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EXECUTIVE BOARD MEETING

SM/23/109
Correction 1

May 23, 2023

To: Members of the Executive Board

From: The Secretary

Subject: **Libya—Selected Issues**

Board Action:	The attached corrections to SM/23/109 (5/5/23) have been provided by the staff
Evident Ambiguity	**Pages 3 (para. 3) and 9**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 1, 3 (para. 2), 10**
Typographical Errors	**Pages 2 and 8**
Questions:	Mr. Gershenson, MCD (ext. 39618) Mr. Matheson, MCD (ext. 34094) Mr. Ghawi, MCD, (MGhawi@imf.org)

INTERNATIONAL MONETARY FUND

LIBYA

SELECTED ISSUES

May 5, 2023

Approved By
Subir Lall (MCD)

Prepared by Shafiq Ghawi with assistance from Vaishnavi Rupavatharam ~~, reviewed by Dmitry Gershenson and Troy Matheson (All~~ (Both MCD)

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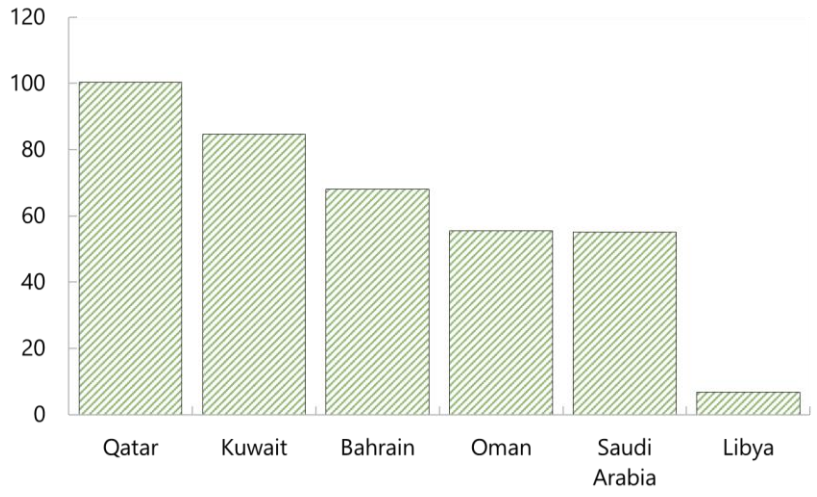
BANKING SECTOR REFORM: A ROADMAP

This paper provides an overview of the challenges facing the banking sector in Libya and puts forward reforms to strengthen financial stability and accelerate credit growth. Priority reforms are identified using the 2012 sound principles for effective supervision, issued by the Basel Committee for Banking Supervision (BCBS), while also considering limitations imposed by the country's fragility and conflict situation. The chapter recommends that the authorities (i) follow a gradual and consultative approach to regulatory reforms and (ii) support the development of human capital and systems at the commercial banks and at the Central Bank of Libya.

A. Banking Sector Challenges

1. The banking sector is rudimentary. Decades of socialist policies during the ~~Gadhafi~~ Ghaddafi era, followed by civil war and political infighting stifled financial sector development, impaired credit intermediation, and contributed to low private sector participation in the economy. A short period of modernization took place between 2005 and 2010, when foreign banks were allowed to acquire ownership stakes in local banks as strategic partners. Today, Libya has 20 banks with total assets of around LYD 143 billion. Loans and credit facilities are less than 15 percent of total banking sector assets, the majority—around 60 percent—are balances at the Central Bank of Libya (CBL). Credit to GDP continues to be low at 12 percent in 2022.

Private Sector Credit, 2022
(Percent of GDP)

