

III — THE MONEY MARKET IN PERSPECTIVE

A — THE COMMERCIAL BANKS

Commercial banking is virtually the only segment of the money market that is at present reasonably well developed. In fact, relative to Lebanon's strictly domestic requirements, the country is practically over-banked. It would be difficult to justify the existence of so many banks in the country — among them certain branches, subsidiaries, and affiliates of some of the largest banks in the world — save in terms of the external business on which the banking system so heavily depends. It would be even more difficult to explain the high premiums which foreign banks have been offering recently — LL. 6 to 8 million — for a bank

¹ Lord Shawcross in a lecture delivered at the City of London Seminar, Kuwait, December 24, 1972.

license in Lebanon except in terms of the prospect of a substantial volume of external business. In fact the magnitude of the premium paid bears witness to the foreign banks' faith in Lebanon's prospects of developing into an international financial center.

Two main policy questions may be posed here in relation to commercial banking : one is the question of entry and the other is that of regulation and supervision of banking activities.

1 — The Question of Entry

A 5 years ban on the establishment of new banks was proclaimed following the Intra crash in the banking reform law of May 9, 1967 — Law 28/67. The ban was subsequently extended for another 5 years period which is due to expire around the middle of 1977. As a result of the ban and of the revival of banking activity in the country after the stagnation which came about in the wake of the Intra failure, a bank license commanded a price in the market. The price started to soar with the denouement of the oil boom in the Middle East.

The question that sooner or later will have to be faced is whether the ban should be allowed to lapse or should be extended beyond 1977, and in case the ban is lifted whether entry should be regulated and in what ways. In principle, keeping the ban for too long would be incompatible with the efforts to promote the country's position as an international center. Its termination should be looked at as a matter of timing.

Perhaps the view upheld steadfastly since the Intra failure in 1966 — that there are too many banks in Lebanon — should now give way to a policy which would allow an expansion in the banking system commensurate with the requirements of the Middle East region. The old-established centers of London and Switzerland thrive on a much larger number of banks than there is in Lebanon.

A case may be made for phasing the ban out in accordance with the following approach.

- a) The ban may be allowed to lapse in 1977.
- b) The Bank of Lebanon should be vested with the abso-

lute authority to regulate the licensing of new banks — i.e. to determine the number of new banks to be admitted at any time and the conditions under which they may be licensed.

c) The high premium that has been paid for bank licenses in the recent past practically rules out the possibility of issuing free licenses after 1977. Hence the Bank of Lebanon may have to announce every now and then the number of licenses to be issued and to offer them to the highest bidders. It would be vital to ensure, via the qualifying conditions set, that only the bidders who can give evidence of unquestionable integrity and adequate banking experience and who are disposed of an appropriate organization are in fact admitted.

d) Because the demand for bank licenses will be identifiable for a few years to come with Lebanon's prospects as an international financial center rather than with its domestic requirements, serious consideration should be given to the possibility of creating a new breed of banks — i.e. banks that specialize exclusively in foreign business. When I first proposed the idea of a « banking free zone », I added in the plan a provision that « banks may be allowed, should they so choose, to stay completely within the free zone, in which case they would refrain from dealing with residents... The ban on the licensing of new banks should not apply to the free zone » (1). Incidentally, a free-zone license would be a close parallel to the off-share license applied in Singapore. There are now 14 « offshore banks » in Singapore, and all are foreign banks. They are authorized to deal in foreign currencies, and recently they have been permitted to deal in Singapore dollars with non-residents on a restricted scale (2). The Asian dollar market is now estimated at about \$ 8 billion.

The Bank of Lebanon may consider issuing, to start with, only free-zone licenses, whereby the new banks may not conduct any business in Lebanese pounds or with residents. To the extent that the high prices recently paid for bank licenses reflect the foreign banks' interest in the regional and international business

1. Salim Hoss, « Lebanon as a Regional Banking Center », *Middle, East Express* — Le Commerce du Levant, Monthly Edition, August 1971, p. IV.

2. *The Banker*, London, September 1974, p. 1093.

that may be conducted from or via Lebanon, there will be a demand for such restricted licenses. Later on, as the domestic market expands and the need for more banks becomes evident, the free-zone banks may be allowed a limited access to the domestic market.

