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FINANCIAL SECTOR ASSESSMENT

LEBANON

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FINANCE AND MARKETS GLOBAL PRACTICE
MIDDLE EAST AND NORTH AFRICA REGIONAL VICE PRESIDENCY

A joint team from the International Monetary Fund (IMF) and World Bank (WB) visited Beirut, Lebanon during February 1-15 and March 29-April 11 to conduct an assessment under the Financial Sector Assessment Program (FSAP). This report summarizes the main findings of the mission, identifies key financial sector vulnerabilities, and provides policy recommendations.

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GLOSSARY

AML/CFT	Anti Money Laundering and Countering Financing of Terrorism
BC	Basic Circular of the Banque du Liban
BCBS	Basel Committee on Banking Supervision
BCC	Banking Control Commission
BCP	Basel Core Principles
BdL	Banque du Liban
CAR	Capital Adequacy Ratio
CC	Central Council Banque du Liban
CD	Certificate of Deposit
CMA	Capital Markets Authority
CMC	Code of Money and Credit
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee
FSU	Financial Stability Unit
FSSA	Financial System Stability Assessment
HBC	Higher Banking Council
HDC	High Debt Committee
ICC	Insurance Control Commission
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LBP	Lebanese Pound
LC	Largely Compliant
LCH	Liquidity Coverage Ratio
ML	Money Laundering
MTDS	Medium Term Debt Strategy
NIB	National Insurance Board
NIGD	National Institute for the Guarantee of Deposits
PDD	Public Debt Directorate
RWA	Risk Weighted Assets
SIB	Systemically Important Bank
SIC	Special Investigation Commission
TD	Term Deposit
TF	Terrorist Financing
WB	World Bank

Executive Summary

Lebanon has maintained financial stability through repeated shocks and challenges for the last quarter century. A stable exchange rate pegged to the dollar, remittances and deposit inflows from nonresidents and Lebanese abroad, and adroit crisis management have helped to preserve confidence through regional and domestic economic and political shocks.

Over time, macroeconomic and financial vulnerabilities have accumulated. Public debt is lower than peaks reached in the past, but is high at 140 percent of GDP, and fiscal and external deficits are large. Covering financing needs requires a continued inflow of remittances and nonresident deposits. With assets close to four times GDP, the financial sector has grown very large, and is dominated by a small number of banks.

Government debt and deposits at the Banque du Liban (BdL) account for close to half of aggregate bank assets and almost all banks have similar business models and risk profiles. Near-term growth prospects have weakened due to the Syrian conflict and the domestic political impasse, and scope for tackling macroeconomic imbalances appears limited. Deposit inflows have slowed, and the balance of payments was in deficit in 2015, for the first time in more than a decade.

Central bank policies help mitigate risks and maintain confidence. The BdL defends the exchange rate, underwrites government debt issuance, keeps interest rates steady at moderate levels, maintains high gross international reserves, provides economic stimulus, and assists in managing weak banks. These actions absorb systemic risks, albeit also leading to the creation of reserve money and the BdL should consider the scope to reduce their interventions as opportunity arises. To date, inflation has remained low and exchange market pressures modest, and while BdL is best placed to judge the balance of the trade-offs, a contingent claim on the banks' and BdL's foreign assets could materialize if pressures emerge in the future. Ultimately, a fiscal correction and a return to a declining public debt ratio is needed to reduce systemic risks and potential threats to financial stability.

The banking system has proven resilient to domestic shocks and regional turmoil. The banking sector has grown and remained profitable despite economic volatility, showing underlying confidence in the banking system. Nonetheless, forward-looking analysis highlights the vulnerabilities inherent in the banks' structure, with high exposures to sovereign, interest rate and real estate risks. The size of the banking sector implies that shoring up capital would take significant resources. The lack of liquid secondary bond markets, the nature of bank assets and deposit concentration implies that liquidity stress could lead to large calls on central bank funding.

Effective oversight and crisis management have underpinned stability. Assessment of compliance with the Basel Core Principles found banking supervision to be effective and the supervisor well respected. Work is underway to ensure a better match between the risk profile of individual banks and their capital levels, a key reform. Strengthening stress testing

capabilities and introducing a framework for recovery and resolution planning are also priorities. Weak small and medium-sized institutions have been promptly handled without financial stability being threatened, through mergers benefiting from financial assistance from the BdL and, in some cases, with regulatory forbearance. Tools and strategies should be developed for managing possible systemic events, and techniques considered that could help reduce the BdL's exposure to loss in resolution, while strengthening the financial system.

The banking sector is, directly and indirectly (through collateral), exposed to real estate. The housing segment has weakened, with declining prices in some market segments. The market downturn has been cushioned by BdL policies that subsidize mortgage loans for middle-income households. The BdL has also begun collecting data for a housing price index that will improve transparency. Additional prudential measures to (i) assess the inventory of built and unsold units and (ii) further professionalize appraisers are important. While current conditions preclude phasing out subsidies in the short run, more efforts will have to be made to calibrate the stimulus program and limit distortions.

Due to structural constraints, Lebanese capital markets remain under-developed. Capital markets contribute very little to the financing of the economy, nor do they represent a risk to financial stability. Renewed attention is being given to capital markets development with the creation of the Capital Market Authority (CMA) and the decision to foster the development of a new trading platform is paving the way for market initiatives. Certain improvements are still needed on the regulatory and supervisory front, including: (i) the creation of the Sanctioning Committee and Capital Markets Tribunal, (ii) implementation of a package of CMA regulations, (iii) enhancing the supervision of Midclear, and (iv) cooperation with the Insurance Control Commission (ICC) to foster a growing and soundly regulated insurance and pension fund industry. As markets grow, the CMA should strive to strike a balance between innovation and investor protection, and shift the nature of its oversight towards monitoring, risk based supervision of intermediaries, and market surveillance. In addition, the CMA should prepare a capital markets development program in consultation with the market.

Insurance markets are sizeable in comparison to peers but expansion prospects are hindered by an inadequate regulatory and institutional framework. At par with some upper-middle income economies, the market still has considerable room for expansion. Such growth would have benefits for domestic contractual savings and the development of capital markets. For safe and financially sound growth to be possible, industry consolidation and professionalization are needed, as smaller family owned and managed insurance companies face challenges to solvency and profitability. Weak firms are distorting competition and may be dissuading large investors from entering the market. Some pension funds remain out of any effective oversight scope of the ICC. The ICC has made commendable progress in regulating the industry but is hampered by lack of independence. A new insurance law to strengthen the system is overdue.

In terms of access to finance, Lebanon stands above regional peers, but below upper-middle income countries. A national comprehensive financial inclusion strategy would help to prioritize targets and related financial services.

Despite progress, access to finance for small and medium enterprises (SMEs) has still room for improvement. In addition to improvements in the credit registry and payments systems, key pieces of legislation concerning the bankruptcy and the secured lending regime should be adopted (draft laws have been prepared but have not been enacted by the Parliament). Improving the credit enabling environment should remain a priority given their sustainable, cost effective impact on access to finance. In a context of political deadlock, BdL stimulus measures have helped to catalyze bank lending to SMEs. Also, the BdL should set up a monitoring and evaluation system to better assess and calibrate the impact of the measures. Revisiting and expanding Kafalat activities would also help. BdL support to equity finance of startups is meeting a positive take up, and should be adjusted to crowd in private investors, open up to startups in sectors other than information technology, and gradually phase down the BdL exposure.

The micro finance industry plays an important role in financial inclusion and, while it does not represent a systemic risk, a well-calibrated regulatory requirement should be imposed to the main players. Without prudential rules, the market would grow at the price of increasing risks, including reputational (over-indebtedness, and cross-borrowing are already observed). There are some signs of overheating with rising competition for viable projects and cross borrowing. The regulatory playing field should be leveled across most micro finance players, through one adjusted regulatory regime.

More could be done to foster financial inclusion within the strict anti-money laundering and terrorism financing regulatory framework. In particular, authorizing bank-led branchless activities could increase bank account penetration. Also, electronic payments could expand rapidly, once the e-signature law is passed.

Key recommendations are summarized below. Other recommendations can be found in Appendix I.

Table 1. Lebanon: Key Recommendations

Banking Sector Supervision
Review of adequacy of supervisory resources
Introduce legal protection for staff of supervisory authorities
Develop and implement integrated risk profile for all banks
Better align capital planning with banks' risk appetite and profile, corporate governance and risk management
Develop capability for undertaking top-down stress tests and require banks to periodically submit bottom-up multi-factor stress tests
Establish supervisory colleges for banks with material cross-border operations
Strengthen regulatory regime concerning banks' exposure to real estate (i.e. LTV ratio for loans to developers, inventory of unsold properties and professionalization of appraiser industry)
Financial integrity
Align ML and TF offenses with FATF standards
Establish a comprehensive mechanism to implement United Nations Council resolutions'TF-related targeted sanctions
Adjust the allocation of AML/CFT supervisory resources and action in line with actual ML/TF risks
Crisis management and preparedness
Formalize internal criteria for access, in stable times, to BdL emergency liquidity assistance for illiquid yet solvent banks
Develop and implement recovery plan requirements
Develop plans for the orderly resolution of systemic banks while protecting depositors
Discontinue policy measures that support mergers between sound banks
Financial development and access to finance
Adopt a national Financial Access to Finance Strategy
Establish the Sanction Committee and the Capital Market Court
Finalize and implement capital market regulation
CMA to prepare and adopt a Capital Market Development Plan
Modernize insurance law to empower an independent insurance regulator
Recalibrate and consider phase-out of stimulus packages, as appropriate, based on a monitoring and evaluation framework

I. POLITICAL AND MACROECONOMIC BACKGROUND

1. **Lebanon has maintained financial stability over the past quarter century.** Despite repeated political and economic shocks and periods of low activity, growth has average about 5 percent since the early 1990s and per capita income has risen to US$11,250 in 2015. The financial sector—overwhelmingly banks—has grown rapidly over this period, as inflows of deposits from nonresidents have financed large and persistent macroeconomic imbalances. Confidence has been underpinned by the exchange rate peg in place since 1997, and adroit crisis management. Current regional turmoil and domestic political difficulties have weakened investment and growth since 2011, with large fiscal deficits and rising public debt. A slowdown in deposit inflows raises the urgency of macroeconomic reforms that would help reduce financing pressures and bolster investor confidence.

