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## LEBANESE FINANCIAL CRISIS: RESTRUCTURING MODEL FOR LEBANESE BANKS

*Lebanon is facing an ongoing economic and financial crisis since October 2019; the consecutive negative shocks led to the implosion of the Lebanese economy as the country's GDP contracted by 26 % in 2020, and the Lebanese banks are facing severe liquidity and solvency troubles. The International Monetary Fund (IMF) and the World Bank have warned that the crisis will worsen if the government doesn't take immediate actions to stop the collapse and prepare a recovery plan for the economy and the financial system. This article analyses several economic and financial indicators in Lebanon to understand the real causes of the crisis and to propose a restructuring model for the country's financial system. To achieve the objectives of this study, secondary data were collected about the Lebanese economy and banks from reliable and trustworthy sources. This study proposes a plan that helps to start getting out of the crisis by restructuring the Lebanese financial system in conjunction with an economic recovery plan. The suggested solutions include the following areas: restructuring the public sector, reducing the government budget deficit, enhancing the efficiency the public institutions, adopting monetary and fiscal policies that stimulate economic growth, implementing a manageable floating exchange rate system, achieving a trade surplus, reach an agreement with the IMF, restructuring the public debt, performing solvency stress tests for banks, proposing a fair loss distribution and haircut, proposing options to restructure banks, improving the corporate governance of banks, liberalizing and integrating the Lebanese financial market.*

**Keywords:** *Financial Crisis; Economic Recovery Plan; Stress Tests; Monetary Policy; Financial Engineering; Dollarization; Restructuring Banks; Merge; Recapitalization; Haircuts.*

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## ЛИВАНСКИЙ ФИНАНСОВЫЙ КРИЗИС: МОДЕЛЬ РЕСТРУКТУРИЗАЦИИ ЛИВАНСКИХ БАНКОВ

*Ливан сталкивается с продолжающимся экономическим и финансовым кризисом с октября 2019 г.; последовательные негативные потрясения привели к обвалу ливанской экономики, поскольку ВВП страны сократился на 26 % в 2020 г., а ливанские банки сталкиваются с серьезными проблемами ликвидности и платежеспособности. Международный валютный фонд (МВФ) и Всемирный банк предупредили, что кризис усугубится, если правительство не предпримет немедленных действий, чтобы остановить коллапс и подготовить план восстановления экономики и финансовой системы. В этой статье анализируются несколько экономических и финансовых показателей в Ливане, чтобы понять реальные причины кризиса и предложить модель реструктуризации финансовой системы страны. Для достижения целей этого исследования были собраны вторичные данные об экономике Ливана и банках из надежных и заслуживающих доверия источников. В этом исследовании предлагается план, который помогает начать выход из кризиса путем реструктуризации ливанской финансовой системы в сочетании с планом экономического восстановления. Предлагаемые решения*

*включают в себя следующие области: реструктуризация государственного сектора, сокращение дефицита государственного бюджета, повышение эффективности государственных институтов, принятие денежно-кредитной и фискальной политики, стимулирующей экономический рост, внедрение управляемой системы плавающего обменного курса, достижение положительного сальдо торгового баланса, достижение соглашения с МВФ, реструктуризация государственного долга, проведение стресс-тестов на платежеспособность для банков, справедливое распределение убытков и «стрижка» активов, варианты реструктуризации банков, улучшение корпоративного управления банками, либерализация и интеграция ливанского финансового рынка.*

**Ключевые слова:** *финансовый кризис; план восстановления экономики; стресс-тесты; денежно-кредитная политика; финансовый инжиниринг; долларизация; реструктуризация банков; слияние; рекапитализация; «стрижка» активов.*

Lebanon is facing acute financial distress which directly affected the Lebanese financial sector, but the pace of the crisis was faster than expected. The inability of the government to take urgent steps to stop the collapse contributed to the disastrous level that this crisis has reached, which was not expected even by most pessimistic analysts. In October 2019, the large and continuous protests accompanied by the closure of roads for several weeks obstructed the normal functioning of Lebanese banks, exacerbated politically contradictory views, and contributed to the beginning of the deterioration of the Lebanese pound in the black market. The International Monetary Fund (IMF) and the Lebanese government are trying to negotiate an agreement that helps Lebanon to start recovering from the crisis, the IMF put several requirements including; the government's approval of reforming budget, enact the capital control legislation, and the amendment of the bank secrecy law. The government's procrastination in taking immediate action to contain the crisis raised doubts that the current ongoing crisis will be an enduring one.