The free-zone banks' exposure to the domestic market should be kept under continuous review in the light of the developing needs of the country.

e) The licenses of the banks taken over in the course of the banking reform undertaken between mid-1967 and the end of 1968 (10 in number, of which one was utilized for the Syrian Commercial Bank) may be offered as free-zone licenses even before the lapse of the existing ban in 1977.

f) In addition to free-zone banks, the Central Bank may, after 1977, authorize the establishment of regular banks with a view to reinforcing the local and Arab elements in the system. The conditions of admission may be so tailored as to ensure the continuance of a local and Arab majority ownership and control in those banks.

2 — The Question of Regulation and Supervision

The upheavals which took place on the international banking scene since October 1973 served to highlight the importance of regulating and supervising the activities of all banks, domestic as well as foreign. The situation was dramatized by the closure of US National Bank of San Diego in October 1973 and the closure of I.D. Herstatt, one of the largest private German banks, in June of this year, and the virtual collapse of the New York bank, Franklin National, as news of its crippling foreign exchange losses started to leak in May of this year. The potential fragility of the international banking situation is further illustrated by the close inter-dependence that developed among the European banks through the inter-bank deposit market. According to recent figures released by the Bank for International Settlements, only \$ 23,870 million of the European banks' total \$ 133,670 million

dollar-denominated external lending was to non-banks (1).

The fact that the foreign banks dominate the banking scene in Lebanon tends to render the situation more difficult to control inasmuch as the financial condition of these banks would ultimately depend not so much on their activities in Lebanon as on their international activities abroad.

The implementation of the « banking free zone » proposition, as it is likely to lure even the smaller local banks into the international banking arena, is bound to accentuate immensely the responsibility shouldered by the Banking Control Commission. A detailed examination of the policies and practices to be pursued by the Central Bank and by the Control Commission in the regulation and surveillance of the functioning of the financial system falls beyond the scope of this paper. In broad terms, however, four complementary approaches to the problem suggest themselves :

(1) — Norms and ratios may have to be imposed with a view to keeping the banks' exposures in various lines of activity within reasonably safe limits. Certain capitalization ratios might commend themselves in this respect, such as a maximum ratio of total investments to equity; a maximum of net foreign-exchange position to equity; and a maximum of total «free-zone» liabilities to equity. In Switzerland a capitalization ratio is already in application. Until the end of 1973, foreign banks were required to cover their commitments by capital resources, roughly calculated, of 10 percent. Since 1973 the application of this requirement has been made more stringent ; (2)

(2) — Express commitments may have to be sought from foreign banks to ensure that they would hasten to the rescue of their subsidiaries, affiliates, or branches in Lebanon if and when the latter's position is in jeopardy. Some such measures have already been attempted by the Control Commission, though on a limited scale. A similar course of action has recently been initi-

1) Mary Campbell, « Policing the International Banking Scene », *The Financial Times*, July 2, 1974, p. 21.

2) Mary Campbell, « Swiss Capital Market, A leading place in the International scene », *The Financial Times*, June 28, 1973, p. 19.

ated by the Bank of England, as it was reported (during the final week of September) to have sought «assurances from the banks shareholders in the many consortium banks in the London Euro-market that they would provide a back-up if need be with extra funds » (1).

(3) — The monetary authorities may have to apply stringent and rigorous conditions for the licensing of new banks in the future in order to ensure that only the healthy and the viable are admitted. The highly selective policy pursued by Singapore in authorizing new foreign banks illustrates the kind of policy that may have to be applied.

(4) — The regulatory and supervisory authorities (the Central Bank and the Control Commission respectively) may have to embark on a selective policy, alongside their customary generalized policy. Special norms, ratios, and restrictions may have to be imposed on individual banks as their specific situations may warrant. The Central Bank has been expressly authorized to apply such « selective controls » in the latest package of amendments to the Money and Credit Law (Article 174), and the Control Commission is authorized by Law 28/67 of May 9, 1969 (Article 9) to lay down plans for individual banks with a view to improving their special situations.

B — OPEN MONEY-MARKET INSTRUMENTS

Open money-market instruments are virtually non-existent in Lebanon. There is no market for commercial paper, acceptances, or treasury bills, and the kind of institutions which deal in such paper, such as the London discount and acceptance houses, are non-existent in Lebanon.

