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The Ugly Truth about Banking and Banks in in Lebanon

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Abstract

Lebanon walked out of Paris II in November of 2002 with US $4.5 billion in soft loans from countries friends of Lebanon. This represented, at the time, 25 percentage of the country's Gross Domestic Product (GDP). It must've been a much needed fund but it was not properly utilized. After that, political class's appetite to spend grew stronger with little to no reforms to report or claim. The nature and magnitude of the debt problem couldn't be made clearer with the statement of, then the chairman of the board or directors of the Association of Banks in Lebanon (ABL), in February of 2012, Dr. Francois Bassil, came out strong against banks continuing on the path of lending the government. It was utterly clear that Lebanon's public debt is getting out of hands and it is no longer sustainable. With banks operating in Lebanon bearing half of the public debt in foreign currencies and over two-third of the debt denominated in domestic currency that put them in the eye of the storm.

Keywords: Banking • Bassil's legitimate • Magnitude • Crisis

Introduction

The government's disorderly default in early March 2020 turned Bassil's legitimate fear into a horrible reality. The nature of the crisis and its magnitude make a government rescue and recovery plan very complex and it will most definitely fall short of dealing with the causes of the crisis. Banks under-estimated the risks associated with buying in Lebanese government debt instruments and over-invested in these securities. Isn't it time to ask if the state of banking in Lebanon, the way it's been, is healthy and sustainable? I doubt it is. I can think of a few areas that banks need to revisit, look long and hard to identify weaknesses and effectively deal with them [1].

Literature Review

The banking model

The excessive reliance on deposits as the only source of fund for banks makes managing liability more challenging relative to a banking sector with more diversified sources of funds. Banks, in recent years, spread their wings very thin knowing the volatility of their sources of funds [2]. Banks uses of funds have been effortlessly allocated as follows:

- Required reserves (25 percentage on Lebanese Pound-LBP and 15 percentage on Foreign Currency-FC, which comes in the form of mandatory placements with Banque Du Liban, BDL, the country's central bank) are balances held at the central bank earning no explicit return. However, what was supposed to be ready reserves failed in 70 percentage of it when that much turned into long-term subsidized loans as a part of an expansionary monetary policy initiative which turned sour because, in pursuit of explicit returns, banks failed to match the high quality of this reserve with high quality loans! Banks utilized every penny in regulation and by doing so, the mandatory reserves effectively dropped from 25 percentage to less than 18 percentage leaving banks exposed [3].
- Excess reserves which, to date, remained as ready reserves in the purest sense of liquidity. Banks allocate this liquidity between cash in Automated Teller Machines (ATMs) and with tellers [4].
- Loans to private sector. Retail (car, personal, housing, loans to individuals), commercial (overdraft facility, term-loans, project finance, to business enterprises). For most banks in Lebanon, the loan-to-deposit ratio jumped over 65 percentage. Not all banks followed best practices in lending. The problems of adverse selection and moral hazard became obvious when at the first sign of deteriorating economic conditions in late 2017, non-performing loans jumped up with little impact on bankers appetite to lend more; lending continued until up mid-2019, right before the big bang-the uprising of October 2019. On the other hand, in order to avoid being penalized through provisions for loan loss reserves, banks practiced a worrisome rigidity in downgrading the quality of their loans; a practice the board of directors and the external

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auditors found no harm in it. Finally, since loan sales is not a viable option here in Lebanon, loans are, by far, the most illiquid form of uses of funds even a simple delinquency in settling a payment on a loan is easily felt in the banks realization of ready liquidity derived from the settlement of debt [5].