2. **The economy is enduring another episode of stress, magnifying macroeconomic imbalances.** Estimated at around 1 percent for 2015, growth is below historical averages. The medium-term current account and fiscal deficits are estimated at around 20 percent and 8-9 percent of GDP, respectively. The public debt ratio, at around 140 percent of GDP, is exceptionally high for an emerging market. The refugee crisis has added to poverty and unemployment, generating additional pressure on the public finances, while foreign investors have pulled back. Traditional growth drivers—tourism, real estate, and construction—have weakened, exports have contracted and investment growth has slowed significantly.

3. **The near-term outlook remains uncertain and vulnerabilities are rising.** Growth is forecast to remain at around 1 percent in 2016. Lower oil prices helped the fiscal outturns in 2015, allowing for a small primary surplus (0.4 percent of GDP). However, with no fundamental policy change in sight, large deficits are expected to persist and public debt dynamics are projected to worsen. While gross reserves remain high, at USD 36.5 billion (about 47 percent of external debt and 24 percent of broad money, including dollar deposits), the current account deficit and slowing growth in deposit inflows led to a decline in reserves in 2015.

4. **In this political and economic context, BdL plays a critical role in maintaining financial and economic stability, pursuing multiple policy objectives**:

- *Keeping sovereign yields steady and low:* the BdL has become the marginal buyer of government debt—in both local currency and Eurobonds—at primary auctions. In this way, the government has benefited from lower interest rates, and benchmark rates from which private lending is priced have remained steady. By placing certificates of deposit (CD) and time deposits (TD) with banks at long tenors, and buying sovereign debt at shorter maturities, the BdL incurs important carry costs.

- *Maintaining high gross international reserves*: while gross reserves of the BdL grew faster than deposits in the system during the global financial crisis, the coverage ratio of reserves to total deposits has been declining steadily since the beginning of 2010.

Reserves are borrowed from the banking sector, and the BdL incurs a cost arising from capturing foreign exchange (FX) resources from the banks and placing them in highly-rated, liquid reserve assets.

- *Providing economic stimulus*: the BdL has loosened domestic monetary conditions by reducing reserve requirements to stimulate lending to specified sectors, and later providing subsidized loans to banks for on-lending to selected borrowers. These measures have helped sustain the market for residential real estate in particular. In addition, the BdL has made funding available to start-ups, with the aim to promote the knowledge economy in Lebanon.*Sustaining banking sector strength*: With 39 percent of their assets invested in CDs, TDs and remunerated reserves, bank profitability is being sustained in a considerable extent. Sovereign debt and claims on the BdL count as liquid assets from a regulatory perspective, and attract zero risk-weights in Lebanese pounds (LBP) and 50 percent in FX (compared to 100 percent as required by the Basel II standardized approach, similar to the risk weight for FX denominated sovereign debt instruments). Recent regulation on restructured loans envisages funding support from the BdL in the form of loans with subsidized rates, with the reduction in funding costs to be passed on to the counterparty of the restructured loan.

- *Managing risks from bank weakness*: in order to avoid undermining depositor confidence, the BdL provides financial assistance to ensure weak banks can be absorbed by the system. Similarly, the BdL has been providing loans at favorable rates to incentivize consolidation of healthy institutions.

5. **While the BdL has been effective in managing systemic risks, using its balance sheet as a buffer to absorb shocks and sustain confidence, there are costs to these policies.** Official data do not allow for detailed analysis (BdL accounts do not show interest payments on CDs and TDs when they accrue, but amortize them over 35 years) but costs could be substantial. The banks' total portfolio of deposits at BdL is equivalent to 48 percent of GDP, while the BdL's net claims on the public sector are 26 percent of GDP. This translates into the creation of new reserve money, credited to the banks' accounts at the BdL, in equivalent amounts. So far, inflation has remained low, exchange market pressures limited and depositor confidence has been maintained, suggesting opportunity costs have been limited. Nonetheless, in the absence of significant reductions in public sector financing needs, these policies may ultimately be inconsistent with maintenance of the exchange rate peg. In addition, the BdL incurs a negative carry on its foreign currency borrowing from banks, due to the maturity mismatch on its foreign currency portfolio.

6. **Without fiscal adjustment, systemic risk will continue to rise, and the BdL's capacity to maintain financial stability could become increasingly stretched.** Decreasing participation in primary auctions and allowing sovereign yields to rise would reduce carry costs for the BdL. But at the same time, it would increase pressure on public finances (government interest payments already equal about 9 percent of GDP, compared to revenues

of about 19 percent), and rises in yields could reduce bank profitability, and have unpredictable effects on confidence. Rising lending rates would transmit quickly into contractionary economic effects (loans are mostly made at floating rates). The high interest elasticity of deposit growth further complicates the picture. While the BdL is best placed to judge the balance of this trade-off, fiscal adjustment leading to lower external financing needs and a declining public debt ratio, along with the resumption of robust growth, are ultimately imperative to bolster financial stability as well as fiscal sustainability.

II. Financial System Structure and Stability Analysis

A. Financial System Structure

7. **The Lebanese financial system is dominated by banks.** Sixty-six banks account for 97 percent of financial system assets, which, at 397 percent of GDP (as of December 2015), are large for a middle-income country. Nonbanks play a correspondingly minor role, and do not give rise to systemic risks.

8. **Foreign deposit inflows underpin reserves and finance external deficits**. Deposit inflows, attracted by high interest rates, exchange rate stability, and remittances of the large Lebanese diaspora, sustain macroeconomic and financial stability. Current account deficits are forecast to remain above 15 percent of GDP over the next five years; total external debt (including nonresident deposits) stood at 175 percent of GDP in 2015. With FDI having decreased in recent years, continued deposit inflows are the only significant source of capital inflows. The current slowdown in nonresident deposit growth led to declines in international reserves of just over 10 percent in the year up to May 2016, the first drop in 11 years. Following an operation to acquire reserves from the banks in return for purchasing holdings of Lebanese pound (LBP) denominated debt at prices including large capital gains for the banks (known as the “financial engineering”), international reserves reached almost US$41 billion. This covers 100 percent of short-term debt/the IMF reserves adequacy metric. Banks have been asked to retain part of the profits from this transaction to meet capital requirements stemming from the adoption of IFRS 9, planned for 2018.

9. **Banks sovereign exposures are high. Public debt was equivalent to 138 percent of GDP at end-2015, and medium-term fiscal deficits are forecast at 9–10 percent of GDP.** Banks are the key source of financing. As of June 2016, holdings of government debt securities account for about 28 percent of assets, while deposits and excess reserves at the BdL account for another 40 percent. Summing up the two, total exposure to the sovereign is more than six times Tier 1 capital, absorbing an increasing share of asset growth as the economy and deposit inflows have slowed (Appendix I, Figure 3). Sovereign spreads are tight compared to countries at similar ratings (despite rising about 100 bps since the financial engineering operation), partly due to BdL intervention in the Eurobond and T-bill markets. With ratings at B- (S&P and Fitch) and B2 (Moody’s), banks are exposed to a downgrade.

10. **The banks are deposit-funded, and secondary debt markets are not well developed.** Banks have minimal reliance on wholesale funding, while deposits have short maturities and are concentrated. The system-wide loan-to-deposit ratio (all currencies) is low at 38 percent due to the large holdings of sovereign and BdL debt. Secondary markets for this debt are illiquid (97 percent of banks' securities portfolios are held to maturity). In order to benefit from the term premium and higher interest margins, banks have gradually invested in longer-term BdL instruments (LBP instruments are issued in tenors up to 30 years, versus up to 15 years for government debt in pounds), including nonmarketable term deposits (TD), increasing maturity mismatches, and they carry interest rate risk accordingly. Early redemption of deposits at the BdL, or use of government and BdL securities as collateral for repo operations could underpin individual banks' liquidity positions in Lebanese pounds. A widespread shock to bank liquidity leading to a demand for foreign currency could result in a drop in international reserves (1 percent of deposits are equivalent to 3 percent of GDP or 3.7 percent of reserves).

11. **As the economy and deposit inflows have slowed, growth in bank assets has tilted steadily toward investments in the BdL.** After rapid growth in private sector exposures during 2008-11, public financing needs absorbed a growing portion of asset growth in the following years. Since Q4 2013, banks have roughly kept their exposure to the government unchanged, but instead continued to accumulate BdL CDs and time deposits at a faster rate. Despite the sharp economic slowdown, the reported NPL ratio has increased only modestly over the past year (to about 4 percent, excluding accrued interest and loan portfolios of two banks under liquidation). However, this measure excludes restructured loans that may be immediately reclassified as performing, subject to regulatory approval. As of September 2015, the system's Common Equity Tier 1 ratio was 10.2 percent.

12. **Banks are profitable, even though the low interest environment has decreased interest margins**. With short-dated LBP treasury-bill yields around 4–5 percent and average deposit rates at 5.6 percent (LBP) and 3.2 percent (USD), net interest margins have been compressed. A shift into longer-dated, higher-yielding BdL instruments, in combination with earnings from foreign operations, has helped to underpin bank profitability, culminating in a growth of almost 10 percent in consolidated profits over 2014. Nevertheless, subdued business volumes are expected to adversely impact bank earnings.

13. **The BdL plays a critical role in sustaining confidence, although, without sustained fiscal adjustment, there are limits to these policies.** The BdL maintains interest rates steady and low through buying government debt (both local and foreign currency) that is not absorbed by the banks. In parallel, BdL issues long maturity certificates of deposit (CDs) and TDs, incurring a carry cost. The BdL maintains the exchange rate peg through intervention and holds high international reserves by accumulating deposits from the banks, incurring further carry costs in the process. By reducing reserve requirements and supporting lending to certain sectors, the BdL is loosening monetary conditions and providing countercyclical economic stimulus, particularly to the real estate sector. The BdL also

provides financial assistance to ensure that weak banks can be absorbed by stronger ones while protecting deposits. These policies have so far been successful in managing systemic risks, but they have limits. Carry costs, intervention in foreign exchange and debt markets, stimulus measures, and anticipating payments to banks have an impact on the BdL's balance sheet and imply the creation of new reserve money. Without fiscal adjustment and a reduction in the financing needs of the economy, the BdL's ability to function as "policymaker of last resort"—and, in doing so, expanding its balance sheet, maintaining interest rates, reserves and the peg, and actively managing the economy—will become increasingly stretched.

