Estimate of Losses Incurred by Banks on Loan Paybacks: Sept 2019-Dec 2022

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Since September 2019, commercial banks in Lebanon have largely ceased granting loans, leading to a decrease in loan balances over the subsequent years (until December 2022, the closing date of our studied period[1]). Not only that, but during the same period BDL issued instructions (Circular 648) that USD loans could be settled at the official exchange rate, not the prevailing and much weaker parallel or market rates. Consequently, we see from Table 1 below that *total* resident loans fell from 98.6 trillion LBP to 39.5 trillion LBP between September 2019 and December 2022, with individual loans falling the most from about 30 trillion LBP to 10.5 trillion LBP. More importantly, given the workings of Circular 648 and the disparity in applied exchange rates, did these loan paybacks involve losses to banks[2]? And if yes, what was their magnitude? That is what we would like to explore in this economic spotlight. One proviso: Circular 648 applies to retail loans only, but as we will see later in the spotlight, we will adjust our estimates to account for this fact.

[1] We end on December 2022 since the official exchange rate was changed to LBP/USD 15,000 by February 2023.

[2] Note that the loan figures are inclusive of provisions, therefore these provisions implicitly embody losses as well

Table 1: Retail and Corporate Loans from September 2019 till December 2022

In Millions LBP	**Sep-19**	**Dec-20**	**Dec-21**	**Dec-22**
Agriculture	1,241,862	839,081	799,640	541,310
Industry	10,519,191	6,529,213	5,688,391	4,577,458
Construction	15,909,902	9,470,873	8,569,229	7,311,914
trade and services	33,960,694	20,200,087	16,853,367	13,180,040
o/w wholesale trade	17,633,858	9,674,394	7,590,065	5,611,824
Financial Intermediation	4,055,032	2,702,828	2,285,037	1,982,236
Others	2,943,853	1,806,314	1,593,235	1,298,804
Individuals	29,974,609	22,844,263	16,403,561	10,554,832
o/w housing loan	18,775,346	15,379,296	11,843,878	7,027,530
o/w Consumer loans	11,199,263	7,464,967	4,559,683	3,527,302
Total	**98,605,143**	**64,392,659**	**52,192,460**	**39,446,594**

Source: BDL

To start with, the official exchange rate as set by BDL stood at LBP 1507.5 per USD throughout the period under scrutiny. However, the parallel market exchange rate told a different story; from September 2019 to December 2020, it stood on average at LBP/USD 6,705 and increased to an average of LBP/USD 16,820 from December 2020 to December 2021 and again increased to LBP/USD 30,315 from December 2021 till December 2022.

Table 2: Value Differences Incurred by Banks due to Disparity between Official and Parallel Exchange Rate

	Sept 19-Dec 20	Dec 20-Dec 21	Dec 21-Dec 22	Value Difference
Average market rate	**6,705**	**16,820**	**30,315**	
Change in agriculture in LBP M	(402,781)	(39,441)	(258,330)	**(394)**
Change in USD M (BDL rate LBP 1507.5/USD)	(267)	(26)	(171)	
Change in USD M (Market rate)	(60)	(2)	(9)	
Value difference incurred due to disparity in exchange rate	**(207)**	**(24)**	**(163)**	
Change in Industry in LBP M	(3,989,978)	(840,822)	(1,110,933)	**(3,260)**
Change in USD M (BDL rate LBP 1507.5/USD)	(2,647)	(558)	(737)	
Change in USD M (Market rate)	(595)	(50)	(37)	
Value difference incurred due to disparity in exchange rate	**(2,052)**	**(508)**	**(700)**	
Change in Construction loan in LBP M	(6,439,029)	(901,644)	(1,257,315)	**(4,648)**
Change in USD M (BDL rate LBP 1507.5/USD)	(4,271)	(598)	(834)	
Change in USD M (Market rate)	(960)	(54)	(41)	
Value difference incurred due to disparity in exchange rate	**(3,311)**	**(545)**	**(793)**	
Change in trade and services in LBP M	(13,760,607)	(3,346,720)	(3,673,327)	**(11,412)**
Change in USD M (BDL rate LBP 1507.5/USD)	(9,128)	(2,220)	(2,437)	
Change in USD M (Market rate)	(2,052)	(199)	(121)	
Value difference incurred due to disparity in exchange rate	**(7,076)**	**(2,021)**	**(2,316)**	
Change in Financial Intermediation in LBP M	(1,352,204)	(417,791)	(302,801)	**(1,138)**
Change in USD M (BDL rate LBP 1507.5/USD)	(897)	(277)	(201)	
Change in USD M (Market rate)	(202)	(25)	(10)	
Value difference incurred due to disparity in exchange rate	**(695)**	**(252)**	**(191)**	
Change in others in LBP M	(1,137,539)	(213,079)	(294,431)	**(899)**
Change in USD M (BDL rate LBP 1507.5/USD)	(755)	(141)	(195)	
Change in USD M (Market rate)	(170)	(13)	(10)	
Value difference incurred due to disparity in exchange rate	**(585)**	**(129)**	**(186)**	
Change in individuals in LBP M	(7,130,346)	(6,440,702)	(5,848,729)	**(11,243)**
Change in USD M (BDL rate LBP 1507.5/USD)	(4,730)	(4,272)	(3,880)	
Change in USD M (Market rate)	(1,063)	(383)	(193)	
Value difference incurred due to disparity in exchange rate	**(3,666)**	**(3,890)**	**(3,687)**	
Total value differences for above loans	**(17,592)**	**(7,368)**	**(8,035)**	**(32,994)**

