pound deposits will need to be properly managed to avoid further hyperinflation

Restructuring Proposal 2

This proposal is totally different from the previous one. In brief, it focuses on the assets of the Lebanese state, which will bear most of the burden of adjustment. In fact, assets held by the government have been badly managed for years, and it was one of the major factors that led to this severe financial crisis. Our proposed plan will be based on the privatization (complete or partial) of public assets that optimistic estimates put at about $22 billion (AUB, Issam Fares Institute, 2021); and then establishing a Lebanese Trust Fund that will manage the proceeds from the sale of these assets. The fund in turn will be governed by an independent entity, aka the sovereign wealth funds in developed countries.

The privatization of state assets should generate high profits in the upcoming years. The Lebanese state can benefit from taking a percentage of the profits generated and from collecting taxes. As such, the government will have a sustainable source of income that will help it to reduce gradually its "debt" to BDL.

BDL will use those funds in mainly two ways:

- Build up the foreign reserves that were depleted during the crisis.
- Reimburse gradually the debt to commercial banks

The elaboration of this plan will have a positive impact on the image of the BDL amid the improvement of its foreign reserve. Furthermore, the gradual reimbursement of the BDL debt to commercial banks will increase their liquidity, which will let them to release partially the deposits of their clients. Of course this plan requires a high degree of transparency from all the parties, and it might take some time to be effectively completed. However, and most important, it will no doubt be hastened by fundamental economic reforms that should jump-start growth and attract private and public (IMF, Cedere, etc...) capital flows that would augment BDL foreign reserves. And, needless to say, the proposal can't succeed without a certain degree of political stability.

4. Conclusion

The Lebanese economic crisis is a very deep one and bank restructuring is not going to be easy, especially if considerations of fairness and efficiency are to be addressed. We have presented here two preliminary proposals: a detailed one that puts the burden of restructuring adjustment mostly on stakeholders; and a brief one that puts it mostly on the state. Perhaps a combination of the two would be the ideal way to go! At any rate, the end purpose of each is to strengthen the solvency and confidence of the banking sector, something that can't be guaranteed without preserving the viable interests of bank stakeholders. Of course, banking restructuring will involve also rationalizing the number of banks through M&As and liquidation, but that should be secondary to the end purpose. And, inevitably, bank restructuring will involve increasing Lirafication in the financial sector and the economy; though this will not bode well for inflation during the crisis, but it could be quite a booster for the use and confidence in the national currency in the long -to medium- run.

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