B. Private sector credit development

14. **While the stock of credit to the private sector is high, growth has slowed and credit cycle risks appear limited.** At 94.5 percent in 2015, the ratio of credit to the private sector to GDP is the highest in the region. About 72 percent of bank lending is dollar denominated. After averaging about 15 percent per annum during 2008-13, private sector credit growth gradually slowed to 7.3 percent during 2015. While credit in LBP has remained robust, in part due to the BdL's stimulus packages, the decline in foreign currency credit growth has been more pronounced. The credit-to-GDP ratio is close to its long-run trend, suggesting that systemic risks from this source are limited at the moment.

15. **Housing and real estate form an important part of bank lending.** As of September 2015, combined loans to real estate-related sectors (housing for individuals, construction and real estate services) represent the largest share (about 41 percent) of total loans, followed by lending to the trade and services sector (excluding real estate services, 36 percent of total loans), "non-housing" lending to households and lending to the industry segment (both accounting for approximately 12 percent of total loans). Lending to the services and trade sector accounts for the largest share of nonperforming loans (52 percent).

16. **Private sector indebtedness appears contained.** The average household debt-to-income ratio has been stable at around 45 percent over the last four years, with the mortgage debt-to-income ratio around 30 percent. Retail lending standards have been tightened in 2015 with the introduction of strict loan-to-value requirements (75 percent for housing loans and cars) and a cap on debt servicing to income (total monthly repayments for all credit and loans) of 35 percent (45 percent if the family is beneficiary of a housing loan). Households are exposed to interest rate risks as most housing loans are made at floating interest rates. Corporate lending is subject to various restrictions, including a maximum loan-to-value for commercial real estate of 60 percent and restrictions on overdraft facilities (only to be used for the financing of current operations and may not exceed 70 percent of the company's working capital). However, there is limited data on corporate sector performance and balance sheet vulnerabilities and the amount of credit creation in the informal sector cannot be adequately measured.

17. **Since 2012, the BdL has deployed various incentive schemes to foster lending and support economic growth.** It has two types of credit support schemes: (i) exemptions from reserve requirements, in the form of either deductions of new loans from bank liabilities subject to reserve requirements or reductions of the reserve requirements by part of the amount of new loans; and (ii) subsidized lending to banks provided they on-lend the borrowed amounts to certain sectors of the economy. Housing loans account for the largest share of credit that benefit from reduced reserve requirements, with a share of almost 76 percent up to 2015; while the industry, tourism and agricultural sectors were the largest recipients of the subsidized on-lending scheme. Altogether, mostly housing and SME benefited of the stimulus program through banks (USD 11 billion or about 22 percent of GDP). Recently, the BdL has launched a smaller-scale program that seeks to address financing gaps for start-ups by making equity finance solutions available (Circular 331).

C. Real Estate Markets

18. **Real estate markets are a pro-cyclical driver of the economic and credit cycles.** The banking system is significantly exposed to the real estate sector, with more than 90 percent of all loans to the private sector exposed either directly (through housing loans to end users, loans to developers, contractors, and to other real estate professionals) or indirectly (through all the other loans to corporates mostly collateralized by real estate). Both parts represent about the same size (LBP 31.6 billion and LBP 31.5 billion) as seen below. The direct exposure as a proportion of total bank assets has increased by 75 percent in 6 years. Home loans grew by 278 percent and construction loans grew by 112 percent over the same period. The boom of home loans went through a relative cooling-off after 2010 although the stock kept steadily increasing with the help of the stimulus package.

19. **Since 2011, the real estate sector has entered a period of stagnation following the 2008-2010 boom**. The main causes are the Syria conflict and deteriorating domestic economic, security and political conditions. In 2015, real estate markets entered a downturn phase as prices surveyed by the BdL show declines above 10 percent in some market segments (high-end housing and commercial real estate), while affordable housing markets are more resilient. Real estate markets in Lebanon tend to follow a standard pattern, with the number of transactions declining before prices begin to fall. New permits data, showing a 9 percent decline from 2014 to 2015 points to a significant slowdown in new construction. Nevertheless, many local stakeholders still trust the resilience of real estate prices and argue that prices follow at ratchet (at worse stagnating, never declining). These participants expect a prompt recovery, based on optimistic assumptions (end of the Syrian conflict, election of a president, et cetera) which results in a self-reinforcing loop with developers refusing to reduce their prices in anticipation that markets will take off again, contributing to further reductions in demand.

20. **The risk of a real estate downturn and the goal of promoting access to housing finance for middle-income households prompted the BdL to dedicate most of its**

stimulus program (about 70 percent so far) to housing through reduced mortgage rates (now at 5.4 percent; but variable rates linked to treasury bills), in order to support the domestic demand for housing. This succeeded in dampening the contraction of the real estate sector, and incentivized developers to shift their production into more affordable units. Yet, the sector activity contracted further in 2015 and the amount of new mortgage loans (7,994) reached in 2015 represents the lowest level since 2008.

21. **Most of the direct exposure of banks is through home loans.** Relatively low LTV, family solidarity, and subsidized low rates have helped to maintain credit quality, as reflected in reported NPL ratios of just above 1 percent, and avoid protracted foreclosure procedures. The deterioration of the portfolio quality is rather observed among loans extended to developers, in terms of NPLs, notwithstanding possible other credit restructuring actions taken by banks. This portfolio is relatively small (USD 1.99 billion) even compared to other construction loans, as many developers have leveraged no or little debt. Yet the BCC should track this portfolio and its concentration (through a survey among banks), before considering if any defeasance vehicle makes sense (unlikely so).

22. **The other following measures are recommended**:

- **Strengthen the prudential regime**. The BdL has adopted a comprehensive prudential regime made of LTV ceilings, periodic re-assessments of collateral value, and consolidated debt service ratios. This has so far prevented banks from problems, but it may be time to:

    - adjust the LTV ratio applied to developers' loans (60 percent) and differentiate the equity of the developer (land, own cash) from the received presales.

    - strengthen the regime of off-plan sales by developers (mandatory completion guarantee, standards for payment schedule according to construction progress) also to pursue consumer protection purposes.

    - estimate the overhang of unsold and completed units (likely in partnership with the Real Estate Developers Association of Lebanon), in order to size up the potential of a further aggravation of market cycles.

    - professionalize the appraisal industry, through guidance to lenders about licensed appraisers and used valuation methodologies. One strong incentive would consist in permitting only certified appraisers to access the BdL database (granular level).

- **Closely monitor the stimulus program**. Even if the phasing out is not feasible in the short run given the adverse evolution of real estate markets, more work is due to better monitor the impact and further calibrate the program (for example through downward adjustment of the maximum loan value, coupled to a home price ceiling) so as to target subsidies and limit market distortions. The credit affordability gain of homeowners is

partly offset by developers retaining high margins (40-50 percent) and prices. In the longer run, the management of housing subsidies should not stay within the BdL, and this program should be phased out.

23. **The mission welcomes the BdL decision to prepare an index of house prices to increase transparency.** The index is expected to be launched in 2019, after a sufficiently large sample of data has been recorded. Data comes from each reported valuation by banks extending new loans. International best practice may help to shorten the delays before launching the index. During the transition phase, BdL has started to watch prices through monthly, rudimentary but revealing, surveys conducted among professional developers, brokers and lenders.

24. **In order to decrease the exposure of the banks to real estate, the BDL is contemplating the establishment of Real Estate Investment Trusts (REITs).** In the medium run, REITs represent a promising avenue for capital markets to fund real estate, but conditions are not ready yet. As REITs target equity investors, they require built and fully leased and diversified real estate assets generating attractive risk-adjusted yields. Their introduction in Lebanon will require a transparent system to track market prices and rents, a regained climate of confidence into real estate assets (once the adverse phase is over), and an operational trading platform. REITs should not be used as a vehicle for any defeasance structure for non-performing loans to developers.

D. Banking System Resilience

25. **Stress tests and sensitivity analyses were used to gauge banking sector soundness.** Capital needs have been identified according to a range of 4 scenarios. Consistent with Basel standards, the stress test allowed the banks to use their capital conservation buffers, reducing the capital adequacy ratio (CAR) hurdle rate from 12 percent to 9.5 percent. Under the baseline scenario, 8 banks become undercapitalized (7.7 percent of system assets and total capital needs reaching 0.7 percent of 2015 GDP), of which 3 are large banks (there are 14 such banks in total, defined as having customer deposits above USD 2 billion). Under more adverse scenarios, the aggregated capital needs would amount from 4.7 to 16.8 percent of GDP, affecting between 8 and 31 banks in total that, together, represent between 46 and 83 percent of total system assets.

III. FINANCIAL STABILITY FRAMEWORK

A. Institutional structure

26. **The BdL and its Governor play key roles in the institutional framework underpinning financial stability.** The BdL, established under the Code of Money and Credit (CMC) in 1963, is responsible for safeguarding the currency of Lebanon, "as a fundamental guarantee for permanent economic and social development", and more specifically for (i) maintaining economic stability, (ii) safeguarding the structure of, and regulating and supervising the banking system and (iii) developing the monetary and financial market. Supervision was later transferred to the BCC. The BdL is managed by the Governor and the Central Council—composed of the Governor as Chairman, four Vice-Governors, the Director General (DG) of the Ministry of Finance (MoF) and the DG of the Ministry of Economy and Trade (MoE).

27. **Responsibilities for prudential supervision and resolution are split:** The BCC is an administratively independent body of the BdL with a mandate to supervise banks, financial institutions, and other regulated entities (money exchange house, brokerage firms and leasing companies), and verify observance of the laws and regulations that apply to the banking sector. The BCC is funded by the BdL and performs its supervisory functions in close coordination with the Governor (who has the legal prerogative to ask for reports prepared by the BCC). Equally, the BCC may request all information deemed necessary for the discharge of its functions from the BdL. The Higher Banking Commission (HBC) is a special quasi-judicial body forming part of the BdL. It functions as a tribunal, with power to impose administrative sanctions (based on reports presented by the BCC to the Governor) should it determine that a bank has violated its bylaws, the applicable provisions of the CMC and/or measures prescribed by BdL, or has submitted incomplete or inaccurate reports or information to the BCC. It is chaired by the Governor of the BdL and consists of a Vice-Governor selected by the Central Council, the MoF DG, a high-ranking judge, the member of the BCC proposed by the Association of Banks and the Chairman of the NDGI. The CMA, established in 2011, is responsible for the supervision of financial market participants and licensing and registration of individuals and institutions that deal with financial instruments. The ICC is a regulatory body in the Ministry of Economy and Trade mandated to monitor and regulate the insurance sector, with the aim to protect the interest of policy holders and to promote the maintenance of an efficient, safe and stable insurance sector. Finally, the Special Investigation Committee (SIC) was established in 2001 as an independent legal entity with judicial status at the BdL. The SIC is Lebanon's Financial Intelligence Unit and supervisory agency for anti-money laundering and countering the financing of terrorism (AML/CFT). The SIC comprises four members: the Governor (chairman), the Chairman of the BCC, the judge appointed to the HBC, and a professional appointed by the Council of Ministers.