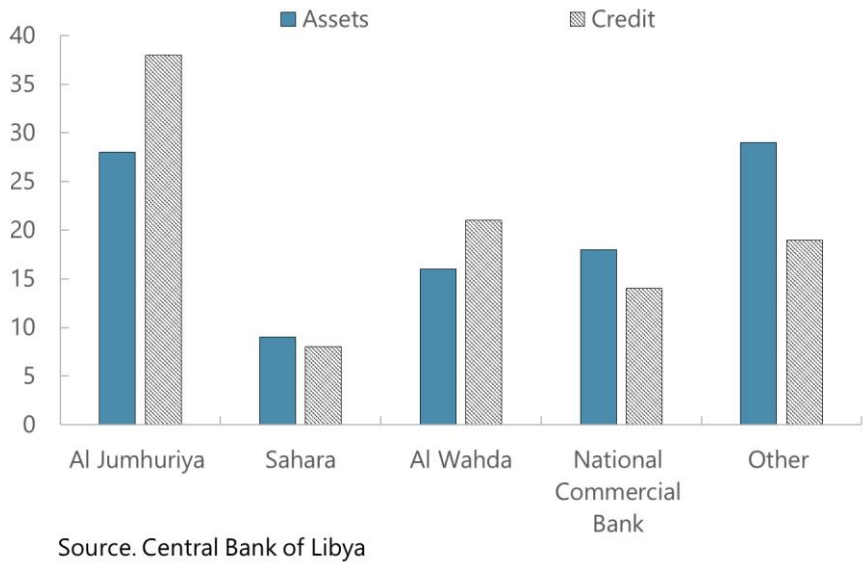


Sources: National Authorities.

2. The CBL's ownership of banks limits competition and undermines governance. The CBL owns two of ~~six banks, including~~ the largest four ~~largest~~ banks, all public: Al Jumhuriya, National Commercial Bank, Al Wahda, and Sahara. Together these banks make up approximately 70 percent of banking sector assets and 80 percent of total credit. Banking supervision is part of the CBL's mandate, and its ownership of commercial banks creates a conflict of interest between its shareholder's profit maximization drive and its regulatory role. In addition, the public sector mindset at banks stifles innovation and contributes to inefficiencies.

Concentration in the Banking Sector

Percent of total



Source. Central Bank of Libya

3. Banks are struggling to develop Islamic finance products. Interest payments haves ~~s~~ been outlawed since 2013 and conventional banks are still struggling to fully convert to an Islamic system and develop Islamic finance products, which is hampering credit growth. To compensate for the loss of interest income, banks have turned to fee income, including on foreign currency transactions; this is one reason why the parallel foreign exchange market continues to exist after the 2021 currency devaluation.

4. The CBL has an ambitious agenda to introduce international standards and best practices to the banking sector. The BCBS sets global capital adequacy standards that determine

of credit, capital, and liquidity.[5] However, further work is needed to ensure proper implementation by banks, strengthening CBL supervision, and developing a macroprudential framework.

13. The CBL should continue to ease CFMs/MPMs as conditions permit. The IMF adopted an institutional view on the use of CFMs in 2012 and recommended their use in a limited manner to address macroeconomic challenges and financial risks. As foreign exchange reserves increase and the political and the security situation improves, the CBL should continue to gradually relax CFM/MPM measures to eventually eliminate the parallel market and support credit growth.

14. In the medium term, crisis management, recovery, and resolution regimes should be developed. These frameworks can serve as a contingency plan to allow the CBL more time to act to limit spillovers from bank failures to the financial system. They will also reduce moral hazard and ensure public funds are not used in bailouts. CBL ownership of the major banks reduces the urgency for the development of these frameworks in the short term. However, they remain essential for private-sector-led development and a well-functioning financial system over the medium term.

15. Legal and administrative procedures need to be developed. To intermediate credit and efficiently allocate resources in the economy, banks rely on an ecosystem that includes accountants, auditors, credit and title deed registries, and tax records. This ecosystem is not well developed in Libya. The accounting and audit profession in Libya faces challenges in accessing information and verifying data, which limits the quality of financial statements and reduces their usability by banks and investors. Significant delays and, in some cases, the complete absence of public financial statements prevents investors from exercising market discipline.

- Tax administration is weak, and the degree of non-compliance is high. Widespread tax exemptions weaken compliance, and the use of manual processes to store information makes tax data less usable by banks.
- The credit registry is infrequently updated and not always used by banks to assess credit. The CBL latest circular 4/2023 reaffirms the process to update and use the information in the credit registry, but it has not yet been implemented. Further automation of the credit registry would improve data quality and usability.
- No collateral registries. Property records were largely destroyed during the Ghaddafi ~~Gadhafi~~ regime and proving ownership was further complicated by internal conflict after the fall of the regime. This rendered immovable assets largely useless as a source of collateral.

16. The rule of law should be strengthened. A legal system that protects ownership rights, enforces contractual obligations, and allows for the efficient realization of collateral is necessary to protect creditors' rights and give comfort to banks to expand credit to the private sector. Where the system is deficient, banks are exposed to higher credit losses. The legal system in Libya is inefficient,

[5] Key prudential ratios may include loan to value, debt service ratio, counter cyclical capital buffer, liquidity coverage and net stable funding.

court proceedings are lengthy, and enforcement is slow. Reforming the legal system and strengthening law enforcement is a cornerstone for banking sector reform, and economic reform more generally.

