QUESTIONS TO BE RAISED ON BDL'S POLICIES

August 2019

Rationale

Since the mid 1990s, Banque du Liban (BDL) has operated monetary policies aimed at maintaining the currency peg.

Over the years, monetary policy worldwide has shifted away from operating in opacity; keeping interventions secret, with aim of taking markets by shock to achieve desired outcomes. Today, modern monetary practices such as “forward guidance”, which refers to the central bank’s communication about the state of the economy and likely future course of monetary policy, aim to influence the financial decisions of actors in the economy.

These practices entail that the central bank should be held accountable for its actions. Accountability is reached by reporting to the legislative and executive branch of the government on its polices, actions, and their impact on the economy.

BDL, however, has been functioning in a level of deep opacity and has become a “black box” in the eyes of experts and officials alike. Quite alarmingly, little is known about the details of BDL’s policies thus raising numerous questions.

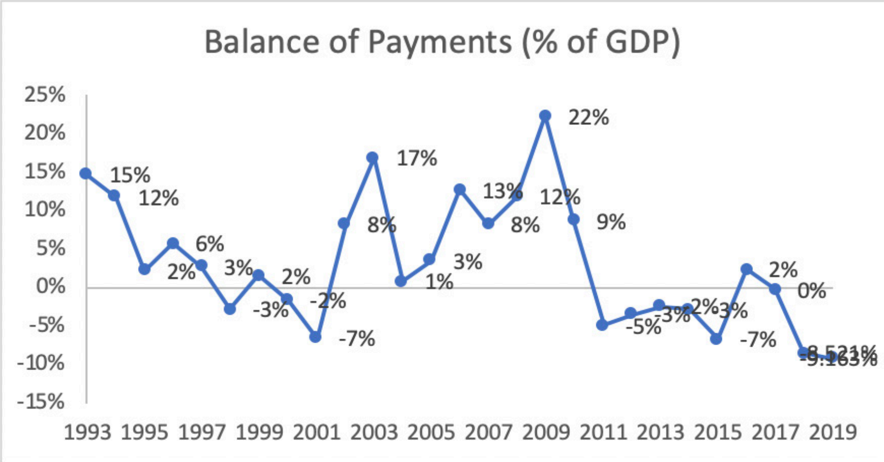
Regardless of the reasons BDL has had for its modus operandi, the time has come for a transparent exchange between it and public officials. This exchange and questioning will provide a solid basis to initiate the debate on the most suitable solutions to dampen the pending crisis.

Quick Brief on BDL’s Monetary Policies

The Lebanese economic model is dependent on foreign inflows to cover for its fiscal and trade deficits. When the foreign flows reverse, they are counteracted by dollar injections from BDL’s foreign currency reserves. These reserves are obtained from the central bank’s certificates of deposit and its deposits facility that banks subscribe to.

Since the early 1990s the balance of payments has been mostly positive with exceptions in the early 2000s when the deficit was filled by BDL pending funds from the Paris donor conference.

Figure 1: Yearly Balance of Payments as Percentage of GDP[1]