As such, Table 2 above captures the value differences of settling loans for the various loans portfolios. For instance, the difference in corporate loans, specifically trade and services, from *September 2019 to December 2020* amounted to a staggering *negative* LBP 13,760,607 million. When translated to USD, this difference was equal to USD 9,128 M based on the official exchange rate, and to USD 2,052M based on the average parallel market rate. As a result, banks faced a gap of USD 7,076M. For the entire period *from September 2019 till December 2022, the gap* reached a total of $11,412M and that is for trade and services loans only, thus underscoring the significant impact of currency devaluation on banks' asset side of their balance sheets.

Similarly, from Table 2, the total gap on retail loans (housing and consumer loans) can be detected as USD 11,243M, construction loans as USD 4,648M, and industry loans as USD 3,260M, and so on. In terms of the whole gap across all periods and all types of loans, this would add up to about a staggering USD 33B. *One adjustment is crucial, though. The data in Table 1 doesn't differentiate between loans extended in LBP and those extended in USD*. So, to be more exact, we have to isolate the loans extended in USD, and given that by September 2019 the dollarization ratio for loans was 70%, *then a rough rule of thumb would imply that the gap arising from exchange rate disparities on USD loans would be USD 23B (0.7 x USD 33B).*

The crucial question of course is, does this value gap involve losses of the same magnitude to banks? The answer is yes, and the argument goes as follows. The workings of Circular 648 amount basically to the fact that BDL would 'buy' these loans from banks and pay for them in return by crediting bank's USD deposits at BDL in the same amount. But the thing is, these credit extensions are – for lack of a better word – in 'lollars', whose value is only a fraction of the full dollar that is equal roughly to the ratio of official to market exchange rate[3]. So this process is costing BDL nothing: it receives the loan payments at a fraction of their value and pays for them by crediting the same fraction to banks' deposits. But it is banks which lose, as they have retired their loans at a fraction of their value but they still have to pay the full value in corresponding deposits to clients. And that is why the value gap on loans paybacks is equal to banks' losses.

However, as we have indicated at the beginning, Circular 648 applies to retail loans only. We adjust for this fact by assuming that most of corporate USD loans have been paid by writing off the corresponding USD deposits of corporate clients and/or by accepting discounted USD checks bought for that purpose. As a result, *we need then to provide an estimate of the USD deposits that banks*

[3] For instance, the current ratio of official to market rate is 16% (15,000x100/90,000), which is almost equal to the fraction at which 'lollars' are exchanged for full dollars.

retired in the process of loans cancellation to arrive at the net losses arising from retail loans. In this respect, it is crucial to note that total resident USD deposits fell from USD 90.8B in September 2019 to USD 73.2B in December 2022, or a fall by USD 17.6B. Of these, we estimate the following:

USD 1.9B = limited withdrawals by clients, in addition to essential (humanitarian) transfers, from October 2019 to April 2020

USD 7.7B = limited withdrawals due to Circular 151 effective April 2020[4]

USD 640M = limited withdrawals due to Circular 158 starting June 2021[5]

The sum of the estimated above is USD 10.2B. Given that total deposits withdrawals during the period was USD 17.6B, then the remaining deposits of USD 7.4B were used to write off corporate loans. ***As a result, banks' net losses could be estimated at USD 15.6B****, or the difference between gross losses of USD 23B and the cancelled deposits of USD 7.4B.*

As important, our estimated losses of $15 billion align with the findings of the IMF report[6], which highlights the consequences of the decline in banks' foreign exchange loan portfolios. The report considers borrowers to have benefited from an implicit subsidy on loan repayments due to the disparity in exchange rates. **And it estimates this subsidy to amount up to $15 billion between March 2020 and January 2023**. As such, the burden of this preferential treatment represents a distribution of income in favor of borrowers at the expense of banks and ultimately depositors – clearly, an unfair process. This, in turn, gives credibility to calls by BDL that borrowers who benefited from Circular 648 should be subject to an excise income tax whose revenue would be used to pay back depositors and reduce banks' losses.

Notwithstanding the preliminary nature of these estimates and the assumptions behind them, we believe that these losses are huge. They represent more than 23% of the original loan portfolio of USD 65.7B, and they add to the litany of unjustified losses incurred by banks and depositors.

[4] The figure is based on extrapolating from BLOM Banks's Circular 151 figure by multiplying it by 7 as the share of BLOM's is 15% of the resident deposits market. Circular 151 allowed for the exchange of limited USD deposits, initially at the rate of LBP/USD 3,900 but later at the rate of LBP/USD 8,000.

[5] Circular 158 involved payments of USD 400 in cash and another USD 400 at the exchange rate of LBP/USD 12,000.

[6] IMF *Lebanon: 2023 Article IV Consultation Press Release; Staff Report and Statement by the Executive Director for Lebanon*, June 2023

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