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September 14, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Lebanon—Financial System Stability Assessment—Update**

The attached paper provides background information to the staff report on the 2001 Article IV consultation discussions with Lebanon (EBS/01/162, 9/13/01), which is tentatively scheduled for discussion on Monday, October 15, 2001. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Lebanon indicating whether or not they consent to the Fund's publication of this paper.

Questions may be referred to Mr. D. Marston (ext. 35631).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Commission and the Islamic Development Bank, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

LEBANON

Financial System Stability Assessment—Update

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September 12, 2001

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I. Overall Assessment and Stability Update[1]

1. The Financial System Stability Assessment of 1999 (FO/Dis/99/113) assessed the financial system in Lebanon to be *"currently profitable and solvent and the structural framework for the conduct of monetary and financial policies is generally effective. The capability of the nonfinancial sector to diversify risks is limited by the embryonic state of nonbank and capital markets." The report further stated that "Notwithstanding considerable success to date, financial intermediation in recent years has been influenced by a slowdown in economic activity, very high and increasing levels of public sector indebtedness to the banking system, and the growing operational challenge of refinancing a stock of domestic debt at a time when risk premiums have risen to defend the nominal exchange anchor."*

2. **The macroeconomic context of financial intermediation in Lebanon has worsened since the last assessment.** Real GDP has slowed to close to zero and the overall fiscal deficit has increased from 18.7 percent to 24.9 percent. The country risk premium on sovereign debt issues has risen reinforced by downgrades on Lebanese sovereign debt issues and dollarization has accelerated. With an exchange peg and a passive interest rate stance, gross international reserves of the central bank have fallen and the adequacy of the net foreign assets of the system to cover LL deposits has declined further. This outturn had—until recently—been reinforced by adverse classifications by the Financial Stability Forum and the Financial Action Task Force on Lebanon's commitment to providing financial system oversight in line with international best practice.[2]

3. **The economic recession has adversely affected the banking system, with most indicators of financial strength declining**. Capital adequacy ratios have declined from 18.7 to 16.9 percent since end 1998. Asset quality has deteriorated, with nonperforming loans increasing from 12.4 to 20.5 percent of total loans at end March 2001, and returns on both assets and equity are now much less robust than they were in 1998. Notwithstanding these trends, capital in the banking system remains relatively high—though inflated by a zero risk weight assigned to LL sovereign debt holdings—and banks remain liquid and profitable. Moreover, banks have responded to the downturn and, prompted also by the supervisory agency, have increased provisions for bad loans and are some ways along in a program to increase capital requirements. There is also evidence of some consolidation across the financial sector: the number of banks has declined, as has the number of insurance

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[1] The mission team preparing this report comprised David Marston (MAE), Ms. Rina Bhattacharya and Ms. Nada Choueiri (both MED), Mr. Marcel Maes (formerly Belgian Banking Commission), and Mr. Timothy Lemay (UN Global Anti-Money Laundering Program).

[2] The June 2000 meeting of the FATF recognized the legislative and implementation efforts of Lebanon in combating money laundering.

companies, the latter due in part to the implementation of a program of restructuring the industry by the authorities.

4. **Stress tests of individual bank portfolios suggest that broad resilience to credit risks has generally improved—in part due to improved provisions—and that direct exposure of banks to foreign exchange risk remains contained.** This resilience however varies across banks, and two medium sized banks, accounting for approximately 7 percent of the system's assets (one of which already has capital below 10 percent, the prudential floor set by the Banking Control Commission) appear particularly vulnerable to credit risk. Banks could however be exposed to risk resulting from foreign currency exposure of bank clients translating into credit risk. While the extent of dollarization in the economy reduces this prospect for large corporates at the aggregate level, individual borrowers may not be as well insulated since their main source of income—wages—is largely in Lebanese pounds, in particular for the case of public sector employees. Moreover, there is evidence that some sectors such as construction, trading, and services—that coincide with likely reliance on LL—are already under stress. **Vulnerability to interest rate risk however has increased substantially due to the large and growing duration mismatch between bank assets and liabilities.** The mismatch has been aggravated by the public debt management strategy to convert short-term LL treasury bills with longer-term foreign currency bond issues. The systemic implication of this mismatch is amplified by the persistent fiscal borrowing needs which sustains pressures on real interest rates.

5. **The resulting portfolio need to maintain liquid assets as a hedge against the duration mismatch, coupled with exceptionally high levels of intermediation, leads to inertia in money markets.** Excess liquidity prevails, but market inactivity is also reinforced by concentration of treasury bills, weak arrangements for primary market auctions and lack of transparency in arrangements for price discovery by the market. Beyond its implications for market development, the latter issue of price discovery weakens the BdL's ability to extract the signals needed to evaluate the sustainability of the policy mix.

6. **The regulatory and supervisory response of the authorities to the 1999 assessment of compliance with the Basel Core Principles for Effective Banking Supervision, and to the concerns raised by the Financial Action Task Force in 2000, has been swift and comprehensive.** Compliance with the Core Principles has improved considerably and is underpinned by a marked change in the supervisory culture in Lebanon. Beyond improved oversight of the banking sector, and while the insurance sector has never posed large risks to the broader financial sector given its size, oversight of this sector has also improved, though the Insurance Control Commission is severely hampered by shortage of staff and other resources.

7. **With regards to the concerns raised by the FATF and the FSF, the authorities have reacted swiftly.** Anti-Money Laundering Legislation was gazetted in April 2001 and implementing regulations issued in May. The regulations cover: a comprehensive definition of money laundering and the criminalization of such; the establishment of a financial intelligence unit; suspicious activity reporting requirements; the lifting of bank secrecy where

money laundering is suspected; the inclusion of supervisors in the loop of secrecy; and know your customer requirements. While the concerns of the FSF overlap somewhat with those of the FATF, to avoid future misclassification the authorities have repealed the law enabling the Banque du Liban (BdL) to license offshore entities.

8. **Notwithstanding these initiatives, further reforms are needed to reduce systemic vulnerability.** The near term challenge remains that of strengthening the systemic liquidity framework—in particular the ability to extract market signals from primary and secondary markets, the introduction of automatic liquidity stabilizers and the design and use of BdL monetary instruments, and modifying the design of debt instruments to moderate interest rate risks in banks. Such actions would improve resilience and augment contingency planning arrangements. Moreover, there is need for more formal and routine monitoring of macroprudential indicators by the BdL to assess soundness and policy sustainability. A complementary focus is for supervisors to also take full account of the growing interest rate risks posed by the duration mismatch, while also strengthening credit supervision. Ongoing efforts to achieve full compliance with the BCP and other international standards are critically dependent on the implementation of the Money Laundering Legislation, but also will depend on sustained actions by supervisors to provide guidance on issues of corporate governance, internal audit and control.

II. Macroprudential Environment

A. Macroeconomic Update

9. **Overall, macroeconomic conditions in Lebanon have worsened considerably in the period since the 1999 FSSA report.** Real GDP growth is estimated to have slowed from 3.0 percent in 1998 to zero in 2000, mainly due to a sharp decline in investment and, in particular, private sector investment. At the same time, the overall fiscal deficit has increased from 18.7 percent of GDP in 1998 to 24.9 percent of GDP in 2000, partly due to rising costs of servicing the public debt but also due to a 3 percent deterioration in the primary balance (Table 1). The markets' reaction to the rising debt ratio has been to increase the risk premia associated with the debt and accelerated dollarization. This process, in the context of an exchange peg and with a passive interest rate stance, has resulted in a loss of gross reserves (Figure 1).

10. **With the gross public debt rising from 119 percent of GDP at the end of 1998 to 153 percent at the end of 2000, the deteriorating fiscal position in the context of a nominal exchange anchor has sustained pressures on interest rates**—the real yield on 24-month treasury bills have risen from 12 percent to 15 percent. However, as the bulk of public debt remains domestically held, the rapid rise of the debt ratio has not had an adverse effect on the balance of payments, with principal and interest payments on the government's external debt remaining somewhat constant at 11 percent of exports of goods and services over the period 1998-2000.

