April 2022

Policy Paper

Lebanon Office

Addressing the Lebanese Banking Crisis

Is a Good Bank – Bad Bank Reconstructing the Solution?

Jean Tawile

ABOUT THE AUTHOR

Jean Tawile is a political economic consultant in the MENA region and a manager at Saradar Bank in Lebanon. In his other capacities, Tawile serves as the president of the Economic Council at the Kataeb Party, a board member of the Rassemblement de Dirigeants et Chefs d'Entreprise Libanais (RDCL) and head of the budget committee at the Lebanese Association for Taxpayers' Rights (ALDIC). Tawile studied economics at St. Joseph University in Beirut, international finance at SKEMA Business School and management at INSEAD. He is a former advisor at Lebanon's Ministry of Economy.

Acknowledgment:

A special thanks goes to Adel Afiouni, former minister of state and investment banker who has been proposing and advocating for this solution since the beginning of the Lebanese crisis

Introduction

Beginning in late 2019, Lebanon has descended into an economic recession so severe that a World Bank paper has described it as "likely to rank in the top 10, possibly top 3, most severe crisis episodes globally since the mid-nineteenth century." The crisis, which has been exacerbated by the COVID-19 pandemic and the devastating Beirut port explosion of August 4, 2020, has severely reduced the quality of life of the country's population. The results included recurring social unrest, drastically increased poverty rates, and widespread shortages of all manner of necessities.

The economic collapse has vindicated in dramatic fashion economist Robert Mundell's theory of the "impossible trinity" – which states that you cannot have a fixed foreign exchange rate, free capital movement and an independent monetary policy at the same time. It has also highlighted the costs of Lebanon's reckless monetary policy, which has depleted foreign exchange (FX) reserves – accumulated over decades at a monumental cost – to try to maintain a fixed exchange rate and free capital flows after the mid-2010s. The drawdown on FX reserves at Bank du Liban (BdL) by 2019 worsened the collapse and exacerbated the deterioration of the public's trust in the financial system, which has led to bank runs, currency hoarding and capital flight from Lebanon. In addition, the Lebanese banking system as of early 2020 until the time of this writing, by virtue of being overexposed to Lebanese sovereign debt and the broader "financial engineering" of the essentially bankrupt Central Bank, can best be described as illiquid, insolvent, and incapable of performing its basic banking duties of attracting and deploying funds.

Restructuring the banking sector is a thorny and painful process, and there is no magic solution to save deposits and the sector, given the unprecedented scale of losses, which by most estimates represent five times Lebanon's current GDP.

This paper aims to introduce a just and effective solution to address the banking crisis. The plan is essentially to separate the good part of the bank, which is salvageable, from the bad part of the bank, which is too difficult to salvage. It is a scientific methodology for bank restructuring which begins with separating the commercial banks' activity from their investment portfolio, and treating each part separately. Merging all of these sections into one bank was the greatest sin, so to speak, that led to the sector's collapse.

This methodology has been applied by many international banks after the "great recession" financial crisis in 2008. Following the global crisis, several euro-area countries set up asset management companies (AMCs), also known as 'bad banks', to address banks' growing non-performing loans (NPLs) that were undermining financial stability. In 2009, the Irish authorities created the National Asset Management Agency (NAMA). The German Bundestag authorized the FMS Wertmanagement AöR in 2010. In Spain, the Management Company for Assets Arising from the Restructuring of the Banking Sector (Sareb) was created in 2012. These institutions were an important step in facilitating economic recovery and restructuring large and critically impaired banking institutions or the banking sectors of each respective country; a story which can be replicated to salvage and improve Lebanon's banking sector as the country charts a recovery path from its current period of collapse.

How did we get here?