Over the years, many countries dealt with severe economic and financial crises differently because creating solutions for financial crises requires some improvisations that take into consideration the specific conditions of the country. The main elements needed to start the long recovery path include; calculating precisely the exact number of losses to ensure the flow of new funds needed to recover from the crisis, determining the new funding sources that contribute to getting out of the crisis, allocating fairly the estimated losses among all the stakeholders responsible for the crisis, each according to its responsibilities, enact the required laws and legislations to prevent committing the same mistakes and provide transparent procedures to ensure that the bailout funds will be used for the intended purpose.

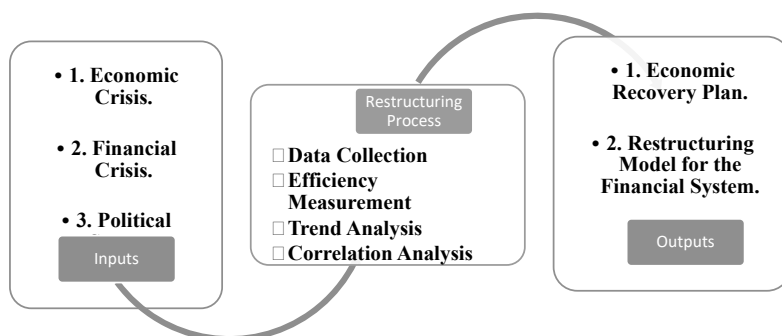
**Review of Literature:** Researchers drew big attention to the effect of restructuring banks on their efficiencies. According to H. Chang et. al., banks restructure their operations to improve their financial intermediation capacity by adopting the most recent technological innovations such as e-banking and other digital technologies associated with online transactions [1]. W. R. Scott described banks as institutions with social structures that have to achieve a high resilience level [2]. In this context, restructuring banks aim to keep their competitiveness as service providers to different categories of clients, and this is performed by adjusting or changing their structures and forms to achieve higher efficiency [2]. M. C. Jensen and W. H. Meckling described the agency theory as a principle that explains the relationship between the owners (principals) and the

agents (managers), banks are restructured based on this theory to reduce agency costs including moral hazard costs, transaction costs, contracting costs, and information costs [3]. J. Hawkins and P. Turner considered mergers as an effective and least costly approach to restructuring banks [4]. A. N. Berger et al. stated that regulators increasingly encourage mergers in periods of financial distresses because mergers may improve efficiency [5].

O. Zaim investigated the effect of financial liberalization in 1980 on the micro-efficiency level of Turkish banks, he found that financial reform stimulated the technical and allocative efficiency of banks [6]. T. K. Gaspard advocated that the high indebtedness in Lebanon resulted from the unrealistic interests paid by the Lebanese government to banks to entice them to invest in the Eurobonds and in the treasuries issued by the central bank to finance the budget deficit [7]. N. N. Zougheib used the data envelopment analysis technique to discuss the challenges and risks surrounding Lebanese banks [8]. He concluded that the high exposure of the banking sector, including the central bank, to sovereign debt, threatened the liquidity, sustainability, and intermediation role of banks [8].

**Data and Methodology.** This paper investigates the reasons for the rapid economic and financial collapse in Lebanon that started in 2019 and why Lebanese banks were affected dramatically by the crises without having sufficient capital and cash reserves to protect their solvency and liquidity, it will also try to propose a restructuring model for the Lebanese financial sector. The methodology used in this research will help to identify the real challenges facing the Lebanese banks, will help to stop the collapse in the Lebanese banking sector, and propose a restructuring model that suits the Lebanese situation. This deductive research uses quantitative secondary data collected from Lebanese banks' reports, the ministry of finance, the central bank of Lebanon, and international agencies such as the International Monetary Fund (IMF), and the World Bank. In addition, reviewing restructuring models for banks implemented previously in other countries represent a valuable source of secondary data that could be used in restructuring Lebanese banks taking into consideration the peculiarity of the Lebanese crisis.