Table 1. Lebanon: Macroeconomic Indicators, 1996-2000

	1996	1997	1998	1999	Prel. 2000
National income and prices	(Annual percent changes)				
Nominal GDP	13.3	12.1	7.7	1.2	-0.4
Real GDP	4.0	4.0	3.0	1.0	0.0
CPI (period average)	8.9	7.7	4.5	0.2	-0.4
Central government operations 1/	(In percent of GDP)				
Revenue	17.3	16.4	18.0	19.5	18.3
Expenditure	39.0	44.0	36.8	35.7	43.2
Of which:					
interest payments	13.0	15.2	13.6	14.5	16.9
other current expenditure	17.1	19.3	12.2	15.0	21.4
capital expenditure	8.8	9.5	11.0	6.2	4.9
Overall deficit (-)	-21.7	-27.6	-18.7	-16.2	-24.9
Primary balance	-8.7	-12.4	-5.1	-1.7	-8.0
Gross public debt 2/	100.0	105.2	118.6	138.4	153.2
Denominated in domestic currency 2/	85.5	89.0	93.1	102.9	107.3
Denominated in foreign currency	14.5	16.2	25.5	35.5	45.9
Money and credit	(Change as percent of beginning-of-period M3)				
Net foreign assets	2.7	-2.5	-3.0	0.3	-1.7
Net domestic assets	25.1	21.8	19.1	10.8	11.3
Of which: Net credit to public sector	13.8	13.6	13.0	5.9	10.4
Credit to private sector	11.4	10.3	9.4	5.8	2.9
Broad money (M3) 3/	27.8	19.3	16.1	11.1	9.6
Interest rates (percent per annum)					
yield on 24-month treasury bills (end-period)	20.5	16.7	16.7	14.6	14.6
new eurobond issues (period average)	9.1	8.0	8.5	8.8	9.1
Balance of payments	(In millions of U.S. dollars, unless otherwise indicated)				
Trade balance	-6,209	-6,248	-5,913	-5,086	-5,083
Net services	791	870	673	790	996
Official transfers	47	48	101	91	89
Private transfers	555	959	740	888	932
Current account	-4,816	-4,371	-4,399	-3,317	-3,065
(In percent of GDP)	-37.1	-29.4	-27.1	-20.0	-18.6
Overall balance	786	420	-488	261	-289
Reserves					
Net official reserves (end-period) 4/	7,399	5,701	6,155	7,815	5,279
(In months of imports of goods and services)	11.2	8.5	10.3	14.9	10.1
(In percent of LL liquidity)	82.0	59.9	56.1	58.2	40.8
(In percent of total liquidity)	39.3	24.9	22.9	26.2	16.1
Debt service (in percent of current receipts)	4.8	18.1	12.0	11.4	11.2
Exchange rates	(Percent change, unless otherwise indicated)				
Exchange rate (LL/US$; period average)	1,571	1,540	1,516	1,508	1,508
Real effective exchange rate (period average)	12.2	18.1	8.1	1.8	6.2
Real effective exchange rate (index, 1990=100)	182.6	215.7	233.2	237.4	252.0
Memorandum item:					
Nominal GDP (in trillions of LL)	20.4	22.9	24.6	24.9	24.9

Sources: Bank of Lebanon; Ministry of Finance; and staff estimates.

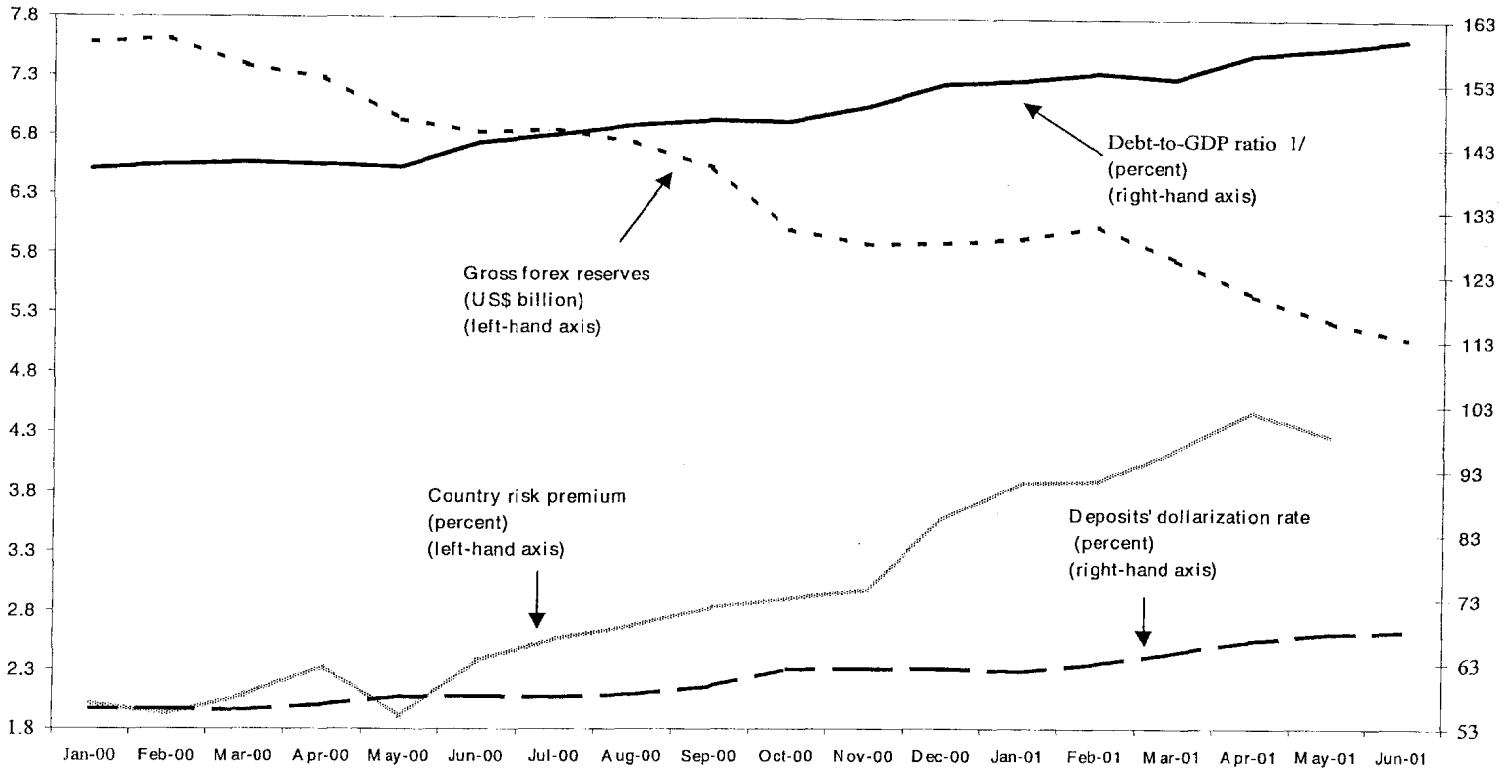
1/ Excluding grants.

2/ Includes government's arrears to the private sector

3/ Includes liquidity in Lebanese pounds, foreign currency deposits and bonds issued by banks.

4/ Include foreign exchange and gold held by the central bank, net of foreign-currency deposits of commercial banks with the central bank.

Figure 1. Lebanon: Selected Macroeconomic Indicators
January 2000 – May 2001



Source: Data provided by the authorities and staff estimates.
1/ Ratio of monthly debt stock to annual GDP for the corresponding year.

11. **The operational challenge in refinancing the public debt and moderating interest costs while retaining credibility in the exchange anchor remains.** In this regard, the BdL continues to play a supportive role, and while the practice observed in 1997-98 of incurring losses (through buying treasury bills at primary auctions and selling these bills to commercial banks at higher yields) has been limited by internal limits on BdL secondary operations,[3] the BdL continues to offer above market rates on its standing deposit facility for foreign exchange,[4] to build up gross international reserves.

12. **Notwithstanding these efforts, the adequacy of foreign exchange reserves to cover Lebanese pound liabilities in the banking system has declined further** since the 1999 FSSA, increasing the vulnerability of the system to portfolio shocks (Figure 2). At end 1998, a switch into foreign currency of 56 percent of the LL portion of M3 would have been sufficient to exhaust the net official gold and foreign exchange reserves of the system. This coverage ratio fell to 41 percent by end 2000, and was only at 32 percent at end-June 2001.

13. **Reflecting these conditions, dollarization continues to increase, with the share of foreign currency deposits to broad money increasing from 57 percent at the end of 1999 to 62 percent at the end of 2000** and 68 percent at end June 2001. Higher dollarization has been also associated with a decline in holdings of LL treasury bills by commercial banks. As their capacity to fund LL denominated assets declines—reinforced by prudential foreign exchange exposure limits—banks' treasury bill holdings have declined from LL17.3 trillion at end-1999 to LL16.8 trillion at end-2000 and to LL14.8 trillion at end-June 2001. Concurrently, starting in May 2000, banks have been increasing their holdings of foreign currency assets relative to foreign currency liabilities to increase their net open foreign exchange position (by US$637 million between April 2000 and March 2001), perhaps reflecting some attempt at hedging against currency risks. Moreover, in the past 12 months three international rating agencies—Standard and Poor's, Moody's and Fitch—lowered their ratings on Lebanese sovereign debt. In May 2001, Standard and Poor's further revised its outlook from stable to negative, and at end-July 2001 Moody's lowered the country ceiling for foreign currency debt one notch to B2 (hence lowering its rating of Lebanese eurobonds to B2) while lowering the rating of LL government debt two notches to B3. Notwithstanding this, and despite increasing risk premia, Lebanon was able to market US$1,550 million in new eurobond issues in April 2001, of which a 15-year bond totaling US$400 million was completely subscribed to by foreign investors at a spread of 647 basis points over U.S.