1 — COMMERCIAL PAPER

Alongside the commercial banking system, there is a large number of small finance companies that deal in small loans and mortgages. These companies often possess a portfolio of bills

(1) *The ECONOMIST*, September 28, 1974, p. 81.

against which they normally obtain discount or loan facilities from the commercial banks. The commercial banks themselves ordinarily possess a portfolio of bills, arising from their loans to their clients, which are eligible for rediscounting at the Bank of Lebanon. There is, however, no commercial paper market in the proper sense.

The need to promote a commercial paper market may be important not only at the domestic level but also for Lebanon's potential as an international financial center, for it may draw for the supply of such paper not only on domestic corporations but also on corporations of high standing in the whole Middle East region and possibly outside the region. For the issuing corporations the commercial paper market would provide a convenient source of short term financing (In New York it would be mostly for 4 to 6 months) often under more favourable terms than bank credit. For the commercial banks commercial paper would be «an ideal instrument for holding as secondary reserves. The risk of loss is negligible; it is paid at maturity with no possibility of extensions; and usually the diversity of issues provides convenient maturity dates. Also, if a bank wishes to obtain cash or build up reserves before the paper matures, it may resell in the open market... » (1).

It should be remembered, however, that the commercial paper market can be open only to large corporations of high standing. Hence its development will depend on the prospects that qualified corporations will emerge in the region. The fact previously stated, that much of the investment activity which will be undertaken in the major capital importing countries of the Middle East is likely to be concentrated in the hands of governments, will probably stand as a negative factor in this respect.

2 — TREASURY BILLS

There is no treasury bills market. Over the 1967-72 period the Government of Lebanon issued L.L. 284 million of Treasury bonds

1) Robinson, Bochumber, Gane, and Farwell, *Financial Institutions*, 3rd edition, p. 204.

with up to 3 years maturity, and since 1972 there has been a net redemption of such bonds. The bonds were issued to meet transient needs. The timing of the 1969 issue seems to have been dictated by the desire to absorb a portion of the excess bank liquidity which at that time was generating undue pressures on the Lebanese pound in the foreign exchange market. The remaining issues were apparently floated to meet momentary budget shortfalls. In all cases the issues were addressed to the banks, and the bonds, though negotiable, were retained by the banks that had subscribed to them until their maturity. Thus no active market for Treasury bills or bonds ever emerged.

The need for a Treasury bills market can hardly be over-emphasized. Marketable Treasury bills are needed as an additional instrument of saving; as a vehicle of secondary reserves for the commercial banks; as an instrument of monetary policy — giving the Central Bank access to open-market operations — and finally as a possible outlet for such institutional investors as insurance companies, the social security system, the deposit insurance corporation, and private pension funds.

Although Treasury bills have been in short supply, there have been varying amounts of promissory notes issued to contractors by Government departments in connection with public works and telecommunications projects. The bulk of these notes soon passed to the hands of banks and other financial institutions.

3 — CERTIFICATES OF DEPOSIT

Another money market instrument that is still lacking in the Lebanese market is the certificate of deposit. Recently introduced into the Lebanese market, it has not yet been accepted on any significant scale. Somehow, perhaps because of the easy liquidity situation in which they had revelled until recently, the commercial banks have not felt the urge to resort to the use of a new instrument like the certificate of deposit.

This instrument is likely to become more popular in the future on three main counts:

a) The mounting competition for local-currency deposits, particularly since the onset of the liquidity crunch in the final

quarter of 1973, may with time impel the banks to introduce the C.D. as a new promotion device.

b) The increasing number of foreign banks in the country, who are familiar with the use of this instrument in other markets, will sooner or later find it appropriate to extend its use to Lebanon.

c) The persistent pressure which the Central Bank and the Banking Control Commission have been exercising, on the commercial banks to keep a fair balance at all times between the maturity structure of their deposits and that of their investments is likely to compel the banks, in the face of increasing demands for longer maturity loans, to explore all possible avenues for lengthening the average maturity of their deposit liabilities. One effective way to achieve this objective would be the use of the C.D. As this instrument combines the fixed-term feature of a time deposit with the marketability feature of an open-market security, it would help to wed the issuing bank's preference for longer term funds with the depositors' preference for highly liquid placements.