One cannot comprehend the extent and severity of the Lebanese banking crisis without understanding what happened in the years leading up to the crisis. Prior to 2011, and despite Syria's military withdrawal from Lebanon and the influx of funds from the diaspora, Lebanon's economy remained under the control of elites that misused public sector funds and critical sources of capital to lubricate their clientele networks and achieve political goals. The positive

Balance of Payments – under which a persistent, highly negative Balance of Trade was seemingly compensated for by financial flows entering Lebanon from abroad – also gave Lebanon's elites a justification for the existing economic model, thereby delaying and putting off needed reforms. In 2011, after several years of relative financial stability despite the volatile political environment, the Syrian internal war and Hizballah's involvement in the conflict started to exert serious pressure on the Lebanese financial system. This external pressure was intensified by the oil crisis in the Gulf and internally by more than two years of Lebanese presidential vacuum following 2014… It is estimated that Banque du Liban (BDL), the Lebanese central bank, lost around US$33 bn of reserves between 2011 & 2016. BDL's net reserves turned negative for the first time in 2014.

To limit the outflow, BDL embarked in the second half of 2016 on a scheme that allowed banks to attract new dollars from outside the system at high yields reaching 13%-14%. That scheme, which originally was described as "financial engineering" by central bank Governor Riad Salameh and in populist narratives become notorious as "Ponzi" scheme, attracted US$14 bn, but failed to stop the hemorrhage of BDL's reserves. Hidden behind reassuring reports on capital adequacy and other key ratios of Lebanon's commercial banks, the financial system continued to bleed US$6 – US$7 billion in each of the years leading up to 2019. Moreover, as the greed of high-interest seeking depositors turned increasingly into fears over the safety of their holdings, demand for converting LBP-denominated holdings to USD intensified at a time when BdL, supporting such conversions in an attempt to defend the peg, required banks to lodge the converted amounts as long-term deposits with BDL. Banks often assumed the financial burden of seeing their deposits blocked at the central bank without necessarily requiring their customers to block the deposits for the same period, thus increasing the bank's risk of not being able to pay a liability on-time.

Further placements of liquidity with the Central Bank were made by banks on a voluntary basis, whether under the financial engineering scheme, which raised around $14bn, or through other arrangements that allowed banks to continue to attract deposits by offering high (too good to be true) interest rates to depositors and generate hefty profits. Doing so allowed them to meet capital requirements under amended International Financial Reporting Standards (IFRS 9) and compensate for losses that may have been made in offshore investments or on local books. Banks' balance sheets therefore became overly exposed to the Central Bank, which exposed banks even more to the decay of governance in the concerned political institutions…

Since October 2019, with a capital controls law being frequently demanded but never adopted up to the time of this report, banks began imposing their own restrictions on foreign currency and capital transfers, as well as limits on withdrawals of USD or even LBP, unwittingly opening the door to judicial conflicts but also to all sort of abuses. Abuses were programmed by differing restrictions between banks, and even differing restrictions between customers at the same bank. Bank-level controls have also significantly curtailed the ability of Lebanese people to send money abroad when necessary, which has led to rising reports of families struggling to wire tuition payments to foreign universities for their children's education.

While court decisions on release of their deposits have been sought in individual cases both in Lebanon and in European courts, the long absence of a capital controls law has by early 2022 translated into sharply rising tensions between the Lebanese judiciary and the banking sector. Two years of perceived malpractice by banks and their executives, along with several high-profile lawsuits against commercial banks and top BDL officials as well as associated individuals, have by the end of the first quarter in 2022 resulted in asset freezes on at least six major Lebanese banks and travel bans on multiple high-level bank executives and board members.

A banking license constitutes a privilege that gives the bank the right to attract and accept deposits from the ordinary citizen, which the bank uses as lender to finance the economy,

provided that it adheres to clear criteria in solvency, portfolio diversity, and liquidity. Unfortunately, the Lebanese banks skirted these standards and, after many years of very conservative banking practices, have since the mid-2010s underperformed or failed in their own vital role of financing the economy. They used more than 60% of people's deposits to put them in sovereign bonds and in bonds and deposits with the Central Bank, and when the Ponzi phase of this financing scheme of public deficits flipped into panics and withdrawals of deposits in bank runs, the results were huge losses for the entire sector until de-facto bankruptcy.