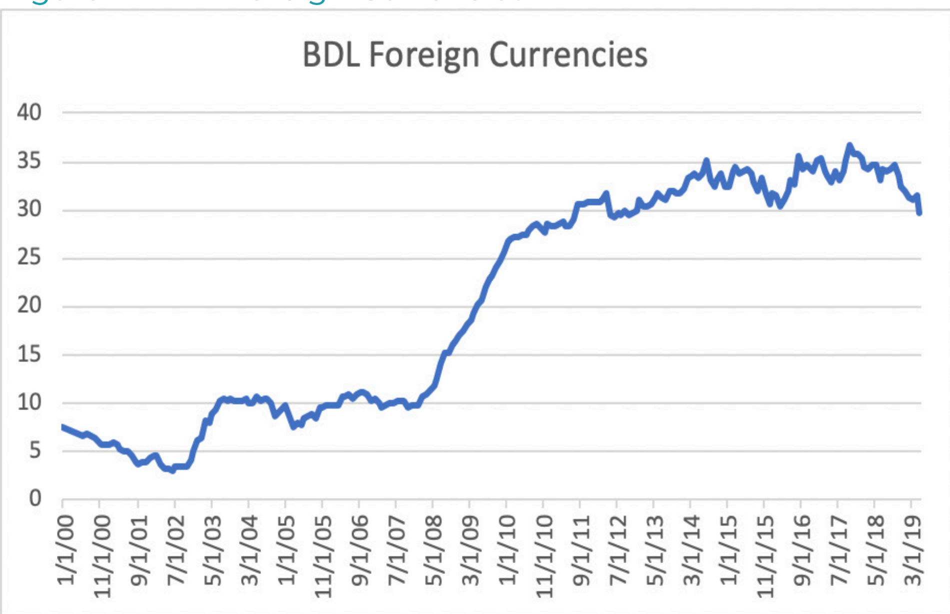


[1]Source: BDL

However, as of 2011, the balance of payments has been passing through an unprecedented deficit cycle in terms of length and continued deficit. It has reached 9.16% of GDP or USD 5.187Bn in outflows in the first five months of 2019; after recording a deficit of 8.52% of GDP in 2018.

Given this backdrop, BDL has had to directly fill this deficit in order to maintain the peg. Moreover, it has engaged in a series of unconventional monetary policies to artificially raise the interest rates in the economy in order to keep on attracting foreign currency deposits as investor confidence waned. These polices have drained liquidity from the market and diverted funding away from the government's deficit; as a result, BDL has also been continuously funding the government for the best part of two years, resulting in a transfer of the debt servicing cost from the government to BDL. Consequently, all these factors have led to a 16.61% YoY drop in BDL's foreign assets on 15/07/2019, or USD 7.37Bn, but little is known about its net reserves.

Figure 2: BDL Foreign Currencies[2]



[2]Source: BDL

Questions to be raised

ON BDL'S PROFITS AND LOSSES:

• The issue: BDL has not been publishing its profit and loss statement, thereby making it impossible to track the size of the gains/losses it derives from its activities. *Note that BDL's profits are mainly derived from open market operations and seigniorage (printing currency).*

• Its importance: Without this statement, the Government cannot verify that BDL's annual transfer to the Treasury complies with its bylaws that state an 80% sharing of profits with the sovereign. On their part, the Parliament cannot account for the level of debt servicing cost that is being transferred from the Treasury to BDL. *Note that BDL has been sharing steadily around USD 40Mn with the sovereign in the absence of this document.*

• Questions to be raised:

› BDL should be asked to share its audited balance sheets and profit & loss statements for at least the past five years. *Note that profit & loss statements for subsidized loans and operations with banks and financial institutions should be shared separately.*

› What is the size of sterilisation operations conducted by BDL and what is their cost?

ON THE 2016 BANK BAILOUT:

• The issue: In 2016 BDL performed its first known "Financial Engineering" operation. The operation came as a bailout to local commercial banks through providing them with above market profits.

• Its importance: In contrast to similar bailouts in the rest of the world where the central bank buys in to the banks through equity, BDL has provided the banks with large profits to be retained and continue on operating with the same ownership base. In other words, the bailout didn't have any preconditions and the banks made a profit from it and continued on operating as they were doing before the operation. Furthermore, banks distributed part of those profits as dividends and significant bonuses.

• Questions to be raised:

› By how much and which banks benefited from this operation?

› What was the legal basis for this unprecedented bailout?

› Was the bailout discussed and approved by BDL's central council, which includes the director general of the Ministry of Finance? As per article 33 (modified by Law No. 8/75 of 5 March 1975) of the "Money and Credit Code".

› What is the justification for this bailout within the "Money and Credit Code"? And how is it aligned with statements from the governor of the Central Bank of the soundness and profitability of the banking system?

› Why wasn't the bailout conditional on a change of management and recapitalization by existing stakeholders? Furthermore, why wasn't it preconditioned on retaining all these profits rather than distributing dividends and significant bonuses?

› Rather than providing the banks with profits why hasn't BDL bought in to the banks and obtained an equity share to secure its rights, as did its international counterparts?

ON BRIDGE LOANS PROVIDED TO THE TREASURY:

• The issue: To cover for the government's foreign currency debt obligations BDL has provided it with USD 2.152Bn in bridge financing. According to the "Money and Credit Code" this form of financing is given at the market rate up to a threshold of 10% of the government's average revenues over the last three fully accounted years and has a maximum tenure of four months. Additional loans can be given to the government in case of adverse economic and financial conditions; these loans are given at market rate +1% and have a maximum tenure of ten years. *Note that these facilities have a maximum duration of four months. As per articles 88, 89, 90, 91, 92, 93, and 94 of the "Money and Credit Code".*

• Its importance: Due to the rise in interest rates in the Lebanese economy and the devotion of the budget to bring down debt servicing costs, the nature of these finances and their terms have to be communicated clearly.