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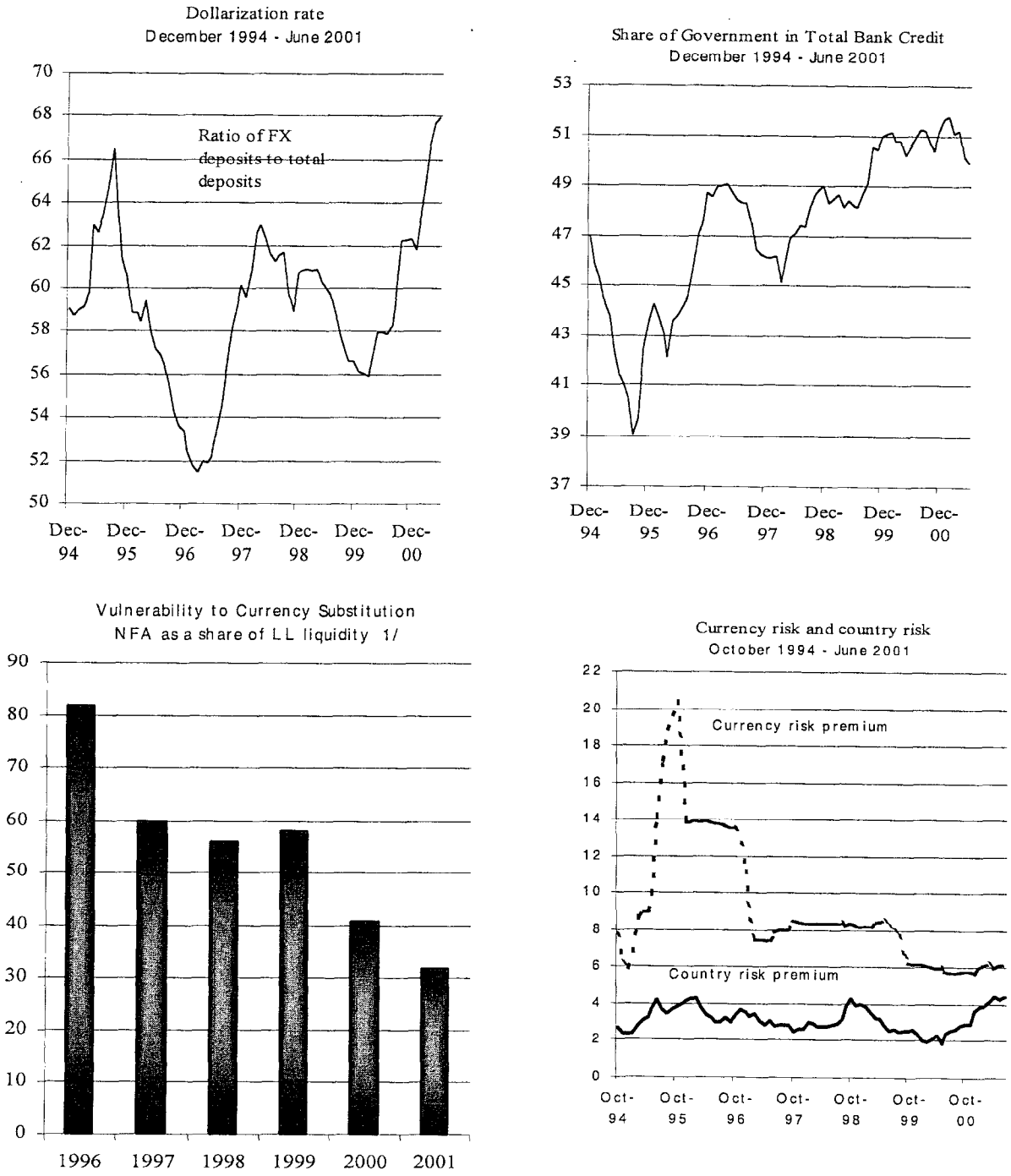
[3] Active BdL intervention resumed in May 2001, when the BdL engaged in swap operations which aimed at facilitating the rollover of LL treasury bills and lengthening their maturities.

[4] In May 2001 the BdL introduced a three-year deposit facility for commercial banks' foreign exchange deposits, paying 9 percent (slightly below the 9.5 percent yield on three-year Lebanese government eurobonds). A gross amount of US$1.45 billion was placed by banks in this facility, part of which was taken from their already existing deposits at the BdL which are of much shorter maturity.

Figure 2. Lebanon: Vulnerability Indicators and Market Assessment (In Percent)



Source: Banque du Liban, Statistics Department; International Finance Statistics; and staff estimates.
1/ End-of-year data for 1996 through 2000. End June data for 2001.

treasuries. It also successfully completed the placement of another seven-year US$750 million eurobond in July, at a spread of 516 basis points above comparable U.S. treasuries.

B. Financial Stability Update

14. **In aggregate, banks in Lebanon continue to be reasonably capitalized,[5] remain profitable and have high liquidity coverage, especially in relation to their LL-denominated liabilities** (Table 2).[6] Notwithstanding capital levels—the values of which are supported by a 60 percent structural limit that allows banks to retain that proportion of capital in foreign currency—the economic recession has adversely affected the banking sector, with most indicators of the banking system's financial strength having deteriorated over the past couple of years. The system's average capital adequacy ratio has fallen from 18.7 at the end of 1998 to 16.9 at the end of 2000. Asset quality has deteriorated, with nonperforming loans (NPLs) of the banking system as a whole increasing from 12.4 percent of total loans at the end of 1998 to 19.2 percent of total loans at the end of 2000. These data are not fully comparable, however, because starting 1999, a new class of loans was introduced, namely "substandard loans," and their inclusion with NPLs inflates the 2000 figures. Indeed, excluding substandard loans, the ratio of NPLs to total loans would have deteriorated to a lower level of 16.0 percent as opposed to 19.2 percent.[7] Moreover, excluding substandard loans, banks appear to have increased their provisioning for bad loans, with the ratio of provisions to nonperforming loans rising from 73 percent to 77.8 percent over the same period (the latter figure becomes 64.6 percent if substandard loans are included with NPLs), and this has had an adverse impact on their profitability.

Profitability

15. **There has also been a squeeze on bank profits (Table 3) through a narrowing of interest rate margins on foreign currency-denominated loans and a sharp increase in net non-interest losses.** While the average interest rate on U.S. dollar deposits was increasing between the third quarter of 1999 and end-2000, the average interest rate on U.S. dollar-denominated loans was rising at a slower pace; consequently, the interest rate margin has fallen from 5.6 percent at the end of 1998 to an average 5.3 percent in 2000. Interest margins on Lebanese pounds were stable over the same period. At the same time, there has been a sharp increase in net non-interest losses, from LL 572 billion in 1998 to LL 1,051 billion in 2000, partly due to a marked decline in returns from securities holdings as a

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[5] Reported capital is supported by the zero risk weight assigned to the still large holdings of domestic sovereign debt.

[6] There has been some consolidation of the banking sector since 1999, with the total number of commercial and specialized banks falling from 79 at end-1998 to 71 in September 2000.

[7] Although data on nonperforming loans by sector is not available, anecdotal evidence suggests that banks that are heavily exposed to the construction sector have suffered the largest deterioration in asset quality.

Table 2. Lebanon: Indicators of Banking System's Financial Strength, 1995-2000
(In billions of Lebanese Pounds; unless otherwise stated)

	1995	1996	1997	1998	1999	2000	Mar-01
Total assets	29,981	38,870	49,498	58,283	63,862	71,614	72,537
Total loans to private sector	10,339	13,106	17,060	19,932	22,270	24,170	24,134
Total capital	1,215	2,157	3,377	4,179	4,522	4,872	5,025
Portfolio quality							
Problem loans 1/	1,714	1,939	2,066	2,478	3,193	4,651	4,958
Provisions against problem loans	1,459	1,556	1,592	1,817	2,014	3,005	3,160
Other provisions for risks and charges	206	259	280	300	301	368	341
Problem loans / Total loans	16.6	14.8	12.1	12.4	14.3	19.2	20.5
Problem loans / Total assets	5.7	5.0	4.2	4.3	5.0	6.5	6.8
Provisions against problem loans / Problem loans	85.1	80.2	77.1	73.3	63.1	64.6	63.7
Total provisions / Problem loans	97.1	93.6	90.6	85.4	72.5	72.5	70.6
Total capital / Problem loans	70.9	111.3	163.5	168.6	141.6	104.8	101.4
Portfolio performance							
Average return on assets (ROA) (in percent)	1.1	1.3	1.4	1.4	1.0	0.7	...
Average return on equity (ROE) (in percent)	27.3	25.2	27.1	23.8	15.7	11.1	...
Capital adequacy							
Total capital/Total assets	4.1	5.5	6.8	7.2	7.1	6.8	6.9
COOKE-ratio (in percent)	15.0	15.1	19.9	18.7	15.0	16.9	...
Exposure to exchange rate risk, LL bn							
Total assets in foreign currency	17,574	20,776	30,093	36,326	38,461	45,792	47,437
Total liabilities in foreign currency	16,113	19,221	29,181	35,494	37,347	44,559	46,262
Net exposure	1,462	1,556	912	832	1,114	1,233	1,174
as percent of total capital	120.3	72.1	27.0	19.9	24.6	25.3	23.4
Estimated exposure to real estate market							
Total loans for construction							
(as percent of total loans)	20.9	21.6	20.6	21.8	22.2	22.4	...
Maturity match (forex operations)							
Credits in FX / Total Credits	87.6	86.6	87.6	89.4	89.0	87.5	...
Deposits in FX / Total Deposits	60.6	54.9	61.0	63.2	60.0	65.1	...
Credits in FX / Deposits in FX	60.7	64.9	57.5	57.1	61.0	50.9	...
Bank loans to private sector / GDP	57.3	64.2	74.6	80.9	89.3	97.2	...
Bank loans in FC to private sector / GDP	50.2	55.6	58.8	67.4	74.2	77.9	...
Bank loans to private sector / Bank assets	34.5	33.7	31.2	31.1	31.7	29.6	28.9
Private exports of goods and services/							
bank loans in FC to private sector	...	...	26.6	21.9	20.5	20.4	...