So, over the years, banks have transformed from institutions that provides various commercial loans to finance the economy to a profit scheme that channels most of the assets of its depositors into the sovereign debt instruments of a quasi-insolvent state and its central bank. One has to acknowledge that this transformation took place under pressure, encouragement, incentivization, or condonation by the regulatory, financial and political authorities, because this transformation served their interests and needs.

A banking sector restructuring will not be possible without a comprehensive plan that addresses the public debt, the gap at BDL, the question of the public loss and burden sharing, and most importantly at the time of this analysis, paves the way for an IMF program that is widely considered as the vital precondition for rebuilding confidence and allow liquidity to flow into the country. In the meantime, delays in dealing with the banking sector crisis continues to exacerbate depositor losses and wealth destruction. The banking sector is of critical importance to build a sustainable economy, unlock productivity growth, secure solid GDP growth, and improve international credit ratings.

A careful bank-by-bank restructuring process is crucial to understand industry risk and required actions and should be completed in accordance with international financial and banking standards; mainly IFRS 9 and Basel III. Proposals that allow for unclear governance structures and uncertainties about the banks' capacity of recapitalizing themselves should be avoided.

Therefore, there is need for a plan that ensures: (1) distressed banks are freed of troubled assets and are given a fresh start; (2) the taxpayer is burdened as little as possible; and (3) moral hazard and other perverse incentives are avoided. Furthermore, in order to provide a foundation for the rescued banks to pursue a sustainable business model, a new regulatory framework for capital markets must be enacted.

Good Bank – Bad Bank Methodology

This structure separates the bank's troubled assets into a separate legal entity – the "bad bank" – thereby allowing management to "draw a line" under the errors of the past and focus on rebuilding the remaining "good bank".

This plan effectively addresses the three key challenges mentioned above; (1) It provides for the transparent removal of toxic assets and gives the banks a fresh start; (2) it offers the chance to keep the cost to taxpayers low; (3) the risk of moral hazard is curtailed.

The commercial activity of the banks will be consolidated under the good bank because this traditional activity of banking finances the economy, and fulfills a vital role without which there is no economic growth. In contrast, the investment portfolio held by any Lebanese bank in sovereign risks is where over-exposure exists and the banking sector as a whole has ultimately stumbled. Banks were never supposed to use their depositors' money for hazardous lending and piling up risk in opaque domestic debt -- thus all banking exposure to such debt must be classified as "bad bank".

Therefore, the proposed plan necessitates separating the good part of the bank, which is salvageable, from the bad part of the bank, which at best will require extensive efforts and much time to salvage. It is a scientific methodology for bank restructuring. This methodology, which we call the "good bank and bad bank" plan, is based on a return to the basic principles of banking in the operation of the good bank and the principles of justice applied in the hierarchy and distribution of losses.

In the bottom line, the plan to "separate the good bank from the bad bank" can be summed up as a reform process that restores the sector to the foundation of authentic banking and its vital role in financing the economy, not investing in sovereign risks.

How are the two banks separated?

The bad bank is defined in literature (e.g. Bank of International Settlements https://www.bis.org/publ/work837.pdf) as the tool for the segregation and management of impaired assets. These exercises have been found to be effective when the segregation of toxic assets is combined with the recapitalization, reduction of future non-performing loan burdens and promotion of new lending on the side of the good bank. In short, the good bank contains a diversified commercial banking loan portfolio that also includes non-performing assets which comprise outstanding but recoverable loans to institutions and individuals, but it is possible to restructure its balance sheet, recapitalize it, re-launch its activity, and restore life to the sector and its branches and employees. This good bank will form the nucleus of the new banking sector, with new administration. All banking operations will be conducted under the supervision of a transparent banking authority and the banking sector will be of a size – a much smaller size when compared with the pre-crisis status quo of Lebanese banking – that is commensurate with the size of the economy.