• Questions to be raised:

› What is the level of bridge loans and budget assistance provided to the Treasury and how will they be paid back?

› What has been and what is the continuing cost of this assistance?

› Has BDL been providing assistance to other state-owned enterprises? (MEA, NSSF...).

ON ITS UNCONVENTIONAL MONETARY POLICIES (FINANCIAL ENGINEERING):

• The issue: BDL has been attracting capital into its deposits facility to build up its hard currency reserves through providing sizable profits to the commercial banking sector[3].

[3]See details in Box 1 below

• Its importance: Banks' bottom lines have benefited greatly from these policies that have crowded out investment from the public and the private sectors. In other words, these operations caused a drop-in money supply and created asymmetries in the money flow mechanism. Furthermore, these operations have raised the cost of credit in the economy and created a subsequent credit squeeze that negatively affected investment and raised bankruptcy rates.

• Questions to be raised:

› What is the nature and size of BDL's different financial engineering schemes? And how have banks benefited from them? Furthermore, what is the amount of bank deposits that BDL has lured using these polices and at what cost?

› What is the total size of BDL's debt, through CDs, loans, and other instruments, that it has incurred due to it polices over the past five years?

› What other side deals has and is BDL undertaking? Is BDL accepting deposits from the private sector apart from authorised commercial banks and financial institutions?

Box 1: Example of BDL's Unconventional Monetary Policies

BDL has been providing banks with high interest rates in order to keep on attracting deposits. These operations have been profitable for the banking sector. The top three local commercial banks derived 4.79% of GDP in interest revenues from the Central Bank during 2018. They work as follows:

Previously in 2018:

1. BDL provides an attractive rate for USD in its deposit facility.

2. It considers these deposits as collateral for an LBP loan amounting to 125% of the original USD deposit amount at a cost of 2%.

3. Previously these LBP amounts were given to the banks to use as they pleased, but this led to increased inflation.

4. Banks are now required to place them in its deposit facility at a rate that exceeds the government's offering on the primary LBP debt market.

5. Due to this difference in rate offerings, local commercial banks have seized to subscribe to the Treasury's debt instruments on the primary market.

This deal has a five-year life span and yields between 16 to 20% depending on its size.

Currently in 2019:

BDL is providing 10% upfront (paid in LBP) on foreign originating dollar deposits and 10% paid semi-annually over a three-year period. This operation results in a 14.3% annual rate of return.

ON THE NETTING PROCESS:

• The issue: BDL has netted out USD 21.29Bn in "Loans to the Financial Sector" against "Financial Sector Deposits" from its balance sheet between 28/02/2019 and 16/03/2019.

• Its importance: The operation led to a 38% reduction in BDL's balance sheet. It may involve an accounting practice of moving the results of its unconventional polices off the Central Bank's balance sheet into an off-balance account, in contrast to internationally accredited accounting standards.

• Questions to be raised:

› What was the financial operation underlying the netting process and how/where are the deals corresponding to these amounts being accounted for post netting?

› BDL has stated that the netting process came in compliance to IFRS reporting standards, which IFRS provisions are being applied?

ON THE SUBSIDIZED DEBT ISSUANCE:

• The issue: A key pillar to bringing down the deficit is stabilizing the Government's debt servicing cost; to reach that goal it has been communicated that banks and/or BDL will subscribe into an LBP 11,000Bn issue at 1% and thus share in the cost of evading a crisis. However, sources have revealed that this deal has not been inked down clearly and is based on a verbal agreement between the Ministry of Finance and the Central Bank; furthermore, the commercial banking sector has not approved of it yet.

• Its importance: The commercial banking sector has parked all its excess liquidity with the central bank and is yielding well above 1% on it and does not have incentive to yield to the 1% request. As such, BDL will have to continue filling this gap and incurring losses through a quasi-fiscal deficit as it lends at one end at 1% and obtains its funds, from the banking sector, at the market rate.

• Questions to be raised:

› The proposed solution implies further monetisation of debt in violation of the "Money and Credit Code", how is this justified?

› Will BDL subscribe into an LBP 11,000Bn issue at 1%? Do the banks have enough liquidity to join this deal? If not, how will this financing need be secured?

› What is BDL's holdings of the Lebanese government's USD government debt?

ON THE LEVEL OF ITS RESERVES:

• The issue: In contrast to international practice, BDL has been listing its holdings of Lebanese Gov. Eurobonds as cash equivalent and thus part of its hard currency reserves. The Central Bank does not indicate what other assets it classifies as reserves. Note that the Lebanese economy creates its own supply of dollars (through lending in USD) that make their way into BDL's reserves.