28. **Interagency coordination is primarily achieved through the office of the Governor and cross-membership in regulatory bodies.** A small number of people have

multiple roles in the oversight architecture, with the Governor at the nodal point, fulfilling multiple roles and holding wide powers. This “Governor-centric” model ensures information exchange and enables effective coordination. However, further development and formalization of coordination arrangements among the agencies, at technical as well as senior managerial level, would reduce the risk that decisions may be delayed, or would have to be taken with inadequate information, in the absence of key staff. Building institutional structures and capacity can also help simplify succession planning for senior staff members in key positions, such as department directors.

B. Banking supervision

29. **The framework for banking supervision is generally in alignment with international standards.** The financial system has survived repeated domestic shocks, regional turmoil, and the global financial crisis, in part due to conservative regulatory practices and assertive supervision. An assessment of the Basel Core Principles of Effective Supervision (BCP) undertaken as part of the FSAP found that supervisory and regulatory responsibilities are clearly defined and the BCC’s mission is adequately anchored in primary legislation. The BCC employs high caliber staff, onsite inspections are comprehensive and the onsite and offsite teams coordinate and communicate on a continuous basis. Supervisory powers are adequate, with the BCC taking steps to improve the timeliness of corrective action. The BCP found some areas for improvement.

- *Operational independence and accountability*. To reduce the scope for possible industry influence over supervisory decisions, BCC staff should be provided with legal protection against lawsuits for actions taken or omissions made while discharging their duties in good faith, and the banking association should not have powers to nominate a member to the Boards of the BCC and HBC. The reasons for removal from office of either the Chairman or any Executive Director of the BCC should be publicly disclosed, and the BCC could publish annual objectives and prepare an annual report on the delivery of its mandate.

- *Access to information*. Banking secrecy precludes the BCC (though not the SIC with respect to AML/CFT) from obtaining information on individual depositors, impeding some analyses (for example of the distribution of deposits from specific high net worth individuals across the banking system), and is not in line with international best practices.

- *Supervisory resources*. Increased complexity of financial services, more demanding international standards for supervisory effectiveness, and a broadening of the BCC’s responsibilities to include some nonbank financial institutions and some aspects of consumer protection will test the BCC’s capacity. In this context, the authorities should review of adequacy of supervisory resources, as a first step toward further capacity building.

- *Regulatory framework*. The regulatory framework is complex, with primary legislation that has not been updated for many years and an extensive set of regulations issued by the BCC and BdL. In the medium term, banking legislation could be updated and streamlined.

30. **The ongoing development of integrated risk profiles and stronger risk-orientation in capital planning, are significant steps forward.** The development of an integrated risk matrix combining indicators for capital adequacy, asset quality, market risks, profitability, and funding and liquidity with qualitative findings on a bank's business model, internal controls, organization, and management strength will complement strong onsite inspections and offsite analysis.

31. **Supervisory review of banks' internal capital plans is the next step in deepening the BCC's assessment of banks' vulnerabilities.** Capital requirements exceed minimum requirements set under Basel III and regulatory standards for capital adequacy are generally appropriate—with the 50 percent risk weight on foreign-currency-denominated securities issued by the BdL being the only notable deviation from international standards. Nonetheless, capital buffers appear modest considering the sovereign and interest rate risks carried by the banks, in addition to the impact of slow growth on asset quality. Annual reviews of banks' internal capital plans—based on a framework considering the sustainability of their business models, the quality of their internal governance and risk control arrangements as well as financial risk factors—will shed greater light on the resilience of individual banks. Adding forward-looking analyses, for example through comprehensive multi-factor stress tests, would complement these efforts.

32. **Recovery planning is at an initial stage and should be advanced.** At present, the BdL relies on the review of banks' capital planning and business plans to gauge banks' resilience to shocks. While this approach provides insight into bank vulnerabilities, it does not specify concrete, credible actions and timelines to be implemented by the bank in case of a shock weakening its financial condition. Recovery plans developed by the bank and approved by its Board of Directors, as well as the authorities, would ensure bank ownership and foster accountability for timely implementation of recovery actions. Plans should be updated regularly, or when market or the bank's own conditions require it, with supervisors closely reviewing and providing feedback to senior management on their adequacy. Supervisory requirements for recovery planning should be issued building on guidance prepared by international standard setters.

33. **The current framework governing problem assets, provisions, and reserves requires strengthening.** The BCC has limited information on renewed, refinanced, and restructured loans, and classification rules fall short of international good practice in some areas (see box 1). Moreover, rules for collateral valuation should be tightened, as banks are not subject to mandatory standards for appraisals—although in practice banks typically use court certified appraisers on the BCC's roster—and oversight over the appraiser profession is

weak. Going forward, intrusive review of asset quality remains essential, also in view of banks' significant real estate exposures. Finally, the authorities could consider introducing regulatory measures limiting lending in foreign currency to borrowers without foreign currency earnings (e.g., by increasing risk weights), with the aim to mitigate currency induced credit risks.

Box 1. Treatment of Restructured Loans

Measures introduced by the BdL in October 2015 can help to resolve distressed credits. Basic Circular (BC) 135 provides guidelines for out-of-court restructuring that broadly reflect the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) Principles for Multi-Creditor Workouts. Among others, the Basic Circular envisages coordination among creditors, with the bank that holds the largest portion of the outstanding debt (the "Manager") being responsible for the development of a preliminary plan (including a new repayment schedule) for dealing with the debtor's financial difficulties. The BC provides for a stand-still period of three months (renewable by another three months), with approval of the restructuring plan requiring approval of least two-thirds of the banks and financial institutions, representing at least 60 percent of the total outstanding debt—with the caveat that the restructuring is not binding on non-consenting creditors.

However, certain incentives—introduced to encourage timely restructuring of distressed credits—are not fully aligned with international best practices:

- Classification. BC 135 does not prescribe that restructured loans are classified as "substandard" (or at least no better than their category prior to restructuring) and that reclassification can only be considered after a reasonable "probation period" (e.g., 12 months) during which timely payments are made by the borrower—which is generally considered good practice.

- Prior approval. Requiring that banks seek prior approval from the BCC for reclassifications of restructured loans, as per BC 135, can help ensure the scope to reclassify is used appropriately. However, it also blurs banks' accountability for maintaining conservative classifications standards and risks ambiguity as approval criteria are not spelled out.

- Assets received in lieu of repayment. By law, banks are required to sell real estate properties acquired as part of the settlement of NPLs within two years, and otherwise establish a reserve over a five-year period (20 percent per year) for the full amount of the properties. This provides proper incentives to banks to divest such properties as soon as practicable, as is considered good practice. However, this period has been lengthened to 20 years for NPLs settled since October 2015. A return to past practices is advisable.

Supervisory oversight remains essential to prevent evergreening and underreporting of NPLs. The introduction of more granular reporting requirements in February 2016—providing the BCC with more information on restructuring modalities and the post-restructuring performance of restructured debts—is a welcome initiative. Enhanced supervisory scrutiny of banks' submissions, and restructuring practices more broadly, can help to deter "cosmetic" restructurings.

34. **Interagency and cross-border cooperation need to be enhanced.** Interagency coordination is primarily achieved through the office of the Governor and cross-membership in regulatory bodies. A small number of people have multiple roles in the oversight architecture, with the Governor at the nodal point, fulfilling multiple roles and holding wide powers. This "Governor-centric" model ensures information exchange and enables effective coordination. However, further development of institutional coordination arrangements, at technical as well as senior managerial level, would reduce the risk that decisions may be delayed, or would have to be taken with inadequate information, in the absence of key staff. Moreover, the expansion of Lebanese banks in the region has made strengthening cross-border coordination an urgent task. The BCC, as home supervisor, has yet to finalize the establishment of two supervisory colleges.

C. Macroprudential Policy Framework

35. **The authorities have been proactive in adopting macroprudential measures to contain risks.** During the past years, the BdL tightened the maximum debt service-to-income ratio and loan-to-value requirements for retail and housing loans, and increased collective provisioning on performing loans. While all of these measures had a micro as well as macroprudential rationale, they have served to strengthen the financial system's overall resilience in the context of weak economic growth and the BdL stimulus program supporting housing loans and the real estate market.

36. **Responsibility for macroprudential policy and systemic risk monitoring is shared between the BdL and the BCC.** The BdL's Financial Stability Unit (FSU) has developed an early warning system and provides internal reports on the financial stability outlook for the Governor, while the BCC has analyzed banks susceptibility to interest rate risks and risks related to their foreign operations. Aspects of macrofinancial risk and possible policy responses are discussed in BdL committees covering related issues (such as the open market committee), while the BCC considers macroeconomic risks for supervisory purposes. The Financial Stability Committee (FSC), which includes representatives of the two agencies and meets monthly, also has a coordinating role, but does not provide formal recommendations to the Governor or Central Council of the BdL.

37. **While the institutional framework has advantages, there is scope for improvement.** The Governor's coordinating role across the macroprudential, microprudential, and monetary policy objectives and the strong operational independence of the BdL and the BCC reduce the risk of inaction or failure to detect problems. A drawback is that there are few institutional mechanisms to bring outside viewpoints to bear or challenge the prevailing views formed within the institutions. The links between systemic risk monitoring and policy determination could be made more comprehensive and formalized through an advisory committee on financial stability issues that would provide recommendations to the Governor and the Central Council. Such an approach could build on existing structures (for example, the FSC and the FSU), and reflect the following features.

- *Broad composition*. A group comprised of representatives of all supervisory agencies and external members, would provide a comprehensive view of financial developments and offer more diverse views and expertise (external members should have knowledge of the financial sector, be independent—e.g., academics or retired financial professionals—and agree to confidentiality requirements as needed).

- *Formal procedures*. The committee could meet regularly on a predefined schedule, which could be announced, and have a secretariat (e.g., the FSU). The committee should discuss key developments and risks in the financial system and both macro- and microprudential policies.

- *Mandate*. The committee would not have decision-making power, but provide recommendations to the Governor or the Central Council after each meeting. Biannual (confidential) reports to the Central Council and other key principals could provide more detailed analysis of relevant trends and emerging risks.