Source: Statistics Department, *Banque du Liban*; and staff calculations.

1/ As determined by banking supervision, taking into account credit performance and collateral.

Table 3. Lebanon: Aggregate Income Statement of the Banking System, 1997-2000 1/

(In billions of Lebanese pounds, unless otherwise stated)

	1997		1998		1999		2000	
INTEREST INCOME		(in percent of interest income)		(in percent of interest income)		(in percent of interest income)		(in percent of interest income)
Interest earned on interbank loans	872	19.9	916	17.7	926	16.0	1,222	17.3
Interest earned on T. bills	1,978	45.1	2,487	47.9	2,840	49.2	3,109	44.1
Interest earned on other loans	1,540	35.1	1,787	34.4	2,012	34.8	2,715	38.5
Total	4,390	100.0	5,190	100.0	5,777	100.0	7,047	100.0
INTEREST EXPENSES		(in percent of interest expense)		(in percent of interest expense)		(in percent of interest expense)		(in percent of interest expense)
Interest paid on interbank borrowing	161	5.0	209	5.4	268	6.2	328	6.0
Interest paid on subordinated debt	34	1.1	17	0.4	24	0.5	26	0.5
Interest paid on other deposits	3,009	93.9	3,655	94.2	4,028	93.2	5,130	93.6
Total	3,204	100.0	3,882	100.0	4,320	100.0	5,483	100.0
NET INTEREST INCOME	1,186		1,308		1,457		1,564	
NON-INTEREST INCOME		(in percent of non-interest income)		(in percent of non-interest income)		(in percent of non-interest income)		(in percent of non-interest income)
Commission earned on interbank loans	3	0.5	4	0.6	5	0.8	4	0.7
Commission earned on other loans	140	23.0	148	23.6	162	26.2	165	27.1
Other commission earned	133	21.9	155	24.7	149	24.0	172	28.2
Net results of securities holdings 2/	178	29.3	117	18.7	117	19.0	67	11.0
Recovered provisioning	60	9.9	93	14.8	90	14.6	67	11.0
Miscellaneous income 3/	94	15.5	110	17.6	96	15.5	134	22.0
Total	608	100.0	626	100.0	620	100.0	609	100.0
NON-INTEREST EXPENSES		(in percent of non-interest expense)		(in percent of non-interest expense)		(in percent of non-interest expense)		(in percent of non-interest expense)
Salary	503	44.6	521	43.5	579	42.7	658	39.6
General expenses	353	31.3	412	34.4	472	34.8	617	37.2
Write-off provision	197	17.5	228	19.0	250	18.5	340	20.5
Administrative expenses (net)	18	1.6	17	1.4	34	2.5	24	1.4
Commission paid	56	5.0	20	1.7	20	1.5	21	1.3
Total	1127	100.0	1,198	100.0	1,355	100.0	1,660	100.0
NET NON-INTEREST INCOME	-519		-572		-735		-1,051	
PROFIT BEFORE TAX	667		736		722		513	
TAX	66		73		119		107	
PROFIT	601		663		603		406	
Memorandum items:		(in percent)		(in percent)		(in percent)		(in percent)
Net interest margin (net interest income/total assets)		2.4		2.2		2.3		2.2
Non-interest income/interest income		13.8		12.1		10.7		8.6

Source: Banking Control Commission.

1/ Commercial and Specialized Banks.

2/ Difference between revenues and costs of selling, buying and holding securities - provisions on securities + recovered provisions on securities.

3/ Includes income from foreign exchange operations, management services, and other investment income.

consequence of the decline of stock market activity, and significant write-off provisions for bad loans in 2000. As a consequence net after-tax profits declined from LL 663 billion in 1998 to LL 603 billion in 1999 and to LL 406 billion; the average return on assets is estimated to have declined from 1.4 percent to 0.7 percent, and on equity from 23.8 percent to 11.1 percent, over the corresponding period.

CAMEL distribution

16. Against this aggregate performance, the 15 largest banks in Lebanon—together representing more than 73 percent of the total assets of the banking sector at the end of 2000—were ranked according to their performance for a selected range of indicators. (Figure 3).[8] All banks--with the exception of one accounting for 5.16 percent of market share—hold capital in excess of the 10 percent solvency standard required by the Banking Control Commission.[9] All are highly liquid in terms of their coverage of LL deposits, with the median liquidity ratio being over 80 percent. The liquidity ratio in foreign currency is much lower, with the median being just under 45 percent, as against the prudential requirement of 25 percent. Nonperforming loans as a percentage of total loans varies considerably across the banks, ranging from around 3 percent to over 35 percent, and exceeding 15 percent for four banks. There is also considerable divergence across the banks with regard to provisioning against nonperforming loans, with the median ratio being just under 70 percent, and in their exposure to the construction sector, with one bank having almost 50 percent exposure to that sector. **Most banks had a return on assets of around 1 percent in 2000, although one bank—a branch of a foreign bank—incurred losses and three other banks—of which one branch of another foreign bank—had a rate of return of 0.5 percent or less.** The banks also vary considerably in terms of their net open foreign exchange position as a share of total capital,[10] and in terms of the extent of their lending to related parties.

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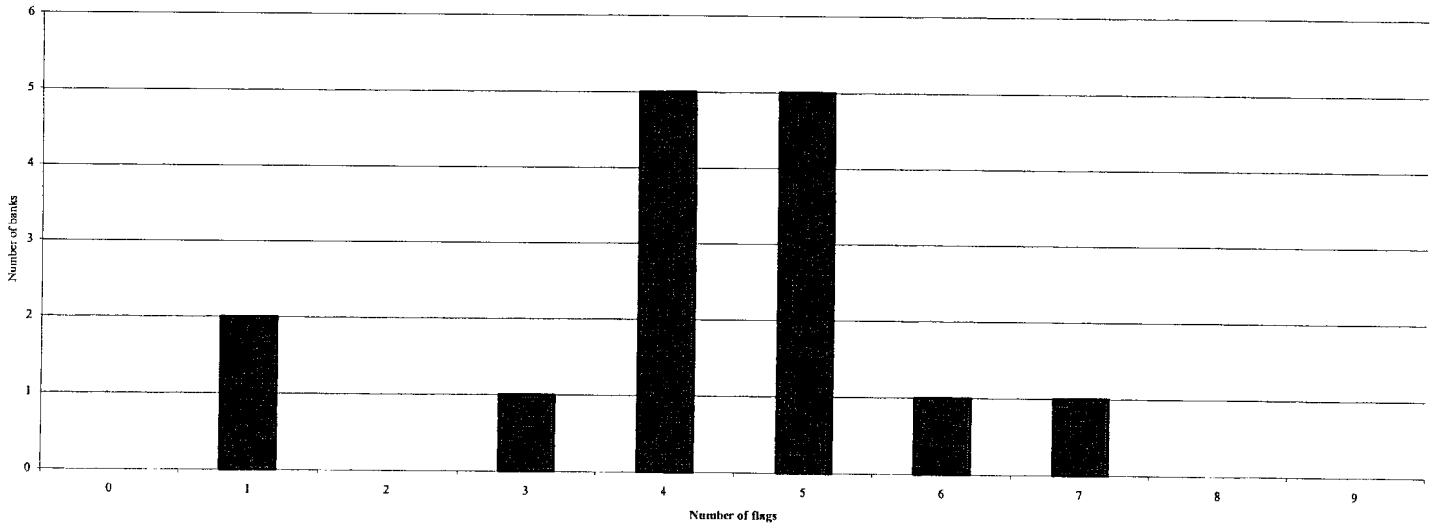
[8] These are: solvency ratio, liquidity ratio (in LL and foreign currency separately), the share of NPLs in total loans, provision for NPLs, exposure to the construction sector, connected lending as a share of capital, and ROA and net foreign currency exposure. For each of the nine indicators the median value was identified, and each bank received a flag for a particular indicator if the bank underperformed relative to the median. For each bank the number of flags across indicators was added to give a total out of nine.