- Placements with non-resident banks, mostly correspondent banks. These placements are used [as a cushion] to facilitate the financing of international trade. Although these deposits are, in principle, ready liquid assets for the banks, today, most of them are held against off balance sheet facilities (e.g., letters of credits, bank guarantees, etc.) extended by the correspondent banks (to the banks). The downgrading of the countrys credit risk rating eats away from the power of these placements in terms of their ability to support international trade [6].
- Placements with resident banks, most of these are referred to as overnight placements but with an actual maturity of one week. This is settled quickly and it is used to manage short-lived surpluses and/or deficits in liquidity. Recent events rendered the overnight market to no use since all banks have been suffering from shortages in liquidity.
- Investments in treasury securities and eurobonds. The exposure that bears the higher risk is the one denominated in foreign currency. The latest awakening by the people of Lebanon over years of corruption and irresponsible spending by the fiscal government brought concerns over the interdependency between the availability of depositors funds, the quality of banks uses of fund, the extent of the central banks exposure to the public sector and the health of the fiscal government and its ability to honor its commitments. That describes the nature and extent of complexity the financial system in Lebanon has been enduring since early 2020. These securities are mostly held till maturity where banks benefit from the coupon payments and a small portion is held for trading. However, recent years witnessed a noticeable conversion of euro bonds into placements with BDL as an expression of the disapproval of banks over the conduct of the fiscal government. These forms of investments suffered immensely with the disorderly sovereign default in March of 2020. Best practices call on banks holding these types of investments to write these assets off completely and immediately! Instead, however, banks continue to consider, to date, these government securities as a part of their high quality assets in their calculations of the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ration (NSFR). That's the kind of false sense of safety and security which I spoke of earlier [7].
- Placement with the central bank of Lebanon. These placements are over and above both the mandatory placements with BDL and the reserve requirements. They are distributed between small clearing balances and the rest in certificates of deposit. These are, in principle, risk-free placements had the central bank kept them as liquid as they ought to be. But, in recent months, it became apparent that BDL used a large portion of these placements, in both domestic and foreign currencies, to bail out the governments ailing public finance filling in the void that banks created by pulling away from lending the government [8].

Discussion

The banking model deployed by most banks has been rigid and outdated for being based on originate-to-hold with most of the assets. In addition, it strictly relies on short-to medium-term deposit funding; it's very restricted with respect to banks ability to convert assets into cash; and weak in properly and effectively assessing the risks associated with the uses and sources of fund. I attribute that to the false sense of safety and security that banks have received from the country's regulatory authority [9]. I recommend that every bank should intentionally differentiate between what is required for regulatory compliance and effective risk management:

- In fact, the data produced by most, if not all, banks is done just enough to satisfy BDL reporting requirements. Banks MIS is guided by the data reporting templates provided by the central bank; these templates that have never been challenged not in form nor in content or substance. The figures in regulatory reporting clearly understate the true risks since it is not risk-driven [10].
- However, the bank's own identification and assessment of all risks is what matters to its solvency. These numbers show if the bank is adequately capitalized or not; and if more needs to be done to cushion the true risks. This is at the heart of what should be expected out of the risk management unit at a bank. Banks have not been paying close attention to risks because it is not a profit-generating activity. Instead, they feel content with just compliance. Compliance is definitely not the job of the chief risk officer [11].

The board of directors should introduce and enforce rules to remove incentives for excessive profit-taking behavior and ensure that the bank is adequately cushioned against true risks at all times [12].

The rules of engagements between the banks and their clients. Banks ought not promise more than they can credibly, sustainably and profitably deliver. For most clients, what is possible today becomes mandatory tomorrow! This is the case in normal times and crisis time should have its own rules of engagement. Unfortunately, banks failed to include communication strategy in their crisis management and business continuity plan [13]. Ever since day one of the crisis and banks have been forcing all kind of controls on movements in clients accounts:

- Controls on withdrawals.
- Controls reaching the level of complete cancelation of credit and debit cards.
- Controls on fund transfers out of Lebanon.
- Banks stopped opening new accounts, giving new loans and cut working hours by half.

All of this happened with no prior notice and/or an explanation to clients why it happened! In addition, not all banks applied the same controls; each bank acted on its own, and these measures were not guided nor mandated by the regulatory authorities. The enthusiasm with which banks mobilized their resources (people, call centers, social media, etc.) to introduce new products and services all collapsed during the most recent crisis. It has been a complete communication breakdown between banks and their clients. In fact, even the association of banks in Lebanon, the banking community's well-endowed lobbyist, has been an absent actor on the banking crisis scene [14].