C. The Principles for Effective Banking Supervision

Applying the principles of effective banking supervision does not prevent bank failure but it significantly reduces the likelihood of bank distress by strengthening the stability of the financial system. It is understood that not all BCBS principles can be implemented in the short term given the political divide, the fragile security situation, and capacity constraints. Nevertheless, the principles serve as a roadmap to guide future reform efforts. In this chapter, the most relevant principles are grouped as they pertain to the banking law, corporate governance and transparency, prudential soundness and conduct requirements.

a) The CBL Governance and Legal Powers

17. The CBL's governance framework should be enhanced. The banking law outlines the CBL's governance structure. Due to the political conflict and the central bank split, it has been difficult to convene the CBL's board of directors, and some governance safeguards specified in the law have not been followed.[6] Reestablishing an effective board for the CBL would strengthen governance and increase public confidence in the financial system. When it is not possible to convene the board, decisions made outside the governance structure should be based on necessity, clearly identified, and disclosed in a transparent manner. Alternative arrangements for governance and oversight should also be introduced; for example, through the development of internal committees that make decisions in a consultative manner and provide scrutiny.

18. The scope of the regulatory parameter to cover innovative financial services (Fintech) should be expanded to support financial inclusion and protect consumers. The existing banking law covers traditional financial institutions like banks, finance companies, investment funds and exchange houses. More recent Fintech business models, such as payment services, crowdfunding, digital assets, and E-money are not explicitly covered. The law should be revised to address these gaps by regulating the financial service activity regardless of the provider. For example, activities such as deposit-taking, providing and arranging credit, issuing stored value, and money remittance should be regulated activities. This approach allows wider coverage of financial service providers, especially when services are offered by telecoms, social media firms, and Fintech startups leveraging technological advancements.

19. Applying a consultative approach before issuing new regulations would minimize unintended consequences and facilitate implementation. New banking laws should require the CBL to publicly consult with stakeholders (e.g., banks, finance companies, consumer groups, academia), before issuing regulations. This process would enable the CBL to better understand the potential impacts of new regulations, any transition periods needed, and implementation challenges.

[6] Since 2014, the CBL board of directors met only once in 2021, when it took the decision to devalue the LYD.

It would also indicate to the banks the regulatory direction, allowing them to prepare, and improving compliance. Currently, limited ~~no~~ consultation takes place.

20. Some requirements stated in the banking law are better covered in regulations. The banking law is unnecessarily prescriptive in some areas and many details captured in the law are better suited for regulations, where they can be easily modified and amended as practices evolve. For example, the fit and proper regime, criteria for auditors and collateral valuers, and who can petition the CBL to conduct an inspection are not common in banking laws. Similarly, many corporate governance articles that cover general assembly, shareholders' protection, and financial statements, may be better covered in listing rules or in the corporate law that apply to all companies.

b) Banks' Corporate Governance and Transparency

21. A fit and proper regime is needed to improve governance and compliance culture at the banks. The starting point for good governance is to build a culture of compliance and internal challenge by having qualified and capable individuals in positions of authority. A fit and proper regime that identifies key control functions at banks, sets out the minimum criteria for candidates, and outlines the CBL's approval and review process. This would improve governance and compliance and reduce corruption within the banking sector. The CBL regulation number 6/22 is a major step forward, but some refinements are needed. For example, candidates should be required to pass regulatory interviews, hold exit interviews with departing officers, and afforded protection from unfair dismissal when acting in good faith. The CBL should also have the power to sanction authorized individuals for misconduct, including imposing a ban on holding office at regulated financial institutions.

22. A fit and proper regime should also apply to banks' controllers. CBL approval should be required for legal or natural persons seeking to hold a controlling interest in a regulated financial institution. A prerequisite for public banks' divestment, a fit and proper controllers' regime is likely to ensure new owners promote good governance, hold management accountable and effectively monitor performance. It also ensures criminal groups do not control financial institutions and engage in money laundering activities.

23. The CBL should implement temporary measures to address its ownership of banks. Until such time when it is possible for the CBL to relinquish its ownership of banks, it should establish internal safeguards to limit conflicts of interest between ownership and supervision. One option is assessing a public bank's board from two separate perspectives—that of an investor, and that of a supervisor. In the former, the focus should be on maximizing return and shareholder wealth, and in the latter the focus should be on risk appetite and governance. Within the CBL, a strict internal separation between functions overseeing investments and banking supervision will be required. Safeguards may also include establishing and observing guidelines on appointing and dismissing banks' board members.

24. The governance structure of banks should be strengthened, including board oversight, decision-making, and accountability. At a minimum, every bank should have an executive committee comprising of the senior executives of the banks as well as committees for