[9] Effective December 2000, banks are required to hold risk-weighted capital of 10 percent and to increase these holdings to 12 percent by December 2001.

[10] Ten out of the fifteen banks had a long position in foreign exchange.

Figure 3. Lebanon: Distribution of Banks According to Ranking of Soundness Indicators



Source: Banking Control Commission; and staff estimates.

Table 4. Stress Tests: Credit, Foreign Exchange, and Interest Rate Risks

Solvency Ratio	Baseline		Credit Risk				Foreign Exchange Risk				Interest Risk			
	Number of Banks	% share of assets	Scenario A1 1/		Scenario B1 2/		Scenario A2 3/		Scenario B2 4/		Scenario A3 5/		Scenario B3 6/	
>20	3	24.7	2	16.7	2	16.7	3	24.7	3	24.7	1	6.9	1	6.9
15-20	5	22.3	5	27.4	2	14.9	5	22.3	5	22.3	1	2.9	0	...
10-15	6	21.3	5	21.0	8	33.5	6	21.3	6	21.3	5	28.3	1	2.9
5-10	1	5.2	2	6.9	1	1.8	1	5.2	1	5.2	6	32.2	9	47.8
0-5	0	...	0	...	1	5.2	0	...	0	...	1	1.8	0	...
Negative	0	...	1	1.5	1	1.5	0	...	0	...	1	1.5	4	15.9

Sources: Banking Control Commission; and staff estimates.

1/ Scenario A1 assumes that 20 percent provisioning is made for the substandard loans of the bank, and that NPL (doubtful and loss) increase by 20 percent, with 50 percent provisioning made for these new NPLs.

2/ Scenario B1 assumes that 20 percent provisioning is made for the substandard loans of the bank, and that NPL (doubtful and loss) increase by 50 percent, with 50 percent provisioning made for these new NPLs.

3/ Scenario A2 assumes a 10 percent devaluation of the Lebanese pound.

4/ Scenario B2 assumes a 50 percent devaluation of the Lebanese pound.

5/ Scenario A3 assumes a 300 basis points increase in the average interest rate, calculated as the weighted average of rates on T bills and deposits. Assumes the duration of LL T-Bills and eurobond holdings are 13 and 40 months respectively, and that the duration of banks' deposits is 40 days. Assumes that present market value of T-bills is the same as their book value.

6/ Scenario B3 assumes a 500 basis points increase in the average interest rate. Same assumptions on durations and market value of T-bills as in 5/.

Stress testing

17. The banking system's ability to absorb macroeconomic shocks was assessed through a set of stress tests, looking at the exposure of the largest 15 banks to moderate credit, foreign exchange and interest rate shocks (Table 4). Similar tests to those performed in the 1999 FSSA were repeated on the 15 banks with the largest asset share of the sector as of December 2000. The results show an **improvement in the resilience of banks to credit and foreign exchange risks, though exposure to interest risk appears to have substantially increased.** (Table 5).

Table 5. Banks in Sample with Solvency Ratio ≤ 10

	1999 FSSA		2001 FSSA follow-up	
	Number of banks	% share of the sector's assets	Number of banks	% share of the sector's assets
Scenario A1 (credit risk) 1/	8	26.0	3	8.4
Scenario B1 (credit risk) 1/	9	31.2	3	8.4
Scenario A2 (foreign exchange risk) 1/	3	9.2	1	5.2
Scenario B2 (foreign exchange risk) 1/	3	9.2	1	5.2
Scenario A3 (interest risk) 1/	5	19.6	8	35.5
Scenario B3 (interest risk) 1/	7	26.8	13	63.7

1/ See Table 4 for the definition of scenarios.

18. **Banks seem generally insulated against direct credit risk.** A more strict provisioning requirement for sub-standard loans and an even relatively large deterioration in loan quality would result in one bank (a branch of a foreign bank, representing 1.5 percent of the sector's assets) becoming insolvent and two other medium sized banks being undercapitalized (one of which is another branch of a foreign bank), while 12 banks (representing 65 percent of the sector's assets) would remain well-capitalized. In the context of the ongoing recession credit risk has increased substantially, as evidenced by the 30 percent growth of NPLs in the year 2000. Thus, the stress test results are broadly reassuring as they imply that most banks are in a relatively strong position to cope with credit risk if NPLs continue to grow at this rate.

19. **Notwithstanding this apparent resilience, the concentration of remaining bank credit in government paper is an increasing source of concern.** Some 45 percent of banks' interest income and 41 percent of total banks' income is derived from government paper yields. Nine of the largest 10 banks (representing 55 percent of the sector's assets) have between 30 and 50 percent of their assets tied up in treasury bill holdings and, as of end-June 2001, commercial banks collectively held about LL 22.1 trillion (32 percent of the

sector's assets) in government paper.[11] Beyond the crowding out implications for the private sector,[12] the exposure makes banks extremely vulnerable to changes in the government's debt management strategy, particularly as it relates to issues of maturity and interest rate.

20. **Banks are potentially highly vulnerable to interest risk.** A 300 basis point increase in the average interest rate would render one bank insolvent and seven undercapitalized, and these banks hold about 36 percent of the sector's assets.[13] The large repricing mismatch between bank assets on the one hand, (mostly held in LL treasury bills and government eurobonds, with average maturity of 11 months and 50 months respectively), and deposits on the other (with average maturity of 71 days), translates into significant potential vulnerability of banks to changes in interest rates.[14] This vulnerability has increased compared to two years ago, not only because banks' holdings of government paper increased by more than 28 percent over the two-year period, but also because **these holdings are increasingly tied up in foreign currency denominated paper with very long maturities.**[15] A few banks are trying to address this issue by looking into attracting longer-term deposits, mainly from international sources. It will be increasingly challenging for banks to moderate their potential exposure to interest risk, however, as long as the share of their government paper assets remains large, particularly so because of the government's avowed intention of lengthening the maturity of public debt.[16]

21. **The repricing mismatch above has policy implications.** The portfolio vulnerability effectively constrains the use of interest rates as a policy tool to stemming dollarization or to defend the peg. The central bank has so far maintained a cap on interest rates, despite the declining appetite of banks for LL government paper recently, in an attempt to alleviate fiscal

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[11] Although the authorities have introduced a risk weight on bank holdings of government eurobonds, domestic currency treasury bill holdings are still treated as a risk less asset.

[12] Commercial banks' claims on the government are only slightly lower than claims on the private sector, which also stood at about 32 percent of the sector's assets at end-June 2001.

[13] Three of these banks are, however, branches of foreign banks, and intervention by the parent institutions is likely to moderate the impact of interest rate shocks should these materialize.

[14] There is no repricing mismatch between loans and deposits as most loans are in the form of overdrafts and technically these interest rates can be adjusted on a continuous basis.

[15] The share of eurobond holdings in total holdings of government paper by banks increased from 17 percent to 25 percent between end-1998 and end-2000.

[16] While duration mismatches are often closed by deposit rollovers in stable markets, the gap in Lebanon is of importance given existing market uncertainties and the nature of bank funding.

pressures due to the large interest bill on government debt. However, should exchange pressures intensify further, the central bank will be greatly constrained in its interest response by the presence of this substantial interest risk faced by banks.

22. **Banks' direct exposure to foreign exchange risk is contained**. A 50 percent devaluation would not significantly change the capitalization of the 15 largest banks, and this holds in the case of a 100 percent devaluation as well (results not shown). Indeed the BdL still maintains strict standards on the foreign currency exposure of banks,[17] and the 15 largest banks are generally in compliance with these regulations, apart from two banks, one of which has a trading position largely short in foreign currency. **Banks could however be exposed to risk resulting from foreign currency exposure of bank clients translating into credit risk**. The mission was not able to obtain data on the exposure of borrowers to foreign exchange risk. Discussions with the authorities and business community representatives suggested that such exposure was relatively insignificant in the corporate sector as transactions largely take place in foreign exchange and both receivables and payables are denominated in foreign currency. Notwithstanding, individual borrowers (accounting for 11.8 percent of loans at end 2000) may not be as well insulated since their main source of income—wages—is largely in Lebanese pounds, in particular for the case of public sector employees. Moreover, there is evidence that some sectors, such as construction and trading and services—and the latter two could coincide with likely reliance on LL—are already under stress.[18]

23. **Finally, banks are technically liquid in both Lebanese pounds and foreign currency and based on liquid asset holdings, 12 out of 15 banks are able to sustain more than a 50 percent run on their deposits.** However, while foreign currency liquidity is largely held in cash and deposits with banks abroad or with the BdL,[19] LL liquidity may be harder to realize in periods of crunch as it is almost entirely held in the form of treasury bills. Here, given the market structure and thin secondary trading in Lebanon (see Section C) the large liquid asset holdings may overstate the ability to realize funds under stress.