As for the bad bank, the portfolio of funds of Lebanese commercial banks that have been placed with the central bank and the state is separated and transferred to a private company. This company transfers its ownership from the banks to the depositors and becomes a direct creditor to the state and the central bank, and participates in the negotiations of restructuring the sovereign debt. It has the same rank in the negotiations and classification as all other creditors of the state.

This mechanism fairly distributes productive/easily salvageable assets on one side and hardly recoverable assets on the other side between the good bank and the bad bank, but what about the distribution of deposits?

How are deposits distributed?

While there are several options for distributing deposits between the good bank and bad bank, these options as much as possible should allow for depositor preferences.

Among available options, this paper recommends that small deposits (an amount up to a ceiling that is to be determined and judiciously applied) remain in the good bank. For large deposits, an also to be determined percentage should likewise and, as much as is financially feasible, be allocated to the good bank. All deposits in the good bank will be protected by the process of restructuring assets and recapitalizing and diversifying the loan portfolio in the

good bank, with the prerequisite passing of a new law which guarantees deposits and entails the stipulations needed to fortify the restructured banking sector.

The bad bank, however, is a private company owned by all the depositors who are provided with deposit certificates in exchange for their deposits that could not be placed the good bank. The private Bad Bank Company obtains its revenues from rescheduling, restructuring and in the long term recovering the sovereign and central bank-issued debts that it has acquired from the commercial banks involved in the restructuring.

Prior to the distribution of deposits between the bad bank and the good bank, a gap-reducing mechanism, such as measures that enable the judiciary to prosecute illicit enrichment, and enforce the recovery of embezzled public funds and smuggled deposits after 2019, should be established with the accompanying laws. Those recovered funds should be used as much as possible to compensate the depositors.

Finally, the Bad Bank Company negotiates directly with the state to recoup possible losses. This includes a proposal to issue debt instruments such as additional bonds by the state and hand these to the bad bank in compensation or mitigation of losses that arose from investments into defaulted bonds, provided that these replacement bonds are conditioned on improving the country's financial position and economic growth at large (contingent liabilities) so as not to increase the public financial burden.

What about shareholders and capital?

Shareholders' capital is distributed in the same proportion as deposits between the good bank and the bad bank.

The capital of the shareholders of the good bank will have to absorb all the losses of the good bank first, and if any capital remains then the shareholders can participate in recapitalizing the good bank by bringing in money from abroad.

As for their capital in the bad bank, shareholders will have the right to benefit from any returns achieved by the bad bank, but only after the depositors' money in the bad bank is paid in full, in line with the principle that depositors have the first right to be repaid out of the company's revenues. Shareholders thus have to wait until depositors have been paid before receiving any return on their investments, but these are the principles of fair hierarchy in distributing losses in any capitalist system, and the shareholders must bear their responsibility.

What's the point? What about the interests of the parties involved?

Why is this good bank – bad bank methodology considered the best, fairest and most effective form of bank restructuring for all parties that have been affected by the Lebanese banking crisis?

First: The small depositor remains in the good bank after is rationalized and recapitalized and it becomes a traditional commercial bank with diversified assets. Thus, we insure small deposits through sound and adequate recapitalization. If it is not possible to preserve the small deposits in full at the good bank, the rest of their rights will be compensated by the bad bank.

Secondly: For the large depositor: the bulk of her or his deposits will be in the bad bank, meaning that the large depositor will own a portfolio of sovereign bonds through a private company. This does not solve the problem, but it improves his position in the sovereign debt

repayment hierarchy. Instead of receiving from the banks what they collect from the payment of debts from the state, this depositor becomes the direct creditor of the state and bypasses the bank as a mediator to obtain his rights directly, positioning the large depositor in the same tier of the creditor hierarchy as the other creditors of the state. This depositor also benefits from any recovery of funds from shareholders in the bad bank or from funds that have been illegally transferred abroad.