**Restructuring Model for Lebanese Banks.** The Lebanese crisis is complex and manifold, it started with popular protests against some government decisions, but it quickly turned into a banking, financial, economic, and exchange rate crisis. Controversy is growing about the first step to resolving the crisis, however, political stability is critical in Lebanon because of the contradictory views between political parties, and because it is impossible to enact the required legislation to overcome the crisis without a minimum level of political consensus among all parties. Dealing with the Lebanese crisis requires simultaneous treatment of the economic and financial situation. An economic recovery plan is required by the International Monetary Fund to sign an agreement with the Lebanese government to lend Lebanon several billions of US dollars over the term of the program. The importance of this agreement goes beyond the funds that will be received from the IFM, it enables Lebanon to regain the trust needed to attract foreign investments and receive some of the promised financial aid and investments that were agreed upon at the «CEDRE» Conference, that was held in 2018 to support Lebanon. Also, a restructuring model for the Lebanese financial sector is essential to restore the intermediation role of the Lebanese banks. The following chart visualizes the elements of the restructuring model for the Lebanese financial sector. It introduces the inputs that contributed to the financial crisis, the outputs that include the solutions for the current situation, and the proposed restructuring process that will be used to achieve the desired results.



The following section discusses the main areas that should be resolved in the recovery plan and restructuring model.

**Public Institutions.** Several actions are required to reduce the burdens of public institutions on the government budget. Restructuring human resources in the public sector by dispensing redundant employees and offering them special end-of-service compensation, and recruiting new talents who are able to deal with modernizing this sector by incorporating the recent technological and online facilities. Unify the retirement criteria of all public sector employees, it is preferable that this plan be part of a national program for older people. Develop a quality management system to ensure that public sector employees have the required expertise and qualifications. Modernize the public sector so that people can perform their transactions electronically. Perform an audit to assess whether the current employees are able to handle advanced duties related to introducing new technologies in public sector institutions or whether there is a need to hire skilled workers to perform advanced functions. Establish regulatory bodies for each public institution that help to create some independence from political intervention and improve the performance of public institutions. Stop the random recruitment in public institutions. Involve the private sector in managing and improving the services of the basic public sectors, especially electricity and telecommunications. Rising public sector wages to attract new talents, but after laying off excess workers within the legal frameworks and limiting new recruitments to the needs.

**Budget Deficit:** The following chart shows the budget deficit in Lebanon as a percentage of the GDP between 2014–2020:

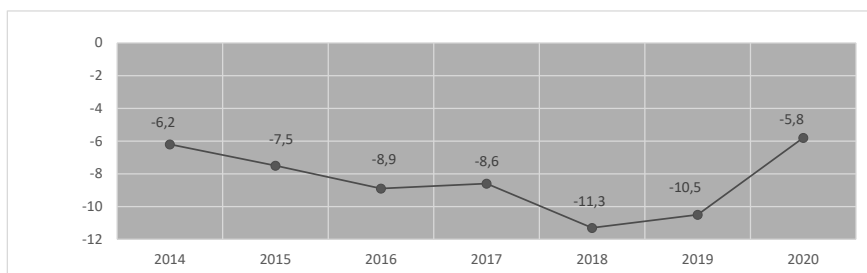


Fig. 1. Budget Deficit in Lebanon (% of GDP)

Source: compiled by the author on the basis of data from the Ministry of Finance in Lebanon.

The economic recovery plan should address the budget deficit clearly and search for advanced and innovative solutions for this problem, solutions include; reducing the burden of the public

sector from the government budget and limiting recruitment only to the needs. Following an effective tax policy to collect sufficient revenues for the government, and most importantly, combating tax evasion and mitigating smuggling. Cancellation of all councils that were established in Lebanon for partisan interests, such as the Council of the South, the Council for Development and Reconstruction, and the Fund for the Displaced. Set up realistic tariffs on the services offered by public institutions that take into account the production costs, this would contribute to the transformation of public institutions into profitable ones and reduce their dependence on government subsidies. Unifying the pension system which contributes to the abolition of some unrealistic pension contributions, especially for security institutions.