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[17] These are mainly a 1 percent limit on the foreign currency trading position (reduced from 5 percent in mid-March 2001), a 60 percent structural position—allowing this proportion of capital to be held in foreign currency--, and a 25 percent liquidity requirement on foreign currency liabilities.

[18] Partial data on large borrowers in the five major banks, suggest that foreign currency exposure in the corporate sector is limited and loans are collateralized, albeit by personal guarantees. NPLs however are largest for the Construction, Manufacturing and Trade sectors. The next largest group of bad loans is amongst Individuals and the Agricultural sector.

[19] In addition, banks are significantly increasing their holdings of eurobonds issued by the Lebanese government, but these are not included in our definition of liquid assets.

C. Systemic Liquidity Update

24. **Arrangements for systemic liquidity in Lebanon continue to be shaped by extraordinary levels of intermediation, dollarization, and the complexities of managing a nominal exchange rate anchor in the context of a large sustained fiscal imbalance.** The financial system intermediates M3 exceeding 200 percent of GDP, of which dollar denominated deposits accounted for 66 percent of M3 in June 2001. The foreign exchange and liquidity risks arising from the scale, possible reversibility and composition of this funding and the mismatch between the average maturities of assets and liabilities, pose significant risk management challenges. Absent deep markets and hedging arrangements, banks manage the potential risks through significant holdings (approximately 45 percent) of liquid assets more or less equally distributed across LL (LL denominated Government of Lebanon treasury bills and excess reserves) and U.S. dollar (FC interest bearing deposits at the BdL, U.S. treasury bills and correspondent account balances with nonresident banks) currencies.[20]

25. **The intermediation framework is also complicated by the policy of moderating interest costs to the budget.** In this context, the BdL, while having indirect monetary instruments at its disposal, focuses more on foreign reserve accumulation and market intervention when needed, as the means of retaining credibility in the peg. The interest rate structure, despite weekly auctions of treasury bills, largely reflects a positive spread between LL and U.S. dollar rates along the yield curve. The resulting operating environment in Lebanon therefore continues to be characterized by relatively high liquidity, low levels of position trading (measured by turnover ratios) reflecting counterparts being on the same side of the market and concentration in the holdings of treasury bills by banks (Table 6).

26. **As these fundamentals affecting market conditions have not changed since reported in the 1999 FSSA report, it is not surprising that there has been limited progress in implementing the reforms proposed in that report** (Appendix I). In this regard however it should be noted that the BdL now has a more reasonable design of its discount window—though nonresident holdings of treasury bills remain ineligible for discount at the BdL—and there appears to be improved coordination between the Ministry of Finance (MOF) and the BdL in issues affecting treasury bills placements. Moreover, the MOF has reported that a comprehensive debt management strategy is being developed for submission to the Council of Ministers.

27. **While resolving the overwhelming impact of the fiscal imbalance on systemic liquidity is the number one priority, the 1999 suggestions to improve the capacity for market resilience even as the fundamentals are addressed remain, and perhaps are even**

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[20] This portfolio continues to be reinforced by extensive prudential regulations requiring observance of a foreign currency liquidity requirement (reduced from 30 to 25 percent).

Table 6. Systemic Liquidity Indicators
(In millions of LL and in percent)

	1998	2000
Market Activity		
I. Government securities markets		
a. Treasury bills outstanding	21, 109.30	25,731.40
b. Trading Volume	15, 902.40	14,742.60
c. Turnover ratio (b/a)	0 .75	0.57
II. Interbank Market		
a. Deposit Liabilities	46, 629.00	57, 334.00
b. Trading Volume	67, 819.00	66, 065.00
c. Turnover ratio (b/a)	1.45	1.15
Market Concentration and effective trading stock of treasury bills		
Total bills outstanding (a+b)	21,109.3	25,731.4
a. *Potential active trading market*	19, 328.5 (100.0)	21,457.7 (100.0)
--Commercial banks	15, 841.8 (81.9)	17,588.8 (81.9)
--Financial institutions	66.3 (0.5)	34.9 (0.3)
-- Public Account	3, 420.4 (17.6)	3,834.0 (17.8)
b. *Inactive trading market*	1,780.8 (100.0)	4,273.7 (100.0)
--Public Sector	1,766.4 (99.2)	2,647.9 (61.9)
--BdL	14.4 (0.8)	1625.8 (38.1)
Average Excess Reserves[21]		
--interest bearing (deposits)	5,326.4	4,673.0
--non-interest bearing (above RR)	205.0	85.0
--percent of reservable liabilities	32.0	25.6

[21] Calculated as the average of quarterly balances.

more relevant in the current context of deteriorated market sentiment and macroeconomic conditions. Amongst the most important of these are:

- The need for the BdL to be able to extract true signals of changes in market sentiment. In this regard, a manipulation-free primary market for treasury bills, can yield important information on the direction and distribution of price and shifts in maturity preferences. Information from secondary markets can be enhanced by reducing the frequency of what are now weekly auctions. Above market interest rates paid by the BdL on its standing foreign currency deposit facility, not only result in losses on the operation by the BdL, but also obscures true clearing rates needed to accumulate reserves. Finally, the BdL's use of exemptions to reserve requirements to support various activities also obscures market signals. Beyond their role in market development, these price and maturity data would be critical to supplement the analysis of market pressures and the sustainability of the current monetary/fiscal policy mix.

- Reducing market concentration in the treasury bill market by opening bids to non-bank bidders, and possibly setting allocation limits to contain concentration, would increase the availability of prospective counter parties in the event of stress and of the need to realize liquidity.

- Introducing automatic liquidity stabilizers through allowing averaging of the foreign currency liquidity requirement and LL reserve requirements would enable the system to manage liquidity shocks without BdL intervention.

- Taking steps to moderate the existing repricing exposure of banks. Beyond possible prudential limits, perhaps more important is for debt managers to recognize this exposure as a potential issue. One option could be to introduce floating rate instruments with inherent shorter repricing possibilities, to better cover the duration gap.

III. Developments in Supervision and Regulation

Bank supervision and regulatory arrangements—including updated BCP conclusions

28. The BCC works in accordance with the Code of Money and Credit (CMC). Secondary legislation however, has been dramatically extended and modified since the 1999 assessment. The BdL and BCC have dramatically accelerated the pace and depth of their efforts in improving prudential supervision. In response to weaknesses identified in compliance with the Basel Core Principles (CPs) for Effective Banking Supervision noted in 1999, an action plan was adopted by the Commission that was newly appointed in

February 2000. The BdL, BCC, and its staff are to be highly commended for the impressive results that have been attained to date. Best practices and standards developed by the Basel Committee on Banking Supervision as well as documents developed by banking supervisors of other countries have been put to good use. This, in a context of a deterioration in the macroeconomic environment for intermediation and with adverse listings by international standard setters, is a welcome development. Notwithstanding, in a number of cases the CMC will have to be amended to provide a more optimal regime for safe and sound banking and to achieve full compliance with the Basel Core Principles.

29. As noted throughout the assessment below, successful implementation of the new rules, regulations and supervisory tools will be a gradual process depending, among other things, on the resources of the BCC. A brief summary of compliance with the preconditions for effective banking supervision and the core principles is provided below.

30. **Objectives, autonomy, powers and resources, CP 1.** Lebanon is compliant or partially compliant with five out of the six component parts of CP1. Important improvements have been realized on CP 1.1 and CP 1.2 and some progress is also to be noted as to CP 1.4 (money laundering and KYC rules). The exception (CP 1.5) is due to the absence of legal protection for supervisors. BCC's insistence on changing the law in order to comply with this CP has been unsuccessful until now. Taken collectively, the CMC and the BdL and BCC secondary legislation and regulation constitute an appropriate legal framework. While compliant, practical application and development of the framework will be a learning process and staff capacity should be kept under constant review.

31. **Licensing and structure, CPS 2-5.** The 1999 assessment has generated an intensive process of providing for additional secondary legislation in this field. As a result, Lebanon is now compliant with the four CPs.