The medium and long term credit banks will probably play a particularly active role in promoting the use of the C.D. in Lebanon because, as just mentioned, it may be a convenient channel of attracting short term funds into longer term deposits.

In any case the future role of the C.D.'s in the Lebanese market will depend to a large extent on the efforts to create a secondary market for them. In London the discount houses are particularly active in the market for certificates of deposit issued by banks. In June 1972 they held \$ 469 million of them (1).

Perhaps the banks in Lebanon, or a limited group of them, should consider the possibility of joining together in establishing a finance company that will have as one of its main objects to deal in the banks' certificates of deposit. The existence of such a company would help considerably in making the C.D.'s more attractive to the depositors.

Such a company may help further in promoting the deve-

1) A. H. Carnwath, from a lecture at the City of London Seminar, October 24, 1972.

lopment of a more sophisticated money market if it assumes the additional functions of dealing in commercial paper and of engaging in forward exchange operations.

For its resources, the company may, besides its capital, draw on special facilities from the banks and possibly from the Central Bank, and may issue its own bonds in the market.

It should be noted that in all cases, the promotion of open market instruments — including commercial paper, Treasury bills, and certificates of deposit — depends on the creation of a secondary market for them, which in turn will depend on the Central Bank's posture as a lender of last resort against such instruments; on the ability to tailor the terms and conditions of the instruments to the requirements of the ultimate private investor rather than merely to the requirements of the banks; and on private initiatives, primarily within the banking system, to create finance companies that specialize in dealing with such instruments. As a lender of last resort, the Central Bank may choose to apply penalty rates so as to discourage any abuse of the facilities it may offer.

C — OTHER MONEY MARKET OPERATIONS

There are only two domains of active money market operations discernible in Lebanon, namely that of inter-bank deposits and that of foreign exchange.

The inter-bank deposits market has grown to be a fairly sizeable one. Certain banks, including some of the larger foreign banks, are in the position of traditional recipients; certain other banks, including a large number of the smaller locally-held banks, are in the position of traditional lenders; the rest find themselves at different times at the receiving or lending end of the market depending on their respective situations. The call-money rate in that market, highly sensitive and easily determinable as it is, is often taken as an efficient bellwether of the general liquidity situation in the banking system.

The foreign exchange market of Lebanon is apparently a fairly active one. Even though practically most of the banks undertake operations in it, it seems to be dominated by a few banks. By international standards, it is still a very thin market. The

average daily volume of transactions probably does not exceed \$ 4 - 6 million, and the bulk of it is conducted by some 15 banks.

The forward foreign exchange market, gauged in terms of the volume transacted, the maturities available, and the currencies involved, is still embryonic. Although statistics are not available, the feeling is that, relative to the foreign trade of Lebanon and relative to the foreign trade financing channelled through the Lebanese banking system for account of the neighbouring Arab countries, the volume of business conducted in the forward market is still very small. This market is needed not only to accomodate the requirements of foreign trade financing but also the requirements of purely financial flows. If the forward market is to develop as rapidly as an international financial center would require, some intervention on the part of the monetary authorities might be necessary.

It should be remarked in this connection that, if the existing unsettling turmoil in the international currency markets has intensified the need for a forward exchange market, it has at the same time served to underline the enormous hazards associated with it. The crippling difficulties which this situation has created for some banking institutions in the West speak for themselves. Proper regulation of the market should therefore be a sine qua non of its development.

Incidentally the risks associated with the forward market are not different from the risks to which a bank would be exposed if it assumes, as many banks in Lebanon are wont to, a long (overbought) uncovered position in the spot market. In times when excess liquidity abounds in the banking system, as has often been the case, it would be difficult to prohibit the banks from taking such positions. Positions should, in any case, be regulated so as to contain the risks associated with them within tolerable safety margins.

There is in Lebanon a fairly broad and active banknote market in which virtually most currencies of the world, including non-convertible currencies, are traded. There are no estimates available for the volume of banknote trade transacted. The feeling is that it is relatively large, though presumably still a far cry from the average yearly turnover of Switzerland which is estimated at

S.F. 1,5 to 2 billion.

The market for Arab currencies is particularly active in Lebanon. Its mainstay is the tourist activity that goes on between Lebanon and the rest of the Arab Middle East and the transfers made by the large number of Lebanese who live in the various Arab countries.