- *Accountability*. To maximize effectiveness, clear communication of macroprudential policy decisions is needed. This includes explanation of objectives, the reasoning underpinning policy decisions and assessment of their effectiveness. Publication of financial stability analysis and/or summary reports of committee meetings could be considered, unless there are risks to financial stability in doing so.

38. **Timely identification and assessment of systemic risks may require additional efforts to close data and information gaps.** Gaps in data coverage exist with regard to household and corporate sector indebtedness, as well as real estate price data—although the BdL has recently initiated the development of a price index. To the extent that improvements to national accounts or complementary data will take time, the BdL could build aggregated data on corporate and household finances using information from the credit bureau. Surveys of senior loan officers can provide information on credit conditions, while property developers can provide insight into supply conditions in the real estate market. Over the medium term, the BdL's FSU could build its own macro stress testing capacity, focused on the identification of systemic (rather than bank-specific) risks.

D. Financial Integrity

39. **Significant progress was made since the 2009 assessment of Lebanon's AML/CFT framework.** Important legislative steps were taken: most of the categories of offenses designated by the standard are now predicate offenses to ML, all designated nonfinancial businesses and professions (DNFBPs) are included in the coverage of the AML/CFT law, and Lebanon has set up a basic framework for the implementation of some targeted financial sanctions related to TF. A new, more comprehensive AML/CFT law was adopted in 2015, AML/CFT supervision of the banking sector is increasingly risk-based, and some steps were taken to implement terrorist financing (TF)-related targeted financial

sanctions (TFS). The authorities conducted a National Risk Assessment (NRA) in 2013/2014 of the risks of money laundering (ML) and TF. The new AML/CFT law also enables the Special Investigation Commission (SIC) to lift the banking secrecy for AML/CFT purposes. In February 2016, the authorities prohibited banks and FIs from doing transactions with bearer share companies (albeit with a two-year phase-out period for existing relationships), a significant positive development.

40. The SIC exerts important efforts to ensure banks' compliance with AML/CFT requirements but its supervisory approach takes ML/TF risks into account only to some extent. The SIC's offsite activity consists of the collection of information on ML/TF risks from different sources, and onsite inspections are rigorous. According to the authorities, banking secrecy is not an obstacle to AML/CFT supervision. The new AML/CFT law appropriately strengthened sanctions for poor compliance, which now need to be applied as appropriate. While ML/TF risks are taken into consideration to some extent, a more risk based approach to the implementation of AML/CFT supervision would prove useful. The findings of inspections do not appear to be commensurate in all dimensions of Lebanon's ML/TF risks, e.g., of corruption. ML/TF risks of financial groups does not appear to be monitored and managed on a consolidated basis.

41. **Some gaps nevertheless remain.** While some mitigating actions were taken in response to the NRA, it is not clear that the assessment included all relevant risks (such as corruption). Also, the NRA appears to have had limited impact on the SIC's approach for risk-based supervision, as the allocation of supervisory resources across financial institutions does not appear to be fully commensurate with risks identified (e.g., for some nonbank money remitters). In addition, the legal framework has some residual gaps, e.g., regarding the criminalization of ML and TF and the AML/CFT law is not yet enforceable in respect of lawyers (as the required implementing regulations have not been issued). Banking secrecy requirements could be an impediment for front line and compliance staff of banks to conduct customer due diligence measures with respect to holders of numbered accounts and safe deposits. Furthermore, in practice, banking secrecy have been lifted for the purposes of information exchange with other competent authorities in few cases.

42. **Measures should be taken to further enhance the AML/CFT framework and its effectiveness.** A more comprehensive assessment of all threats, vulnerabilities and consequences associated with ML and TF should be undertaken, its results shared with all stakeholders (including private sector participants), and appropriate mitigating actions taken. The SIC should continue its efforts to strengthen its risk-based supervisory approach, ensuring that the allocation of resources is fully commensurate with actual ML and TF risks. The authorities should fully align the ML and TF offenses with international standards; define beneficial ownership in line with the FATF glossary; enhance the framework for TF-related targeted financial sanctions; ensure that regulations extending enforceability of the AML/CFT law to lawyers are issued; and ensure that banking secrecy is not an obstacle to the sound and effective implementation of the AML/CFT framework.

43. **Some foreign banks have curtailed the provision of financial services to Lebanese banks and remittance companies.** The factors leading to this phenomenon are multiple and interrelated, and may include the proximity to the civil war in Syria and active terrorist groups in Syria and Iraq, consequences of bilateral initiatives such as the U.S. "Hizballah International Financing Prevention Act of 2015," and perceived weaknesses in the AML/CFT and tax transparency regimes. This development may also reflect concerns about perceived weaknesses in the AML/CFT regime. While the withdrawal of correspondent banking relationships does not appear significant in macro-economic or financial stability terms, a quantification of its impact in volumes and prices of transactions or in driving higher risk transactions to less transparent channels has not yet been undertaken. The authorities are encouraged to collect and analyze data on the extent of withdrawal of financial services and its impact on Lebanese banks and financial services users, including on financial inclusion, and take appropriate mitigating action on the basis of their analysis.

E. Crisis Management and Preparedness

44. **The framework for dealing with vulnerable banks has helped maintain financial stability.** High external and fiscal funding needs and dependence on inflows of nonresident deposits underscore the importance of maintaining confidence, and in managing weak banks the authorities have ensured that depositors and other creditors were fully protected. In the current economic context, the FSAP mission focused on enhancements to the authorities' approach that could increase efficiency without compromising financial stability objectives.

45. **The authorities have strong enforcement powers and could take a more structured approach in identifying and dealing with weak banks.** The BCC can require banks to remedy breaches, correct deficiencies in internal governance, control, audit or risk management, and address any risk that could affect the bank's safety and soundness. If there is a failure to comply, the case is transferred to the HBC, which can impose remedial actions and whose decisions are not subject to review. While the authorities have a track record of intervening in weak banks, no uniform and clearly documented processes are in place to guide the authorities' and ensure timely action, including with respect to resolution measures.

46. **Banks can be resolved through a number of different proceedings.** Merging weak banks with sound banks is the authorities' preferred option. The HBC can also appoint a temporary manager with a full range of powers (including shareholder powers) to restructure, resolve, or wind down the bank. Other proceedings include putting a bank under an expedited court-based proceeding ("suspension of payments") or under the supervision of a special bankruptcy court. These have not been used in recent practice, but they serve as a credible threat, particularly as they permit the temporary seizure of all assets of the bank's directors, senior management, and auditors.

47. **Financial distress in small and medium banks has been handled through mergers.** The BdL has used mergers as a resolution tool, and has also assisted mergers of

sound, small banks with larger institutions in order to encourage consolidation in the financial system. In both cases, BdL assistance for absorbing banks may be provided via subsidized loans to cover costs borne by the acquiring institution; in addition, the legal framework allows for various forms of regulatory forbearance, such as grace periods for complying with capital requirements. The merger law does not provide for the partial transfer of assets and liabilities. However, in practice the BdL can impose losses on shareholders and sell distressed assets before a merger with shareholder agreement (which is achieved under the threat of liquidation).

48. **When circumstances permit, the authorities should develop resolution options leading to closures of failed firms while protecting depositors.** The financing needs of the economy and financial stability considerations currently support the approach of protecting all creditors via whole-bank mergers. While this approach has been effective in reducing financial stability risks from weak banks, forced or assisted mergers impede market discipline and do not allow for a segregation and liquidation of bad assets in a receivership, burdening the acquiring bank with recovery efforts. In the longer term, assuming reforms have lowered reliance on deposit inflows to finance macroeconomic imbalances, alternative resolution approaches that enable the removal of marginal banks from the banking system should be considered. The legal reforms necessary to achieve this aim should ensure that (i) insured deposits remain fully protected; (ii) losses are allocated to shareholders and, as needed, creditors (in accordance with the creditor hierarchy); and (iii) public support to failing banks is minimized.

49. **In due course, reforms are needed to better align the deposit insurance scheme with international good practices.** As the need to protect all creditors is eased and bank resolution options are revisited, an effective deposit insurance scheme will be needed. In the long term, the National Institute for the Guarantee of Deposits (NIGD) should be reformed and made an operationally independent public sector agency, governed by a Board composed of public sector representatives and nonbank private experts, and fully funded on an ex ante basis via industry premiums. Government contributions should be halted and coverage levels increased. Enabling the NIGD to provide financing to asset and liability transfers, up to the "least cost test" (i.e., the equivalent amount that would be made available in a straight payout of insured deposits) would support resolution, minimize disruption and delays faced by depositors and reduce resolution costs. If paid out, depositors should ideally recover their funds within seven business days.

50. **Emergency liquidity assistance is primarily provided through the BdL's repo facility under flexible conditions.** Liquidity support would typically be made available for up to 21 days, denominated in either US dollars or Lebanese Pounds. To participate, banks need to be solvent and be able to provide to acceptable collateral (treasury bills or BdL CDs). If a bank comes too frequently, however, or is in weak financial conditions, the BdL refers it to the BCC for review. In extreme cases, the BdL can ease collateral requirements. If monetary conditions were to deteriorate because of excessive emergency liquidity, the BdL

also has a range of open market instruments to absorb market liquidity. While this system has been effective, the BdL could issue rules formalizing criteria for access to such liquidity facilities in stable times.

51. **Crisis preparedness should be strengthened.** In a systemic crisis, coordinated policy development and prompt decisions are key. This calls for adequate preparation through a dedicated committee with high-level participation of senior officials from the BdL, supervisory agencies, and the MoF. In normal times, this committee's task is to analyze threats to financial stability, exchange information, and develop coordinated responses (including a communication policy) that could be taken if a crisis occurs. In times of crisis, the committee takes on the critical role of coordinating and implementing government policies.

52. **As part of their crisis preparation efforts, the authorities should review the tools available to cope with financial distress in systemic institutions.** Mergers of such institutions may not be feasible, risk undermining the health of the acquiring bank and could lead to excessive concentration in the banking sector. Identification of critical functions performed by systemic institutions that need to be preserved, and development of bank-specific resolution plans should be undertaken. Policies for the establishment of bridge banks and a roster of qualified and experienced individuals able to act as temporary managers should be developed.