32. **Prudential regulations and requirements, CP's 6-15.** Lebanon is compliant with two out of ten CPs and partially compliant with eight. Since the previous assessment, Lebanon has improved his status on CP 6, 14 and 15. The capital adequacy ratio (CP 6) has been dramatically raised from 8 percent to 12 percent. This can be seen as an alternative measure for the absence to date of specific capital requirement for interest rate risk. This requirement or a system of quantitative restrictions on the exposure of Lebanese banks to this risk is currently under examination and will be introduced by the end of the year. Progress has also been realized by making internal control units mandatory in banks and by addressing issues of corporate governance in banks (CP 14). Additional recommendations, best practices and guidelines are being prepared for implementation by April 2001. With respect to money laundering (CP 15) the upgrade of the 1999 assessment to a partially compliant status is based on BdL making the Due Diligence Convention (DDC) of the Lebanese Bankers Association mandatory and imposing strict "Know-Your-Customer" rules. This approach

was completed by requiring the external auditors to verify the banks' compliance with the DDC and address detailed reports on the subject to the BdL and the BCC.[22]

33. The BCC has tasked itself with a comprehensive action plan addressing each and every deficiency that has been noted in the previous assessment. Several working groups have been set up and intensive staff training has been organized in order to reach the necessary critical mass that will allow bank examiners to act professionally in particular areas. Progress has been made in the consolidation of current procedures and requirements regarding the examination of loan and investment portfolios of banks and results are awaited by April 2001 (CP 7). The loan classification issue (CP 8)is being revisited and results are planned for December 2001. New guidelines on management information systems are also prepared.

34. **Methods on ongoing supervision, CP 16-20.** The 1999 assessment, while recognizing the efforts that had been realized to improve the efficiency of the supervisory process, pointed to the need to address remaining deficiencies in a more consistent and coherent way. The internal organization, workflow schemes and business lines had to be adapted to a number of changes in the operational implementation of the off-site and on-site supervisory activities. The BCC, in acknowledging these comments, set up a thorough revision of its working processes. Quality management initiatives were taken and staff members were associated closely in the review process by setting up several specialized committees. The BCC is to be commended with this management change. There is no doubt that Lebanon will be fully compliant with CP 16 on completion of the ongoing work. Lebanon has gained full compliance status on CP 17 due to the improved contacts between supervisors and the intensive training efforts of staff members. External auditors have been required to increase their collaboration with the BCC in verifying the compliance of banks with the DDC (CP 19).

35. **Corrective action, CP 22, and cooperation with foreign supervisors, CP 24.** A formalized system of graduated corrective measures has not yet been developed. However, the proactive stance of the newly appointed BCC members constitutes a major improvement (CP 22). As to cooperation with foreign supervisors, the authorities do not oppose the exchange of information and are actively engaged in contacts with different foreign supervisors. This policy is being intensified and discussions on the conclusion of a MOU with France currently receive the highest priority. Communication of information covered by the bank secrecy obligation to another supervisor, is however still impossible, except as provided for under the new Anti-Money Laundering Law. Given the classical reciprocity principle that underlies MOU's this restriction could prevent host country in entering such agreements (CP 24).

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[22] This framework has been substantially enhanced with the passage of the Anti-Money Laundering Law in May 2001.

36. **Lebanon is compliant on the remaining CPs (Accounting—CP 21, Global supervision—CP 23, Foreign banks' branches—CP 25).** Table 7 provides the 1999 and 2001 assessments results – (+ = 2001 assessment).

IV. Issues of Offshore Centers and Money Laundering—The Views and Assessments of the Financial Stability Forum and the Financial Action Task Force

37. **In May 2000, the Financial Stability Forum (FSF) released its grouping of offshore financial centers that considered the opinions of onshore supervisors in 27 countries.** The FSF listed Lebanon along with 26 others in Group III, the worst of three groups.[23] Countries in Group III are designated by the FSF as "*generally seen as having low quality of supervision and/or being non-cooperative with onshore supervisors, and with little or no attempt being made to adhere to international standards.*"

38. **The authorities viewed the characterization as unfortunate and argued that, had there been proper due diligence, it would have been discovered that Lebanon has never registered an offshore financial institution,** despite the existence of legislation (Legislative Decree 46 of June 24, 1983) that enabled the establishment of such institutions. To correct the possibility of future misclassification as an offshore center, the authorities repealed paragraph 4 of Decree 46 (Law on Offshore Centers) as published in Official Gazette # 1 (January 2, 2000).

39. **Beyond issues of classification, Section III updates the assessment of Lebanon's compliance with the Basel Core Principles for Effective Banking Supervision.** Of particular importance is the assessment of those Core Principles relating to issues affecting the framework and procedures to prevent the misuse of the financial system for money laundering and intermediating the proceeds of crime. In the 1999 assessment of core principles Lebanon had been adjudged to have been noncompliant; in particular, the FSSA report had noted that "*Given the rise in money laundering operations, international attitudes to bank secrecy have changed in recent years. Changes in the law should be considered, or Lebanon might run the risk of being outside the mainstream and shunned by other members of the international banking community.*"

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[23] The other two groups are: Group I—jurisdictions generally viewed as cooperative, with a high quality of supervision, which largely adhere to international standards, and Group II—jurisdictions generally seen as having procedures for supervision and cooperation in place, but where actual performance falls below international standards, and there is substantial room for improvement.

Table 7. Lebanon: Compliance with Basel Core Principles

CP	SUBJECT	FULL	PARTIAL	NON	2001 COMMENT
1.1	Clear supervisory responsibilities	+	←X		Recent BdL-BCC Protocol on synergy
1.2	Independence and resources	+	←X		Recent BdL-BCC Protocol on Budget.
1.3	Legal framework		X		To be completed on a number of points.
1.4	Supervisory powers		X		Depositors and fiduciary accounts.
1.5	Legal protection			X	Absent.
1.6	Information sharing		+	←X	MoUs to be written.
2	Permissible activities	+	←X		
3	Licensing of banks	+	←X		
4	Transfer of ownership	X			
5	Acquisitions and investments	+	←X		
6	Capital requirements	+	←X		
7	Loan policies	+	←X		
8	Loan classification		X		Recommendations for provisioning.
9	Management information or risk concentration		X		EDP-audit to be launched.
10	Connected lending	X			
11	Country risks		X		Guidelines.
12	Market risks		X		Interest rate risk.
13	Other material risks		X		Increase control of global risk management.
14	Internal controls		+	←X	Additional guidelines to be issued.
15	Money laundering		+	←X	Creditor identity not accessible.
16	On-site/off-site supervision	+	←X		
17	Understanding banks operations	+	←X		
18	Prudential reporting		X		Increasing distribution in the BCC and coordination with the BdL.
19	Independent examination of prudential information	X			
20	Consolidated supervision	X			
21	Accounting and disclosure	X			
22	Corrective action		X		Need for graduated corrective measures.
23	Global supervision	X			
24	Cooperation with foreign supervisors		X		Need for formal rules and MoUs.
25	Foreign banks' branches	X			
	TOTAL: 30 of which for (2001)	**(16) 7**	**(13) 19**	**(1) 4**	

Note : The comments above refer only selectively to important issues for improvement.

+ : a 2001 assessment that differs from 1999.
←X : a 1999 assessment that is upgraded in 2001.
X : a 1999 assessment that remained unchanged in 2001.

40. **Despite Lebanon making its Due Diligence Convention to Prevent Money Laundering Operations mandatory in April 2000, the report of the Financial Action Task Force on NonCooperating Countries and Territories for Lebanon of June 2000 found Lebanon to be noncompliant with 15 of its 25 principles.** Broadly, these deficiencies emanated from a sense of excessive secrecy, with particular concerns noted in the areas of inadequate procedures for licensing, customer and beneficial owner identification, reporting suspicious transactions, international cooperation on information exchange, and the absence of a formal institutional mechanism to execute anti-money laundering efforts.

41. **The Law on *Fighting Money Laundering Offences* has now been passed by the Parliament and envisages inter alia.**

- A comprehensive definition of money laundering and the criminalization of such, including any asset that proceeds from the growing, manufacturing or trading in narcotics; associations of wrongdoers and identified as organized crime; engaging in illegal trade of arms; terrorist acts; stealing or embezzlement of public or private funds; and counterfeiting money or official documents.

- The establishment of a financial intelligence unit called the Special Investigation Commission (SIC), that is formally empowered to lift bank secrecy in cases where it finds money laundering, thus allowing investigation, prosecution and international cooperation on suspected money laundering activities, notwithstanding the 1956 Secrecy Law.

- Suspicious Activity reporting to the Commission emanating from External Auditors, BCC bank examiners and from banks themselves.

- Know-your-customer procedures that are to be verified by examiners and auditors.

42. Largely in recognition of this progress in passing legislation and the subsequent issuance of implementing regulations, the FATF in its June 2001 meetings recognized Lebanon's efforts though requiring sustained implementation before there would be consideration of de-listing.