• Its importance: By listing assets as cash equivalent, they are counted in its reserves and portray a vague image of what is really liquid and available for a quick response from BDL in adverse times. As for Lebanese dollars, these have not been created by the Federal Reserve and cannot be supplied in cash during a bank run.

• Questions to be raised:

› What is the level of real liquid reserves at the Central Bank?

› If BDL continues on holding to Lebanese Gov. Eurobonds will it mark them to market, given the large drop in their price and rating over the last year?

› What loss has BDL incurred on its holdings of Lebanese Gov. Eurobonds? *Given the large decline of their price and rating to near junk status.*

ON THE CAPITAL ADEQUACY OF COMMERCIAL BANKS:

• The issue: Lebanon's sovereign credit rating has already been downgraded by one of the three major rating agencies to CCC; a downgrade by further agency will place it in the CCC bracket, thus requiring banks, under international financial regulatory accords, to hold more capital as reserves. These reserves can be obtained either through retaining profits or equity injections.

• Its importance: Trusted and knowledgeable sources have indicated that BDL will provide banks with additional profits when a further downgrading takes place. This operation will lead to an equivalent loss on BDL's side. Alternatively, financial rationale indicates that the banks should instead raise their own capital through issuing shares and if needed the central bank can purchase them. In doing so the central bank ensures it won't make a loss since it has invested in the banks and can sell these shares at a later stage.

• Questions to be raised:

› Given that a safer option of banks raising their own capital through issuing shares is available, why is BDL heading towards a more costly solution?

› Why is BDL so keen on maintaining banking sector profitability?

ON BLOCKING THE RELEASE OF IMF ARTICLE IV REPORTS:

• The issue: By joining the IMF, a country agrees to subject its economic and financial polices to international scrutiny; this scrutiny is aimed at identifying weaknesses that could lead to financial and economic instability. A key pillar of this process is Article IV consultations; during these missions a team of IMF economists visit the country and attend high level meetings where they discuss economic and financial developments and outlooks. Following these missions, the IMF issues a country report analysing the country's economic and financial footing in detail along with a list of recommendations. BDL has been blocking the publication of Lebanon's Article IV country reports since 2016. *Note that what is still released is the staff concluding statement that includes quick observations made by staff prior to diving deep in to the analytical process behind the report.*

• Its importance: The Article IV country report are a major source of information on Lebanon, its economy, banking & finance, fiscal, balance of payments etc. These reports provided an honest and technical assessment of the state of the economy and the financial system and the IMF's recommendations are used as guidelines.

• Question to be raised:

› Why has BDL been blocking the publication of these report? What in them has it been hiding?

ON THE SIZE OF BDL:

• The issue: Between the beginning of 2016 and 15/07/2019 BDL's balance sheet has grown by 42.64% even though its foreign assets dropped by 0.19% over the same period. The growth has been fuelled by a 200.95% increase in loans to the financial sector (post netting), a 107.25% rise in other assets, and an 84.33% rise in its securities portfolio. Furthermore, BDL has been constantly hiring more costly employees that have been seconded to various ministries.

• Its importance: The growth in BDL's balance sheet seems to be driven by a large rise in lending to the local financial sector and various other activities hidden in its balance sheet under vague line items. These changes in its balance sheet weaken BDL's stance and thus its ability to maintain the peg and the financial system as a whole in stressful events. Furthermore, the Central Bank's growing labour force raises its costs greatly and seconding them to ministries contributes to the quasi-fiscal deficit.

• Questions to be raised:

› What lies behind the rapid growth in the size of BDL's balance sheet? And what does each line item entail?

› Why is BDL constantly growing its labour force? Additionally, why and what roles do they play at other institutions?

Kulluna Irada is a civic organization for political reform, engaged in setting the foundations for a modern, secure, efficient, sustainable and just state. It is funded exclusively by Lebanese citizens in Lebanon and abroad. Kulluna Irada believes transparency, accountability and citizen participation as major constituents of good governance. The organization's goal is to raise awareness on public issues and engage constituencies of the Lebanese society: citizens, NGOs, experts, municipalities, and members of Parliament and Government in order to find and implement sustainable solutions.

Kulluna Irada
Beirut Digital District
BDD 1281, Ground Floor
Syriac Patriarchate Street
Bachoura – Beirut, Lebanon
+961 1 640 020
info@kulluna-irada.org