F. Debt Management

53. **High financing needs imply risks in public debt management are substantial.** While the debt to GDP ratio dropped from 169 percent in 2007 to 139 percent at the end of 2015, debt management remains heavily constrained by high funding needs and the lack of an active government bond market mainly on the domestic side. Most outstanding debt is in LBP securities and USD Eurobonds. While maturities in the domestic market have been gradually extended, interest costs equal 46.5 percent of revenues as of 2015. Even a moderate increase in domestic and external interest rates would have a substantial budgetary impact. Debt service is 150 percent of revenues, and gross issuance in 2015 was approximately LBP 22 trillion, or 28.8 percent of GDP (including rollover of T-bills).

54. **The BdL plays a role in backstopping public debt markets**. LBP government securities are issued in maturities of up to 15 years at auctions executed by BdL, according to a quarterly calendar published by the Public Debt Directorate (PDD) since 2015. The PDD informs BdL (but does not publish) target volumes for individual securities on a monthly basis. Eurobonds are issued through a group of lead managers in line with standard practice, implying that pricing includes a focus on facilitating secondary market trading. The dominant investor group is domestic commercial banks, but BdL and public institutions (social security and deposit insurance) holdings of domestic debt are increasing. BdL alone holds 37 percent of the LBP debt (up from 32 percent as of end 2014), as a result of their taking of sovereign

bonds at the desired yields. In parallel, BdL issues CDs and TDs with maturities up to 30 years acquired by banks, effectively acting as an intermediary. Interest rates for Treasury securities and CDs (and TDs) are the same for the same maturities, but as the tenor of CDs exceeds the tenor of government securities, this intermediation implies an important cost of carry.

55. **Interest rates are not market-determined.** The domestic yield curve is fixed from 3 months up to 30 years, and there is no secondary market trading. Actively traded government securities perform a key role in financial markets by providing a reference yield curve for pricing financial products. The prices on government securities and CDs are preset, and primary rates for government securities have been unchanged since April 2012.[1] The LBP yield curve is determined by BdL applying a steepness to the yield curve similar to the one of US Treasuries, with additional spreads for longer maturities. There is no solid analytical foundation for the use of the US Treasury curve in the context of the Lebanese economy. This system reduces refinancing risks and interest costs for the government, at the cost of increasing exposure and costs for the BdL, as well as the absence of market-determined reference yield curve. The continuation of this policy will be adverse to the development of private fixed income securities.

56. **While the extension of the average maturity of the domestic debt has eased refinancing pressures, the cost of the debt has increased.** In an environment where the yield curve is expected to be unchanged and investors are seeking to maximize yields, the maturity profile of government securities (and CDs) has been extended. Over the past decade the longest maturity for government securities has increased from 5 to 15 years. This has implied a substantial reduction in the share of short-term debt, at the cost of a higher interest burden.

57. **Governance and accountability could be strengthened.** The High Debt Committee (HDC), comprising the Minister of Finance, the Governor of BdL, and senior civil servants, was established by law as an advisory board to discuss and enclose the MTDS prepared by PDD and also to act as a platform for coordination between the MoF and BdL in debt management. Decisions on domestic borrowing are mainly taken at the PDD level, including division of maturities on each week and their respective target allocation. For Eurobonds issuance, the PDD decides on all issuance-related features (timing of the issuance, yield, joint lead managers selection, law ceiling….). The role of the HDC could be re-activated and strengthened. The PDD has updated the debt management strategy for the period 2016-18 but has not been yet published by the Minister of Finances. The PDD's role as the debt manager should be consolidated, centralizing debt management responsibilities, including decisions on domestic borrowing and Eurobond issuance. The PDD itself should be strengthened.

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[1] Except a decrease of 42 bps in the 7 year and 52 bps in the 10-year TB bonds in 2015.

58. **Once financing pressures ease, the BdL should retreat from participating in primary auctions.** Debt management considerations remain dominated by fiscal needs and policies designed to maintain confidence. Considering the potential negative consequences for financial stability and debt sustainability of interest rate fluctuations, fiscal correction and reduced funding needs are a precondition for fundamental reform of the debt markets to allow for market pricing. If funding pressures ease over the medium term the BdL could step back from primary market participation and the government move to market-determined auctions with flexible interest rates. As a first step, the BdL could intervene only in instances of unusually low demand, implying that occasionally auctions may not be fully covered. If a move to market-based pricing is undertaken:

- To indicate a gradual move, initially a band for interest rates could be established that is informally communicated to the market (the band can be wider for shorter maturities).

- To foster an active market and lower funding cost, PDD should provide a high degree of transparency and predictability, and move towards building benchmarks in specific maturities.

- In order to facilitate a separation of monetary and debt management policy that would support market development, BdL and MoF should divide the yield curve with BdL issuing only in the short end, and the government in maturities of 1 year and above.

- To allow investors to better plan their activities, and increase transparency and predictability, indicative target amounts for domestic borrowing should be published on a monthly basis.

59. **In the short to medium-term, reforms to reduce costs could be considered.** From the perspective of PDD, the move towards lengthening the average time to maturity of the domestic debt has cost implications, and provides limited additional risk reduction. Similarly, and since Eurobonds are held largely by the same investors that buy domestic securities, alternative issuance mechanisms with a stronger focus on pricing could be considered (e.g. domestic issuance while keeping standard Eurobond legal documentation and book-building process). Considering the implications for other policy objectives, coordination with the BdL on these issues will matter. Finally, the legal framework for Eurobond issuance requiring stand-alone approvals for each issue could be revised in favor of issuance size and timing being regulated through the debt management strategy

IV. FINANCIAL SECTOR DEVELOPMENT AND ACCESS TO FINANCE

A. Financial Infrastructure

60. **Most financial sector components fare relatively low compare with peer upper-middle income economies**. According to the Global FINDEX Data Base, 47 percent of adults have a bank account, versus 70 percent in upper-middle income countries. Also, in addition to a difficult environment, SME access to finance remains constrained by a lack of adequate financial sector infrastructure. Micro-finance is growing fast but faces raising difficulties that may hamper its development.

61. **There is significant room for increased financial access and the authorities should adopt a more strategic approach to advance this agenda**. A National Financial Access to Finance Strategy, designed around a well-defined set of policy-relevant indicators and supported by a robust data infrastructure, would help the authorities prioritize and address the issues in a comprehensive and orderly manner.

62. **Despite good progress on payment and credit reporting systems, key financial infrastructure pillars are still missing.** In particular, consideration should be given to improvements in the insolvency regime and the secured transactions framework, where draft laws have been prepared but not yet discussed in the Parliament. The credit reporting system could be further improved. Also, a stronger financial infrastructure is also deemed to contribute to a more accessible and stable financial sector.

63. **The insolvency regime hampers access to credit.** Lebanon's insolvency law lacks provisions that are needed for a dynamic private sector and effective debt recovery: chief among these, the law adopts a punitive approach toward debtors, rather than treating the insolvency framework as a constructive set of measures. There is an absence of pre-insolvency procedures in the insolvency law, making it difficult to rescue financially distressed, but viable, entities. Regarding the implementation of the insolvency law, Lebanese banks report excessive delays with numerous appeals. This environment prompts a number of undesirable effects hindering access to finance: banks' strong preference for fixed assets as collateral and over-collateralization are prevalent. Banks tend to negotiate informally with the borrowers, a practice that has been recently encouraged by a BdL circular promoting out-of-court workout resolution. However, it is recommended that the insolvency law is modernized (a new insolvency law is being drafted by the Prime Minister's Office and the Ministry of Justice, with the support of the IFC).

64. **A more efficient secured transactions regime would further facilitate access to finance while improving financial stability.** Effective secured transactions laws and collateral registries are an important component of a healthy financial sector and business climate in that they allow the use of movable assets (both tangible and intangible) as collateral to back lending. In the case of Lebanon, a more diversified pool of collateral would also contribute to lowering the pro-cyclical effects of over-reliance on properties and land as

the main collateral base for bank loans. Many SME and startups do not hold such fixed assets. A draft law on secured transactions designed to address the inadequate legal and institutional framework has been prepared by the Presidency of the Council of Ministers in partnership with IFC.

65. **Significant improvements are being made on the credit reporting system.** The only source of information available to lenders to assess borrowers' credit risk is a Public Credit Registry (PCR) hosted by the BdL. The PCR collects and disseminates, through two distinct systems, the Central Office of Credit Risk and the Central Office of Returned Checks, both positive and negative information. It is currently undergoing substantial modernization aiming at automating manual data manipulation and eliminating the collection threshold currently set at US$3,000 (to be reduced to $0 by December 2016). In the medium to long term, the BdL may want to consider improvements aiming at i) collecting and providing additional information on firms above a certain level of debt (balance sheets, peer group analysis, geographical analysis, etc.), and ii) delegating the collection and sharing mechanism for small loans to one or two of the existing informal private credit bureaus (under strict BdL licensing and monitoring).

66. **The National Payment System (NPS) has been significantly enhanced in the last few years, but progress is still required in the legal framework and supervision.** The core NPS infrastructure is composed of a large value payments system (BdL-RTGS), a low value bulk retail payments system (BdL – CLEAR), both hosted by the BdL, and a custodian and clearing center for financial instruments (Midclear, owned at 99 percent by the BdL). This robust infrastructure has allowed a steady development of payment and settlement system activities. Further developments are undertaken by the BdL in order to improve the automation of some Government payments (benefits, pensions, civil servant salaries, etc.). It is worth noting that the NPS remains constrained by an outdated legal and regulatory framework, which does not adequately protect critical payment systems operations like finality, netting, collateral rights and validity of electronic instructions. Legal measures to address these issues have been pending in Parliament for some time. Also, the BdL Payment System Department should allocate and train resources for on-site and off-site inspections.

B. Capital Market

67. **The contribution of capital markets to the financing of the Lebanese economy has remained marginal to date—but there are new opportunities**. Compared to upper-middle income peer countries, Lebanon fares poorly with only 10 listed companies (representing a market capitalization of about 24 percent of GDP, versus 40 percent for the peer group), 28 domestic mutual funds and 481 foreign funds with total assets under management of USD 795 million and USD 886 million, respectively. The size of private bond markets is also insignificant.

68. **This under-development results from several structural issues:**(i) a corporate structure dominated by family businesses whose owners are reluctant to share ownership and change governance practices and have concerns about the cost of disclosure; (ii) a large banking sector extending attractive debt financing to viable companies with sufficient collateral; (iii) a thin base of domestic non-bank institutional investors; (iv) the lack of a sufficiently robust and tested framework for capital markets activities to provide confidence to investors and v) limitations in the current market infrastructure (in particular the Beirut Stock Exchange). However, as mandated by the Capital Market Law, the cabinet recently approved its privatization, and work is underway to prepare a draft decree to be submitted to the cabinet for approval.