The relationship between banks and the central bank

The central bank of Lebanon (BDL) failed to effectively supervise banks because the manner with which the sitting governor planted the seed of this relationship and helped it grow, it presented BDL as a chaperone not a whip. It made banks live under the impression that compliance shall set them free not necessarily effective risk management! With the blessing of the banking control commission, banks left it up to the regulators to size their (banks) risks. In effect, this recent crisis showed that:

- Commercial banks and the central bank of Lebanon are reflections of each other.
- The activities of both are inextricably intertwined and the institutions undeniably share a commonality of interests.
- Central bank supervision of commercial banks, helping to assure maintenance of standards and sound banking practices, contributes to the health of the industry and to the trust and confidence upon which banking depends. This quickly tumbled on that morning after the crisis ignited; a testimony of failure.

Finally, the extent to which the Special Investigation Commission (SIC) was accommodating to banks on Anti-Money Laundering (AML) issues resulted in the death of two banks so far, the Lebanese Canadian Bank in 2011, and Jammal Trust Bank in 2019 [15]. In most jurisdictions, the undo button on AML issues has been disabled long time ago; expect in Lebanon with the SIC culture, we can undo and do over again and again until we get it right or we get caught by the US Treasury!

Lending practices

Banks focused more on the Credit Approval Process (CAP) and less on the Asset Life Cycle (ALC). The CAP concentrates the power of decision in the hands of one or two who are either most familiar or most intimate with clients and with a strong tendency to socialize the decision-making process; and it helps the bank score a loan with little attention to what happens after origination and recognition of the facility. However, the ALC engages the bank with proper planning ranging from developing a target market to securing that the facility is in line with the bank's strategic objectives, all the way to securing a good performance and timely settlement of the debt leading to repeat businesses. Considering that the bank originates an asset to hold till maturity, it is the better approach to focus on the asset life cycle.

Looking ahead

A clear plan to reschedule and/or restructure public debt is undoubtedly necessary but it is not sufficient. A strong prerequisite for improving Lebanon's capacity to recover and reclaim its economic power is a sound banking sector. Banks have failed to properly assess the risks associated with their sources and uses of funds. Today, banks are carrying loads of troubled assets which severely constrained banks ability to meet deposit outflows; and it most likely will drain their capital at a time the government is completely handicapped and not capable of providing the much needed bailout. Prompt restructuring and adequate recapitalization are a must; although there shall be consequences!

Recapitalization involves a major change in the way banks are funded and it essentially involves providing the banks with new capital. This improves the banks balance sheet and prevents them from going bust. Since the start of the economic crisis and the resulting credit crunch, banks operating in Lebanon have lost much money because:

- First and for most, the government of Lebanon took the irresponsible decision to default on its debt in the absence of a plan to restructure or reschedule the debt. Banks operating in Lebanon are major creditors (banks hold 50 percentage of the debt denominated in foreign currency and over 70 percentage of the debt denominated in domestic currency).
- BDL's decision to continuously bail out the bankrupted government with depositors money made the problem worst and rendered recovery and BDL's capacity as lender of last resort near impossible.
- The recession was exacerbated by the un-legislated capital controls, and led to more defaults by individuals and business entities which expanded the portfolio of non-performing loans.

Conclusion

The credit crunch meant that banks are no longer able to lend to each other; they cannot meet the demand for deposit withdrawals and they lost confidence. This created the need for recapitalization. Recapitalization is necessary, but not sufficient, for the rescue and recovery of banks. Over and above the drive to adequately capitalize, banks should agree to an improvement course of actions (self-imposed or imposed by the regulatory authority):

- Accurately assess the true volume of non-performing loans, and maintain reasonable levels of lending since excess lending created problems in the first place.
- Ensure proper identification and assessment of all risks on all placements.
- Freeze the payment of bonuses and dividends until capital is restored to an adequate level.
- Consolidate, downsize, and/or merge. What is important at this juncture is the health of the financial sector and not the health of any one particular financial institution.
- Reassess the capacity of key management positions to deliver. Positions such as corporate banking, chief financial officer, chief risk officer, treasury, chief internal audit, and head of branch network.
- Reassess the composition of the board of directors and the capacity of each member to deliver as expected and required.
- Limit the period of engagement between each financial institution and its external auditors to no more than five years only.
- Cleanse your institution from all political contamination and detach from dependency on politically exposed persons.

Fresh fund can help improve bank liquidity, but it doesn't necessarily improve nor sustain its performance. There is more to healthy banking sector than just recapitalization and the extra fresh fund.

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