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Rethinking Lebanon's Central Bank

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Following my article published in this esteemed newspaper on March 22, 2020, in which I proposed that Lebanese banks "take the bull by the horn,“ lead the way in proposing to their customers a way out of the crisis through several creative options, and lead the way also in negotiations with the government to reach a complementary assistance that would at the end save the Lebanese people's bank deposits.

I hereby outline a complementary solution that should be adopted. It involves rethinking the structure and role of the Central Bank so it can contribute efficiently to the envisaged banking solution and save the financial system. A continuation of the present status quo means further losses and may end up costing the depositors a big haircut, bankruptcies among banks, or simply a forced conversion of the dollar deposits into Lebanese pounds. All of these outcomes would mean a disaster for the depositors and the reputation of the country.

Restructuring the Central Bank and wiping out its losses could increase its reserves, attract fresh dollars from abroad, allow it to generate guaranties that could be useful to finance imports, re-establish the confidence in the monetary system, and bring back liquidity to banks over time.

Basing our analysis on the government adviser's numbers, Lazard, which concluded that the Central Bank had losses of $44 billion from its past operations in stabilizing the currency, paying the price of the so-called "Financial Engineering Operations," paying very high interest rates to banks in dollar deposits and not being able to reinvest at attractive returns. To those losses, Lazard states we should add the inevitable losses in their Eurobonds Portfolio and their portfolio of Lebanese pound denominated bonds, which they estimate at around $18 billion. All the above losses and potential losses are extremely high for a Central Bank, in absolute terms and especially given the size of the Lebanese economy. From there it becomes obvious that we need rethink the bank's situation and role.

The Central Bank owes also to banks about $75 billion that it is unable to repay at maturity after taking into account the compulsory reserves it has, in the amount of $19 billion (which are the bank's property at the end) and the amounts that banks owe the Central Bank in lines of credit that it extended to them during the crisis.

The Central Bank net reserves, in our view stand now at around $2.5 billion. The pressure on the bank is set to increase significantly when the confinement will cease because there will be a need for foreign currencies to import nonessential imports such as clothing, cars, equipment, which are at a standstill now. The scarcity of funds to import these goods and the inability to meet all of it will cause even higher inflation and a further depreciation of the currency, which the country needs to avoid as much as possible, in order to avoid social unrest.

To face this situation, and to be able to repay the tens of millions that the Central Bank owes to commercial banks, it is essential to save the bank and restructure it. How??

1- The structure of the Central Bank should be converted into a Swiss National Bank model that is called in Switzerland "Mutuality." Switzerland has an important banking and central banking system that has the confidence of most foreign depositors and governments. Lebanon should orient itself in this direction. This involves opening up the capital to foreign investors mainly from the diaspora, because this would help the country and at the same time offer them a safe investment in their mother country.

Same for some Lebanese investors. The interest of both will be based on the fact that the Central Bank, as all central banks in the world, has a right of "Seigneurie“ whereby they can guaranty profitability by the exclusivity they have in issuing currency, by lending to banks at a rate it determines, by using the bank's reserve requirements and not paying interest on them by borrowing at cheaper rates and so on. Shares of the Central Bank will be traded in a foreign stock exchange, and all the shares that it issues will be nonvoting so there can be no interference by shareholders in the management of the Central Bank. This is the principle of the mutualization.

The Central Bank also trades part of the funds it owes to banks into preferred shares in the Central Bank, also traded in the market. This formula would insure that banks will receive the priority on profits of the Central Bank and would improve the rating and credibility of banks vis-a-vis their correspondent banks by the fact that it comes within a complete restructuring and strengthening of the Central Bank outlined in this article. It would improve its balance sheet and reduce its cost of funding and allow issuing guarantees or Letters of Credit.

2- In return for the funds that the state owes to the Central Bank, it will trade assets against Lebanese pound bonds and Eurobonds. These assets will consist of land from the 1 billion square meters the state owns, buildings, some institutions that it will manage better than the state did. This would cover a large part of its losses, strengthen its balance sheet, allowing it to issue guaranties to foreign central banks and states so that they deposit funds with the Central Bank, which in return will boost its reserves and increase its margin of action.