FSSA REFORM—SHORT-TERM AGENDA (AUGUST 1999)
OBJECTIVE-TO IMPROVE THE CAPACITY OF THE FINANCIAL SYSTEM TO ABSORB LIQUIDITY SHOCKS AND THE SUPERVISORY CAPACITY TO MONITOR AND REGULATE CREDIT AND INTEREST RATE RISKS

Proposed Reforms	Action Taken
Improve Systemic liquidity Infrastructure:	
• Remove the nonprice restrictions on BdL discount facility. These include the restriction that bills can only be discounted after being in circulation for three months; and that discounting arrangements at the central bank are restricted to household and nonresident clients.	BdL facility has been modified. Bills can now be discounted after 30 days; banks have access to above market repo rates at anytime; nonresidents holdings of treasury bills cannot be discounted at the BdL but can be sold on the secondary market.
• Revise the existing procedures for setting the BdL discount rate. The discount rate should be above market, but if too high, becomes irrelevant to market participants. In revising the rate structure, the BdL could test the market by reducing the discount rate gradually—with the level of the rate being determined by the volume of encashments.	Discount rate now set as 300 basis points above BdL repo rate.
• Strengthen the approach to the market and debt management. As initial step, a joint-BdL/MOF high-level policy committee supported by more frequent meetings at technical level could be established. This committee would ensure consistency between BdL liquidity and MOF cash flow forecasts.	There is no formal joint committee. However, the Director General of the MOF attends the BdL's Open Market Committee meetings that convene monthly.
• Improve the primary market auctions for treasury bills. This can be achieved through adherence to volume announcements in allocations at the auction; establishing a bidding and allocation limit to prevent concentration; transparently disclose information on auction results—including information on high, low, average and total subscription of bids vis-à-vis volume offered.	Auction results indicating volume offered and subscription by maturity are now published by the MOF. Adherence to volume announcements however is inconsistent, and there has been no action to address concentration.
• The proposed Joint Policy Committee should develop an overall debt management strategy for Lebanon. The strategy would deal with issues of domestic/foreign currency mix and maturity profile of debt stock; as well as infrastructure design issues, in particular, the role of a primary dealer framework and consolidation of depository and settlement systems.	The MOF indicated that a debt management strategy has been developed and will be submitted to the Council of Ministers for approval. The modalities were not shared with the mission.
Design of monetary instruments:	
• The BdL should provide markets with information on the supply and availability of liquidity in the system to reduce market uncertainty.	No new action taken.
• Introduce automatic liquidity stabilizers. The BdL should allow reserve averaging on LL requirement, initially on a partial basis—estimate is that averaging, provided reserve holdings do not fall below 75 percent, could be initially adequate; and require that liquid asset ratio on foreign currency deposits be met on an average basis.	No new action taken.
• Revise BdL instruments through: (a) liquid asset ratio uniformly pricing the BdL LL deposit facility at below market interest rates; (b) averaging of liquid asset ratio (LAR) on foreign currency deposits, and pricing the U.S. dollar deposit facility at below market; and (c) introduce overnight repo maturity to enable provision of overnight funding in support of payment system.	No new action taken.

• Define modalities for collateralized emergency credit facility. This action would be on a contingency basis in the event of stresses requiring BdL action.	"Emergency" credit is only provided through existing repo arrangements.
Supervisory framework:	
• Supplement the BdL decision of March 1998 on market risks, through subjecting interest rate risks to quantitative restrictions or capital charge. Concurrently, supervisors should also monitor the way in which banks manage these risks, including effective board and senior management oversight, internal controls and risk measurement and monitoring procedures.	The BCC has addressed this issue through an overall increase in capital requirements from 8 to 12 percent to be achieved by 2001, with an interim benchmark of 10 percent by end 2000. Consideration is also being given to applying specific risk charges in the future.
• Improve credit risk evaluation, through the BCC requiring written policies, endorsed by the banks' board for credit evaluation, and internal controls to support these. Compliance with these requirements should be checked during on-site inspection. Moreover, training is needed for BCC supervisors to enable them to have full and updated knowledge of market developments, concerning both individual markets and business, as well as, the macroeconomic environment of banks' operations.	The BCC has invested in a range of targeted training courses for staff and continues a loan-by-loan evaluation system during on-site inspection.
• Bring existing regulations on country and transfer risks in line with international best practice. This involves strengthening the BdL decision of March 1998 to include the requirement that exposures should be reported by banks.	Addressed through increased capital charges and also through specific limitations. Banks can only invest in OECD assets, and non-OECD investments carry a 100 percent risk weight.
Payment system:	
• BdL should require a pool of collateral to ensure settlement. This would remove the need for the BdL having to unwind payments or intervene with liquidity, when one or more banks cannot meet their net debit settlement obligations.	MAE mission scheduled.

FSSA REFORM—MEDIUM-TERM
OBJECTIVE: TO STRENGTHEN FRAMEWORK AND ESTABLISH THE BASIS FOR OVERALL RESILIENCE AND THE CAPABILITIES FOR RISK DIVERSIFICATION OF NONFINANCIAL SECTORS IN THE ECONOMY

Supervisory framework:	
• Improve the effectiveness of graduated corrective action framework. This could be achieved by clarifying the roles and responsibilities of the BCC within tripartite management structure aimed at providing the BCC with greater enforcement powers.	A new protocol governing and clarifying roles and responsibilities; independence and decision-making processes have been established between the HBC, BdL and the BCC.
• Conduct comprehensive audit of work methods to improve workflow schemes and business lines in the operational implementation of on- and off-site supervisory activities within the BCC. In addition, streamline the lines of communication between the BCC, BdL and HBC.	There has been a substantial overhaul of internal workflow practices which greatly improves supervision effectiveness. In addition, protocol on relations within the tripartite structure has been adopted.
• Modify the Secrecy Law to improve overall effectiveness of bank supervision. The particular focus should be to increase the BCC capacity for supervision of suspected criminal transactions, by allowing BCC supervisors access to information on banks' creditors and fiduciary agents.	Legislation on ML has been passed by Parliament and envisages bringing supervisors within the ambit of the Secrecy law in instances of suspicious activity. Moreover, external auditors are now required to check compliance and report breaches of the law.
• Formalize information exchange between the BCC and counterpart supervisors in relevant countries.	Ongoing work to establish MOUs with external supervisors and exchange of information is also envisaged under the ML legislation.
Nonbanking Sector: Insurance industry:	
• Facilitate the consolidation of the industry; the Ministry of Economy should articulate a restructuring plan for the insurance industry. This plan would include elements related to canceling the license of insolvent companies; memoranda of understanding with companies having positive net worth but not in full regulatory compliance; limiting the overdue period for admission of receivables as assets; and restricting entry to the sector of only highly reputable companies during the restructuring period.	(i) A restructuring program, involving revocation of licenses where there have been breaches of laws; voluntary liquidations; and mergers is being implemented—18 companies have been affected in 1999-2000. (ii) At least 4 reputable internationally active insurers and reinsurers have been licensed as joint ventures. (iii) Program to reduce receivables launched and in most cases has resulted in either capital injections or closures.
• Revise proposed amendments to the Insurance Bill especially as it relates to minimum capital requirements, solvency margins, and exit provisions.	Under the new Insurance Law passed in June 1999, capital requirements have been increased to $US1.5 million to be met by June 2001. Already all but 18 companies have complied.

• The Ministry of Economy should retain reputable auditing, actuarial firms to assist in on, and off-site supervision. Retaining these firms should be on a continuous basis to support the Insurance Control Commission in undertaking on- and off-site supervision of the insurance industry and in requiring the highest standards of disclosure.	No action—the ICC continues to rely on in-house staff. Despite commendable efforts, the ICC remains understaffed and requires resources to ensure regular on-site program for all companies. To maximize effectiveness with limited resources the ICC targets a watch list.
• Strengthen the supervisory capacities of the ICC. The ICC should consider enlisting the help of the BCC in the short-term and adopt the loan classification and provisioning standard now applied by the BCC to banks.	Loan classification and provisioning standards have been developed by the ICC.
Payment system:	
• Develop and implement same day exchange, clearing and settlement of checks in preparation for proposed Real Time Gross Settlement System.	MAE mission scheduled.
Tax treatment of financial instruments:	
• Review taxation regime as it relates to (a) the tax treatment of interest to remove current discrimination between different debt instruments; and (b) the stamp tax on bank loans, while corporate bonds are exempted.	No action taken.
Capital markets:	
• Review current draft law to establish a regulatory structure for capital markets in light of current market conditions. The objective should be to ensure that the law serves the needs of the investment community and takes into account the principles outlined in the Objectives and Principles of Securities Regulation issued by the International Organization of Securities Commissions (IOSCO) 1998.	Draft Law and implementing regulations prepared and approved by the Council of Ministers of the previous government. The package will be resubmitted for approval by the current Council of Ministers prior to submission to Parliament.
• Initiate work to improve the trading system of Beirut Stock Exchange, including: (a) measures to improve liquidity and arbitrage possibilities between the domestic share market and the GDR market; and (b) modify existing price fixing arrangements into a continuous quotation/order driven system. In addition, a full review of existing regulations is needed to eliminate actions that can detract from overall market integrity—such as market manipulation.	The Amendment to Article 84 of the By Laws of the BSE of September 25, 2001, enables the BSE to price securities through a continuous matching of demand and supply (CTS) on a platform of an Electronic Trading System. Chapter 7 of the amended article outlines the modalities, responsibilities and oversight to govern the CTS.