69. **The creation of the CMA has renewed momentum**. Law 161 gives the CMA the mandate to regulate, supervise and develop the market. Over the last three years, the CMA has built capacity and is now acknowledged as an independent regulatory authority with responsibilities ranging from products approval and licensing of intermediaries to supervision (including comprehensive audits) and enforcement.

70. **The CMA has prepared a set of regulations in line with best international practices and in consultation with market participants; it remains though to be published in order to be enforced**. With support from the World Bank, the CMA has prepared six main regulations: Licensing and Registration, Market Conduct, Business Conduct, Securities Offering, Listing Rules, and Mutual Fund (Collective Investment Schemes). The first five have already been approved by the CMA Board and are undergoing translation to Arabic before being published and enforced. The last one is pending discussion by the Board. Prior to their approval, regulations were shared and discussed in an open consultative process with all stakeholders in order to get their views given their experience on the ground.

71. **Despite this critical progress, more effort is needed to ensure that a robust regulatory and institutional framework is in place.** In particular:

- The Sanctioning Committee and the Capital Markets Court should be established as a matter of priority, sufficient investigative powers should be given to the former, and adequate legal protection provided to the CMA staff—if necessary via a legal reform—to ensure that robust enforcement mechanisms with appropriate checks and balances are in place.

- The first package of regulations must be published. The CMA informed that the Market Conduct and Business Conduct Regulations will be published soon and will take effect as of January 1, 2017.

- Given the role of Midclear in both the national payments system (NPS) and the securities market (including as a future CCP for derivatives), its governance should be overhauled (creation of an audit committee, and documented procedures for measuring, monitoring

and mitigating risks) and its oversight enhanced, ideally via a system of dual supervision (by BdL and CMA).

- More formal arrangements for coordination and cooperation with the BCC and the ICC should be developed to minimize overlaps, avoid gaps, and ensure a level playing field.
- Finally, enhancements in the supervisory program seem in order as markets expand, in particular placing more emphasis in ongoing monitoring of issuers, CIS and products, applying a risk based approach to the supervision of intermediaries, and automatizing market surveillance. A system to identify risks across the market should be developed.

Box 2. Key features of capital market oversight

Institutional setting. The overall structure of the oversight framework is in line with the IOSCO Principles, provided that the following key steps are made: (i) constitution of the Sanctioning Committee and the Capital Markets Tribunal; (ii) adoption and implementation of precise investigative powers for the Sanctioning Committee; and (iii) clarification on whether the legal framework provides the CMA staff with adequate legal protection.

Capital Markets regulation. The CMA rightly prioritized the development of a set of regulations for key participants (all broadly compliant with IOSCO principles): (i) offer and the Listing Regulations (for issuers); (ii) licensing, business and market conduct rules (for intermediaries), (iii) mutual fund regulations (for collective investment schemes); and (iv) capital requirements for securities intermediaries. The CMA also started to work on regulations on exchanges. In addition, the CMA should consider clarifying the treatment of foreign securities and updating the framework for securitization, as part of this first package of regulations.

Supervisory regime. Supervisory activities have, justifiably, mostly focused on the authorization of offerings and onsite inspections of securities intermediaries. Looking forward, the CMA should deepen its supervisory program by including monitoring of issuers, collective investment schemes and products and implementing a full-fledge risk based supervisory approach for intermediaries. A process of risk identification framework is also needed, which would support systemic risk analysis and a broadening of the regulatory perimeter, with periodic reports discussed with the CMA Board. In parallel, the oversight of Midclear—owned by BdL but not supervised by a dedicated team—should be strengthened.

Interagency coordination. Issues pertaining to coordination with the other regulators have been addressed so far on an ad-hoc basis via the CMA board that includes the Governor and the BCC Chairman. A formalization of coordination arrangements is advisable, possibly including the creation of a coordination committee where issues related to the participation of banks in securities markets could be discussed on a regular basis. In particular, enhanced coordination with the ICC is important in view of life insurance products that embed investment products. A Memorandum of Understanding between the CMA and ICC remains to be signed.

Cross-border cooperation. The Law and IOSCO standards require the CMA to cooperate with foreign regulators. The CMA has found ways to fulfill this duty, in spite of shortcomings of the legal framework. The CMA signed MoUs with foreign regulators and provided actual assistance. Yet, the CMA would gain clarity by issuing an internal procedure stating the basis for cooperation and detailing procedures for providing information and receiving testimony at the request of foreign regulators. In addition, it could request the SIC to sign an undertaking whereby the SIC commits to process on a timely basis requests for information that the CMA Chair sends to it as a result of a request from foreign regulators.

Source: Technical Note (forthcoming) “Capital Markets: Regulatory and Supervisory Issues”.

72. **Establishment of a new electronic trading platform would be a positive step for the market.** This initiative is welcome, particularly in light of the enhanced fit and proper and governance requirements envisioned for the operator, and the specifications envisioned for the platform including (i) the trading of different types of assets, (ii) the fact that the operator and/or its members would act as market makers, and (iii) the robust mechanisms for market surveillance it would include. It should however be accompanied by enhancements in risk management not only vis-à-vis a future derivatives markets, but also vis-à-vis the cash markets.

73. **A capital markets development plan is needed.** This plan should provide a comprehensive analysis of the key challenges affecting both supply and demand, offer a realistic view of the potential development of various markets and recommend measures to help realize this potential. The plan should also explore the future role of the CMA. During the first years of its creation, the Board rightly focused on administrative and operational issues, and ensured that a basic regulatory framework and supervisory program were in place. Now as the CMA matures and markets expand, the Board should focus on its role of setting the strategic direction of the CMA in both its supervisory and developmental roles, so as to strike the right balance between ensuring investor protection and financial stability, without creating undue barriers to entry or costs to innovation. The CMA could advise the government about other policies likely to facilitate this development.

C. Insurance sector

74. **The insurance sector is small compared to the banking sector, but is somewhat larger than in peer countries**. Total assets amounted to USD 4.3 billion at the end of 2014 (8.6 percent of GDP while banking sector assets represent 373 percent of GDP). Yet the sector is larger than that of some upper-middle income economy peers with a total premium (life, non-life, personal accident and health) to GDP of 2.6 percent (a peer group composed of Costa Rica, Croatia, Panama, Uruguay, Turkey, Mexico and Romania shows premium to GDP reaching 2.1 percent). This is due in part to an active role in long-term savings and health care provision in the private sector. However, non-life branch insurance penetration appears to be 30 percent lower than its peers (with a claim ratio 41 percent higher). There is considerable room for market expansion and deepening. This expansion would help corporates and households better manage their risk exposure, support investment and growth, contribute to financial inclusion, and the expansion of domestic contractual savings (insurance and long-term savings)—fundamental to developing Lebanese capital markets.

75. **The sound development of the industry is impeded by structural market factors.** Recent market growth was driven by medical insurance, life (protection) and motor insurance, themselves driven by increased bank lending (mortgage and car loans). However, there is a large number of unspecialized insurance companies (51) operating in a relatively small market; including many small, family owned and managed companies, some of which

do not have adequate professional capacity. 18 companies are owned by banks or global groups, and these represent most of the market share.

76. **Market fragmentation leads to intense price competition, and also carries operational risks.** Small insurance companies have been able to make only limited investments in risk management and pricing techniques. In 2014, one insurance company out of five posted financial losses. Several lines of business are not currently profitable (like group medical insurance) despite persistent ICC efforts to raise the level of technical provisions. Earthquake property insurance is both under-capitalized and under-developed (with a low penetration rate beneath 15 percent). Most business models remain too focused on the organic growth of successful operations and approaches. This results in the absence of new products, lines of service, or distribution channels. There is insufficient innovation, and service quality is poor. Scarce expert resources get diluted across many companies (in particular, more actuaries would be needed).

77. **Some consolidation would help to create larger pools of resources to support growth,** limit on-going competition only through price (and the observed short-term run for cash) and contribute to attract large international groups.

78. **The ICC is instrumental in maintaining the industry in a generally sound situation.** The ICC team has improved its analytical tools over the last few years and in particular since the modular FSAP evaluation of December 2013. Among other accomplishments, the ICC has developed a new dashboard of risks and losses across business lines and companies, a new scoring system, stress-testing tools, improved transparent disclosure, modeled earthquake insurance, and developed new Guidelines on Product Review Process used to review product development but also to file insurance products. The ICC keeps strengthening the prudential framework by issuing guidelines that are raising the level of technical provisions, thus incentivizing smaller players to withdraw, merge or resell their insurance licenses. This approach is laudable but the ICC cannot exercise other direct measures to accelerate the consolidation of the sector. In 2016, the ICC plans to (i) issue guidelines on policy conditions and benefits for motor third party liability (main branch insurance), pricing, reserving, and performance monitoring; and (ii) to improve ICC's risk-based supervision.

79. **Yet, the modernization of the insurance law is overdue if the regulatory effectiveness of the ICC is to be strengthened.** Its current independence is severely limited, with the ICC reporting to the Ministry of Economy and Trade, and many decisions made at ministerial level resulting in political influence being a risk. For example, the ICC can suspend licenses but rarely uses this power, as companies and brokers lobby the Ministry to gain delays. The former ICC Head has not been replaced; his functions are currently being fulfilled by an acting head. Any decree or license-related decision is reviewed by a National Insurance Board, where five representatives of the insurance industry sit. Even if the final decision belongs to the Minister, this NIB process subjects the ICC to more lobbying

pressure. The NIB is also appointed by a decision of the Council of Ministers with a 3-year mandate. But as this mandate has expired and there is no Cabinet to appoint the new Board, the ICC cannot effect major decisions for an undetermined period. The ICC keeps issuing “guidelines" and some “decisions” without this process, but the ability to enforce these guidelines is questionable.

80. **Without this reform, the commendable technical endeavors of the ICC are not sufficient to take the insurance sector to the next level of development.** Besides improving the governance of the ICC, the NIB could be replaced by a more conventional and open consultation process with industry associations (ACAL, LIBS) and other public stakeholders. The law could update the scope of ICC activities, as some insurance activities—not referred within the initial law—and pension fund activities have been developing in the absence of any prudential oversight. The reform should also introduce flexibility through proportional approaches to regulation. A stronger regime will elevate prudential requirements to international benchmarks and improve the dynamics of the market. This also matters for foreign investors, thus facilitating the consolidation and professionalization of the sector.