**Economic Growth.** In 2020, economic growth reached an all-time low of  $-25,91\%$ , the following chart shows the GDP growth in Lebanon between the years 2009–2021:



Fig. 2. Gross Domestic Product growth in Lebanon

Source: compiled by the author on the basis of data from the World Bank

Several actions are required in the economic recovery plan to promote economic growth, they include; Creating an investment environment by rehabilitating the infrastructure to encourage investors to return to Lebanon. Create a stable political and security environment. Strengthening the independence of the judiciary contributes to stimulating foreign investments. Reducing the bureaucracy and modernizing the administration which contribute to shortening the time required to establish businesses in Lebanon. Adopting monetary and fiscal policies that stimulate economic growth and encourage domestic and foreign investors to invest in productive sectors instead of depositing their capital at banks for receiving high interest.

**Restructuring Public Debt.** The following chart shows the constitutions of public debt between 2012–2019, it is worth noting that Eurobonds are traded in exchanges and the distribution of their holders may change daily, but both Lebanese banks and the central bank were largely exposed to the government Eurobonds:

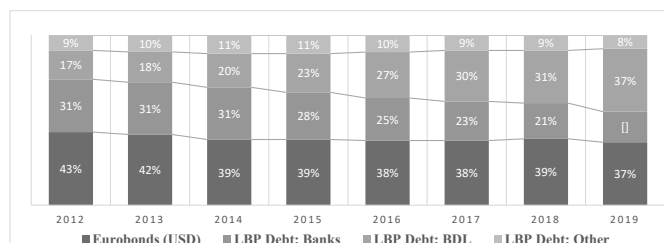


Fig. 3. Composition of Lebanese Public Debt (% of Total Debt)

Source: compiled by the author on the basis of data from the Ministry of Finance Lebanon

Restructuring the public debt will help Lebanon to regain its good reputation in the international financial markets, and it may enable Lebanon to issue new Eurobonds in the near future even if this could be done just by paying high-interest rates. In conclusion, restructuring the public debt affects the distribution of losses and forces the government to pay part of the losses equivalent to its responsibilities and based on a deal between the holders of the Eurobonds and the government, which could be achieved by a dialogue between the government and the holders of the Eurobonds.

**Interest Rate and Dollarization.** The following chart shows the dollarization rate of deposits at Lebanese banks between 2013–2021:

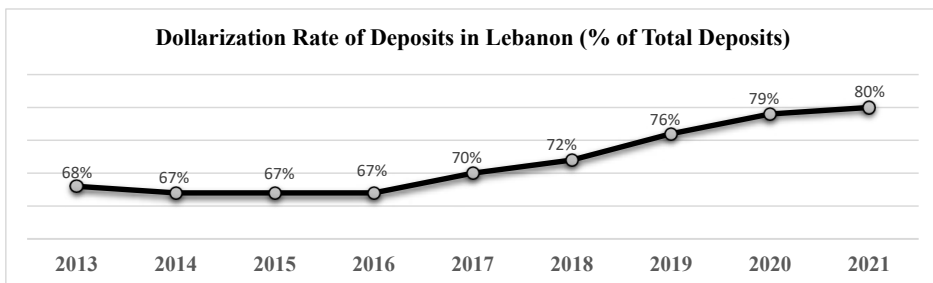


Fig. 4. Dollarization Rate of Deposits in Lebanon (% of Total Deposits)

Source: compiled by the author on the basis of data from Banque Du Liban BDL

The economic recovery plan must set a well-defined monetary policy provided that it is viable and the central bank is able to implement it. This policy must adopt a floating exchange rate system within acceptable margins, unify the exchange rate quotes, and ensure that all the country's administrations; security, financial, and administrative, will ensure the proper implementation of this policy, and enact the laws and legislations to fight the black market activities in the exchange rate. Dollarization could be the last choice to implement because it withholds from the state the ability to influence its economy, including implementing its own monetary policy and selecting the best exchange rate regime. However, around 80 % of goods and services in Lebanon are now priced in US dollars, and most salaries including those of the employees in the public sector institutions are paid in US dollars at the 'SAYRAFA' rate, this makes dollarization possible for a limited period of time to promote the stability in the exchange rate market and helps to implement a successful plan to restore the economic activities.