An additional suggestion is that the state guarantees to grant Lebanese depositors additional compensation only in the form of conditional bonds, in order to reduce the catastrophic social crisis caused by the evaporation of the savings of a large group of Lebanese due to mismanagement, waste and corruption.

Third: For the banking sector, this plan secures a quick rescue of the sector, and allows its reconstruction by separating the bad part of it into a private company and by recapitalizing the good part. It also facilitates a return to the traditional banking activity that finances the economy. This is a necessary national priority because there is no growth or economic movement without banks.

Fourth: Shareholders bear the losses of a good bank, which is normal under a capitalist system and allows them to recapitalize a good bank if they bring in additional money from abroad. As for their share in the bad bank, they keep it, but they do not get any return from it until the depositors' money is paid in full. This is also normal in the hierarchy of creditors of any financial institution that has faltered, as the depositor has priority over the shareholders.

Fifth: For the state and the central bank, there is no change in their status except that their largest creditor becomes the bad bank, i.e. the private company owned by the depositors. In a very desirable reshaping of the relationship between the citizen and the state, the segregation of impaired assets thus generates additional pressure from thousands of citizens on the state to reform its finances and pay as much of its debts as possible.

What are the conditions that are required for the success of this thorny process?

Good Bank-Bad Bank is a thorny process that requires updating the numbers, scanning assets in banks, and scrutinizing losses in a transparent manner to determine how to apply them accurately.

Conditions for its success:

1. A clear and transparent law for restructuring banks, which is supervised by new trusted supervisory bodies, with the proviso that each good bank is taken over by a new administration.
2. Cancellation of the license of any bank that no longer has a commercial loan portfolio, i.e. canceling the license of any bank that does not have a good bank and merging its deposit base with those of other good and bad banks as appropriate under the regulations on deposit ceilings for inclusion in the good bank.
3. An independent institution specialized in managing the bad bank and negotiating with the state to compensate for the largest possible amount of deposits.
4. Implementation and enforcement of laws and regulations that exclude from any banking such funds which are proven to have be amassed by public officials or politically exposed persons (PEPs) through corruption and embezzlement as well as funds that have already

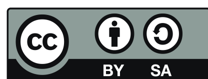
been compensated with payments of exorbitant interest rates before or during the economic crisis (possibly a period starting in 2015 until end 2022). Excluding suspicious funds and exorbitant interests from any restructuring process to ease the bill of losses and limiting them to the owners of the right deposits.

5. The state recovers the looted funds, illegal transfers, etc., and uses these funds to mitigate depositors' losses and compensate them in the good bank and then in the bad bank.
6. The state acknowledges and shoulders its grave responsibility for squandering a large part of depositors' money by allocating more and more borrowed funds to the financing of expenses under an obvious and unsustainable Ponzi scheme. It remedies this deep moral and fiscal failure by issuing special bonds to Lebanese depositors, to support them and compensate for their losses and to secure a social protection network for victims of financial mismanagement over decades.

Disclaimer: The views expressed in this publication are those of the author and do not necessarily reflect the official policy or position of the Konrad-Adenauer-Stiftung or its Lebanon Office

Konrad-Adenauer-Stiftung e. V.

Mr. Michael Bauer
Country Office Lebanon
https://www.kas.de/en/web/libanon
23 Benoît Barakat Str
Jabre Building, 5th floor
Badaro – Beirut
Phone +961 (0)1 388 095/6
Fax +961 (0)1 388 097
info.beirut@kas.de



The text of this publication is published under a
Creative Commons license: "Creative Commons
Attribution- Share Alike 4.0 international" (CC BY-SA 4.0),
https://creativecommons.org/licenses/by-sa/4.0/legalcode