81. **The ICC and the CMA must solve the matter of regulatory coordination for funds related to life insurance.** The Memorandum of Understanding between the ICC and the CMA has not been signed yet, short of a final agreement about their respective roles (CMA to regulate the fund’s activities, ICC to regulate insurance activities).

D. SME Access to Finance

82. **SMEs are important contributors to the economy – yet access to finance remains a constraint, among others, to their development.** It is estimated that there are 67,344 SMEs in Lebanon (96.1 percent of registered firms), employing 50 percent of the working population and contributing 27 percent of total revenues. Yet, only about one fifth of total private sector credit is channeled to SMEs. This reflects some insufficiencies in financial infrastructure (see part B), limited capacity of SMEs to meet the usual collateral requirements, and weak business proposals. Moreover, only a few commercial banks have dedicated SME units—although this is beginning to improve. Non-financial constraints also loom large—particularly the weak investment climate (Lebanon ranks 123 out of 189 countries on the Doing Business index in 2016—a deterioration from 121 in 2015). In addition, access to finance may not represent the most important hurdle to SME development, compared to other factors such as political instability, access to services such as electricity, licensing steps and corruption.

83. **The BdL and the Government have sought to address this lacuna in the financial system with a wide variety of support programs**:

- The Kafalat program and Credit Guarantees. Established in 1999, Kafalat is a financial company which operates a partial credit guarantee (PCG) program for SMEs to help them access bank financing. Guarantees range from 75 to 90 percent. The program mandates that banks take only limited collateral—and interest rates are subsidized under the scheme described below.

- The reserve requirements exemption program (RREP). Two RREP components, paired with the Kafalat PCG scheme, allow banks to get a remunerative return on the amount equivalent to the financing they provide under this scheme, while offering SME borrowers low cost borrowing (ranging currently from 2.5 percent in LBP and 4.6 percent in USD). Under the RREP, total SME loans granted by the banks reached US$2.9 billion.

- The subsidized lending program. In 2013 BdL started augmenting the RREP with a direct subsidized line of credit to banks. In March 2016, the amount of subsidized lines of credit amounted to US$0.75 billion. Of the funding to SMEs, the vast majority (88.6 percent or US$0.665 billion) has not been guaranteed by Kafalat.

- Support for start-up enterprises. In 2013, the BdL issued Circular 331 which provides financial support to start-up companies, incubators and accelerators. A US$400 million BdL facility provides interest free loans for up to seven years – guaranteed 75 percent by the BdL. Of the US$400 million available, US$243 million has already been committed and around US$60 million has been disbursed – mainly through funds. The response to the Circular 331 Program seems positive from market players who see the provision of early stage finance as an important component of business innovation eco-system development.

84. **Together, these instruments have increased lending to SMEs, while their sustainability and efficiency needs to be analyzed.** While contributing to financial access (it is estimated that the stimulus package represents one-third of the total loans to SMEs), it is not clear to what extent these schemes have had an impact on growth and employment as no monitoring and evaluation systems exist to measure the impact of these instruments, making it difficult to better calibrate them both in terms of volume and targeting.

85. **When the economic situation allows, the BdL should downsize these programs. In the meantime, it should revisit them with a view to increasing their impact.** The following immediate measures are suggested:

- Implement a robust monitoring and evaluation framework to determine whether these schemes are providing value for money. Any further expansion of the subsidized lending schemes should be based on these results;

- Analyze the recent reduction in Kafalat guarantees (which have halved over the past five years) and contemplate the design of new products (portfolio guarantees, MFI financing guarantees, and other riskier lending activities) in synergy with BdL programs;

- Determine how to crowd in more private funding under Circular 331 – so that these catalytic public funds can withdraw as soon as possible—and reduce the resulting exposure of the BdL. The BdL should also expand its eligibility criteria to all start-ups rather than only IT related activities, and ascertain that the disbursement ratio can rise to normal levels.

86. **In parallel, the BdL and the Government should improve the financial sector infrastructure** – as enhanced financial infrastructure is one of the most effective means of supporting SME finance. An insolvency and creditor rights regime which permits speedy and fair resolution in instances of default; a secured transactions registry; on-line and easily accessible credit information systems; and electronic payments systems—have all been demonstrated to support increased SME lending. Addressing these should be the primary focus of SME support programs.

E. Micro Finance

87. **The MFI sector is small in terms of assets but has a significant outreach.** The total MFI portfolio is estimated at US$230 million. With the exception of one player, none receives deposits or investment funds from their clients. According to market players' statistics, credits are extended to approximately 230,000 active borrowers, which would reflect a considerable market penetration, given the size of the adult population. The top five MFIs represent 80 percent of the market, out of with the first and second largest are NGOs. These two NGOs are not regulated by the BCC. Funding in most cases originally comes from domestic or international NGOs. More recently, under the RREP, several MFIs have managed to source the majority of their funding from banks (LBP28 billion in total).

88. **The micro-finance market shows signs of overheating.** The sector has been growing rapidly over the recent years and, according to market players, competition has become more intense. Moreover, cross borrowing and over indebtedness require more careful oversight: a recent study indicates that 30 percent of micro finance borrowers have cross borrowings with another financial institution.

89. **MFI's are not working on a level playing field.** Micro finance NGOs which have transformed into regulated MFIs appreciate the support for systems development, enhanced management and oversight, and strengthened governance arrangements that this transition has required—and the access that this has given them to credit information and to bank lending. However, they complain about unfair competition from the non-regulated NGO.

90. **Implementation and enforcement of a unified regulatory framework for all market players exceeding a certain lending size is recommended**. This regulatory regime should be calibrated to the needs of the industry. Particularly, the examinations of loan officers and the capital required for opening new branches should be less stringent than for banks. Finally, those MFIs which have not yet transformed into a financial institution should

be given a short transition period to do so—to even the playing field for all operators working in this space.

91. **The Micro Finance Association, established in early 2015, deserves further support.** The Association should also be encouraged to collected better, more standardized and more regular data on the industry so as to better inform policy decisions. It should also play a central role in areas such as financial literacy and consumer protection.

F. Financial inclusion

92. **Lebanon stands out among regional peers with respect to financial inclusion.** According to the Global FINDEX Data Base—47 percent of adults have a bank account, compared to 14 percent overall for MENA. For upper-middle income countries the rate is 70 percent, however. Lebanon has also experienced the largest increase in bank account ownership in the region since 2011—with account ownership increasing by 10 percent. Nonetheless Lebanon compares less well to a wider sample of countries at a similar level of GDP per capita, and should aspire to the achievements of the upper-middle income countries in East Asia, Latin America and Eastern Europe where average account ownership is significantly higher.

93. **Account ownership is unequal, as women, the poor, and young people are excluded in large numbers.** Despite making good progress on gender access, there is room to improve to meet global peers. Making further progress with respect to the poor, youth, and disadvantaged regions – should also be a focus moving forward.

94. **An analytical framework should be developed.** It is important to develop a comprehensive range of indicators to measure how different priority groups of population and/or SMEs may access and actively use different types of financial services, in terms of payments, savings, insurance, and loans. This analytical framework could inform the Financial Access to Finance Strategy.

95. **Medium to long terms solutions for financial inclusion would require an evolution of the banking sector's business model.** For reasons pertaining to the necessity to maintain a high level of AML/CFT regulatory compliance and the necessity to fight cybercrimes, the BdL has so far not allowed the development of "branchless banking". Basic financial services such as cash in, cash out, transfers, deposits and savings are still provided by licensed banks and money transfer firms. There are a few initiatives, such as PinPay or CMO, offering electronic payment services but they serve clients that already have bank accounts (albeit with limited inter-operability). While keeping Customer Due Diligence and Know Your Customer requirements at a high level, the BdL should consider allowing the banking system to develop branchless-banking activities with the objective of providing affordable basic financial services to the unbanked population.

APPENDIX I. OTHER RECOMMENDATIONS

Institutional Framework
Formalize arrangements for interagency coordination between BCC, CMA, and the ICC; establish an advisory committee for macroprudential policy making
Banking Sector Supervision
Reconsider the practice of the Association of Banks in Lebanon proposing one of the members of the BCC board and the HBC
Increase interaction with banks' executive and non-executive board members
Shorten timeframe between the identification of prudential shortcomings and the implementation of corrective actions
Extend supervisory sanctioning powers to individuals
Develop inspection program for foreign branches and subsidiaries of Lebanese banks
Align risk weight of foreign currency denominated BdL exposures with the Basel Capital Accord
Review banks' collateral valuation practices via thematic inspections and, if needed, issue supervisory guidance
Professionalize the appraiser industry via the introduction of professional standards
Align regulatory treatment of restructured loans with international good practice
Formalize the LCR as mandatory standard for liquidity risk management purposes
Remediate residual gaps in banks' disaster recovery and business continuity plans
Develop methodology for identifying systemically important banks and introduce capital surcharges
Macroprudential Policy Framework
Start preparing periodic reports on key developments and risks in the financial sector; and improve the transmission of macroprudential policies via clear communication
Accelerate efforts to close data and information gaps on household and corporate sector indebtedness
Strengthen the regime of off-plan sales by developers
Finalize the house price index
Financial Integrity
Define beneficial owners in line with international standards (i.e. including with reference to effective control other than through ownership)
Strengthen the fit and proper testing for AML/CFT purposes
Ensure that AML/CFT supervision is commensurate to ML/TF risks
Consider prohibiting the use of bearer shares
Crisis Management and Preparedness

Establish decision criteria for BCC actions in case of financial distress, including the possible taking of early intervention and resolution measures.
Clarify the role of the HBC with regard the oversight of temporary managers
Formalize internal criteria for access, in stable times, to BdL emergency liquidity assistance for illiquid yet solvent banks
Consider arrangements for the set-up and operationalization of bridge banks
Establishment roster of well-qualified temporary managers
Align the NIGD with international best practices via a phased approach
Strengthen crisis preparation arrangements via the setup of a coordinating crisis management committee
Financial Development and Access to Finance
Adopt a comprehensive National Financial Sector Development Strategy
Adopt the laws on insolvency, secured transactions and payment systems
Improve the Public Credit Registry
Strengthen National Payment System supervision
Strengthen the governance and oversight of Midclear
CMA to adopt more risk-based supervision
Consider designing new Kafalat products and revisit its risk taking policy
Optimize the 331 circular on start-up financing to (i) leverage private sector financing, (ii) open-up to non-IT start-ups; and (iii) reduce risk exposure of the BdL
Develop and implement unified regulatory framework, adopted to microfinance