**Trade Deficit.** The economic recovery plan must include effective tools to achieve a trade surplus or at least reduce the trade deficit in the coming years. The following suggestions help to rebalance the trading activities in Lebanon; lifting subsidies on most imported goods, especially oil derivatives. Holding the international community responsible for the displaced Syrians and Palestinians and forcing them to provide urgent aid to Lebanon to cover the costs of their consumption of electricity and other imported goods. Put high taxes on luxury imported goods. Stop customs evasion, and review agreements with some countries whose imported products are exempted from taxes. Stop all smuggling operations to Syria, which cost Lebanon losing foreign currencies from its reserves. Enact laws to return the smuggled funds in foreign currencies outside the country after the outbreak of the crisis, which helps Lebanon to increase its reserves in foreign currencies.

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**IMF Program.** The following points must be addressed in the economic recovery plan to enhance the chances of Lebanon signing an agreement with the IMF; addresses the defects and the fundamental problems in the weak governance. Enhance transparency by enforcing reforms centered on enacting anti-corruption legislation. Improve the competitiveness and effectiveness of public institutions, particularly the energy sector. Perform international audits of the BDL and all public institutions. Restructure the public debt to restore credibility, predictability, and transparency of the fiscal framework. Expanding the social safety net program to protect the most vulnerable. Restructure the financial sector including banks and BDL. Establish a credible monetary policy, controlling the exchange rate activities within a flexible regime accompanied by the unification of the multiple exchange rates, and enact as soon as possible formal capital control legislation.

**Solvency Stress Tests.** The restructuring model for the Lebanese financial system must start with performing stress tests for all Lebanese banks to identify how banks will be affected by different restructuring scenarios based on proposed economic and financial assumptions. The available resolutions and restructuring options that could be used in restructuring Lebanese banks depend on the results of the stress test, these options include recapitalization, merger, and liquidation.

**Dollarization of Deposits.** The dollarization of deposits in the future must be restricted to deposits in fresh dollars, they should be invested or used by banks in the best interest of their depositors and at moderate risk levels that guarantee that they will not be lost, banks should diversify their investments following global standards of diversification, and meet the Basel I, II, and III requirements regarding liquidity and solvency ratios.

**Interest Rates.** The monetary policy must be built on economic and financial facts and BDL must set up the interest rates to promote economic growth and to reduce the volatility in the exchange rate market but under a floating exchange rate system. The monetary policy must encourage people to deposit and borrow from banks in Lebanese pounds. Also, banks must have sufficient flexibility to compete in attracting clients, by offering clients a variety of loan options and competitive interest rates on deposits, but within an acceptable margin of profitability and without exposing their deposits to excessive risk.

**Corporate Governance.** The restructuring model for banks must enhance the culture of preparing good corporate governance and it is preferable to prepare ESG corporate governance to ensure that banks can achieve sustainable growth and ethical operations toward the whole society. Good corporate governance is directly affected by enhancing the Lebanese financial market and encouraging all Lebanese banks to list their shares in BSE.

**Financial Markets.** Improving the performance of BSE requires several steps that must be addressed in the restructuring model, they include; Setting up well-defined and strict rules by the Capital Market Authority CMA to regulate, supervise, license, and monitor the financial market activities of the listed companies to protect investors. The financial market must offer a variety of financial securities and derivatives such as options, swaps, mutual funds, and Exchange-traded Funds (ETFs). List some public institutions in BSE after restructuring their operations to stimulate the private sector to contribute to the development of these sectors. Encourage the managers of pension funds, insurance companies, social security funds, and other institutional investors to invest in the BSE by offering them tax exemptions on dividends and interest received.

The analysis performed in this study confirmed the need for an economic recovery plan required by the IMF to sign an agreement with the Lebanese government, and a restructuring model for the financial sector to restore confidence in the financial sector. The proposed solutions aim to reduce the burden on the government budget, improve the quality of services of the public institutions, reactivate the operations of public sector institutions, adopt monetary and fiscal policies that stimulate economic growth, implement a manageable floating exchange rate system, address the budget deficit and resolve this problem, find effective tools to achieve a trade surplus, reach an agreement with the IMF, and propose a restructuring criterion for the public debt. The restructuring model developed in this article suggests performing solvency stress tests for banks to classify them as solvent or insolvent, proposing a fair loss distribution and haircut, proposing options to resolve and restructure banks, discussing the dollarization of deposits in the future, describing the realistic policies that should be followed by banks regarding interest rate and corporate governance, and integrating the Lebanese financial market with the world.

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