3- After executing the above, the Central Bank establishes contact with foreign government entities specialized in financing exports from their own countries, as well as guaranteeing payments for these exports and propose a partial guaranty from the Central Bank to these entities to entice their private companies to export and undertake projects in

Lebanon. By this method, Lebanon would promote investment and would reduce its need for foreign currencies and boost the Lebanese balance of payments. These entities are as an example: COFACE in France, SACE in Italy, OPIC in the U.S. as well as similar ones in other countries whose private sector is or may become interested in trading or investing in Lebanon.

4- The Central Bank initiates then what are known as Currency Swap Operations with friendly countries to reinforce its currency reserves, once it has tools that allow it to stabilize the Lebanese pound to a certain extend. This would enhance its foreign currency reserves. It also refrains from undertaking any more operations so called “Financial Engineering.”

5- With the Central Bank reinforced and getting its credibility back it would seek standby lines of credit to be used during periods of temporary need for liquidity and stabilization of the monetary situation. To obtain these, the Central Bank would post as collateral some specific assets recovered by the state in the procedure described in No. 2 above.

6- Initiate a circular and obtain Parliament backup through a law to strengthen the country’s foreign currency situation by recovering all large amount of funds transferred abroad or withdrawn in cash since the closure of banks in October 2020 and the Association of Banks unilateral decision for capital control. This decision was not respected by many of the association’s own board members and members at large. This behavior was a prejudice to those depositors who were discriminated against and who lost many opportunities through these actions that are a breach of fiduciary duty of bankers and of their ethical code. These actions also placed the entire country at risk as it means emptying it from its capital at a time of severe political instability and a risk of collapse of the overall monetary system. Penalties of not abiding should range from withdrawing the banking license to civil and penal punishment. Customers who refuse to abide should also be subject to penalties for being in cahoots and putting the country at risk. These funds would strengthen the system by about 5 billion dollars much needed at this time of financial depression.

7- The Central Bank under this new reform program, would refrain from financing the state, except in real emergency situations as per the existing law. It also stops financing or backing interest rates for the electricity company, industry, tourism, press, startups and others. The above roles that the Central Bank was progressively playing were due to the absence of the state action in this regard and are not part of its role as a Central Bank, as known in the Western world.

8- The Banking Supervisory Committee at the Central Bank, should be revamped, its prerogatives changed, and the nomination process revisited. It has failed to sound the alarm when banks were taking big risks in their investments, were putting much too many eggs in one basket and failed to abide by rules of diversification and limits in committing to financing one sole client. They also failed to sound the alarm when banks undertook big mismatching of assets and liabilities by investing very long term in Eurobonds when their client deposits had short maturities risking as a result a liquidity crisis that ultimately happened. Perhaps the members of this committee should not come from local banks who have very close ties to them but from foreign banking institutions to avoid being influenced. At a minimum they should have at least left the local banking institutions many years before their appointment.

In summary, this committee failed in its control of banks, which resulted in the big crisis they are all going through and their losses and lack of liquidity that make them unable to honor their customer demands since six months and will not be able for the foreseeable future.9- The Central Bank should stop all mismatching in currencies, which consists for example of taking dollars from banks, (which are in fact the customer deposits), and lending it to the government in Lebanese pounds hence taking the risk of devaluation of the currency in addition to the risk of default of the government. Finally, the Central Bank should go back to principle of having quasi-total autonomy in its decisions, which is the main purpose of its existence.

This new structure for the Central Bank that includes recapitalization, reorganization, absorption of past losses and a revisited role, must come in to complement and support of my earlier proposition for bank restructuring and ways of dealing with the deposits. It allows the Central Bank to have the possibility to play an important role in the rebirth of the country and the saving of the financial system. To succeed, it has also to be accompanied by a beginning of serious reforms, of a steep reduction of corruption and firm credible steps to recover stolen funds of the past years as well as a first injection of fresh funds from CEDRE, the IMF, World Bank, BOT projects or others. It will bring back confidence in Lebanon’s financial system, would entice people to liberate and spend the estimated $5 billion stuck in the homes and will bring back velocity of money in the system. It will stabilize banks once they go through a recapitalization and will protect deposits that could then be set free progressively over time.

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