

## **IV — THE CAPITAL MARKET IN PERSPECTIVE**

Any discussion of the capital market should cover such a wide range of subjects as the commercial banks' involvement in medium term credit; the roles of medium and long term credit banks, the quasi-government banks (BCAIF and NBITD), insurance companies, the Bourse of Beirut, the bond market, and possible additions to the existing institutional structure. Obviously we can only give a cursory review of all these subjects.

### **A — THE ROLE OF THE COMMERCIAL BANKS IN THE CAPITAL MARKET**

Prior to the Intra crash in 1966 some of the banks in Lebanon engaged extensively in long term investments, including real estate and equity investments. Since then the banks have retrenched to the more conventional lines of banking, spontaneously as they witnessed the lessons afforded by the Intra crisis and its aftermaths, and under pressure from the Banking Control Commission which was formed towards the middle of 1967. In fact the very banks that had conspicuously indulged in unorthodox banking practices were liquidated under the reform program which was implemented following the Intra failure (1).

This does not mean that the banking system severed its links with the capital market. The banks have continued to supply medium term credit under the guise of short term advances which are rolled over at maturity. In certain cases loans of up to 8 years have been extended by individual banks to prime customers. In

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(1) By the end of 1968, 10 banks had been taken over by the authorities and 4 others had been placed under a voluntary liquidation scheme.

some cases similar loans were syndicated.

The commercial banks have also played a leading role in the few international issues which were floated in Lebanese pounds since 1972. The banks took up reportedly a minor portion of the European Investment Bank and Renault issues, but nearly the entirety of the World Bank issue and State Bank of India loan.

The role of the banks in providing medium-term loans will presumably be reinforced by a recent amendment to the Money and Credit Law (promulgated in November 1973) which empowers the Central Bank to grant one-year loans, renewable in case of need, against 3-year paper, provided such paper originates in industrial, agricultural, public works, or export operations. In view of the basic transformation function of banks, whereby they tend to make somewhat longer-maturity investments than their liabilities, the newly introduced eligibility of 3-year paper will tend to make medium term lending, for possibly slightly longer periods than 3 years, a regular line of activity for the commercial banks. Considering that the commercial banks are already engaged in medium term (rollover) financing, the newly introduced eligibility of medium term paper will at least serve to regularize a going practice.

## **B — THE MEDIUM AND LONG TERM CREDIT BANKS**

The law governing medium and long term credit banks — Law 22/67 of April 21, 1967 provides tax incentives for the establishment of such banks and prescribes certain regulations relative to their capitalization and operations. The banks that satisfy the conditions set out in the Law are exempted from income tax for seven years and are thenceforth indefinitely exempted from income tax up to the equivalent of 4 percent of their paid-in capital.

The Law did not produce any results until close to the end of 1972, when one of the existing commercial banks opted for conversion to a medium and long term credit bank, since then two consortium banks — embracing Lebanese, European, and Japanese groups — were established, and at least two more are now in the offing, both as consortium banks.

The Law seems to be too restrictive to allow the term-credit

banks (as they will be referred to hereinafter) to perform an effective role at the regional level. Some of the restrictions seem to prejudice the very viability of these banks in the long run. The following remarks may be made in this connection.

The term-credit banks are prohibited from accepting deposits for shorter periods than two years. In view of the high liquidity preference of the depositors in Lebanon, and in view of the competitive rates which are ordinarily offered by the commercial banks for short term deposits, it has been very difficult for the term-credit banks to attract deposits on any substantial scale. This restriction seems to have been inspired partly by the dictum that medium and long term loans, as such bank are designed to undertake, ought to be balanced by medium and long term resources, and partly by the desire to keep these banks off the arena of competition with the commercial banks. Obviously life would have been much easier for the term-credit banks if the minimum permissible deposit period was set at one rather than two years.

It will also be desirable to exempt the longer term deposits of these banks (those exceeding a specified maturity) from the reserve requirement. Variable reserves tend naturally to prejudice the banks' ability to commit themselves to a fixed interest on medium and long term deposits.

Similarly these banks are not allowed to grant any loans that fall due for payment partly or wholly within less than two years. This provision, which is also apparently inspired by the desire to keep these banks out of direct competition with the commercial banks, looks to be unduly restrictive. In the case of housing and consumer loans, it would be often in the interest of both the bank and the borrower to provide for the partial redemption of a loan starting from the very first year. It may thus be advisable to allow for a partial redemption, say up to 25 or 30 percent of a loan, within the first two years.

The term-credit banks may deposit funds with the other banks but only subject to notice not exceeding 15 days. This restriction might have been prompted by the desire to inhibit the term-credit banks from getting too pre-occupied with money market operations to pursue their primary objective of term lending. In fact this limitation is likely to be very damaging to the

smooth functioning of these banks. Very often a bank finds itself possessed of large amounts of liquid funds for which no immediate outlets of long term investment might be available. Because of that restriction the banks would have either :

a) to place these funds subject to 15 - days notice, thereby missing the opportunity of a higher income which might be realizable on longer term placements, or

b) to seek to invest too much of the funds too hastily in long term outlets, possibly at the risk of taking sub-optimal decisions.

In either case, the restriction is clearly not consistent with the best interests of the bank.

After all, the decision-making process in investment is inherently a long and time-consuming one. An investment opportunity has to be identified and thoroughly evaluated, possibly from the technical, economic, and legal points of view, before a financial transaction can be consummated. Thus when a term-credit bank raises large sums of money, as it is hopefully supposed to do when it obtains a syndicated loan or when it floats a bond issue, the amounts so raised can be applied to long term investment only gradually and over an extended span of time. In the interim, if the bank is not allowed to maximize its income on the liquid funds available, the effective cost of funds to the bank would be correspondingly higher. The implications of a higher-cost bias are self-evident, especially with respect to the regional role that the term-credit banks are expected to play and with respect to their competitive position vis-a-vis the commercial banks.

Thus term-credit banks should be allowed greater freedom of action in investing their excess funds in the money market. Perhaps their investment in open market instruments -- i.e. commercial paper, Treasury bills, and certificates of deposit should be particularly favoured in the interest of promoting the development of an active money market.

The Law also imposes highly restrictive limitations on the banks' equity participations. Total equity investments, together with other fixed assets, may not exceed 75 percent of a banks' own net worth. In addition, a bank may invest in equities up to 25 percent of its deposit liabilities that have a maturity of over

five years. In any case a bank's holdings of any single company's stock may not exceed 25 percent of the bank's own net worth or 15 percent of the company's own capital.

Term-credit banks — if they are to operate as investment companies, as they in fact should to some extent — should be capable of investing a larger amount than the equivalent of 75 percent of their net worth in equity participations, subject of course to certain stringent conditions as to the quality of the admissible stocks. The additional participations allowed are practically ruled out as they are linked to total deposits of longer than 5 years which are hard to come by. For no plausible reason the additional participations allowed are linked to long term deposit liabilities to the exclusion of other long term obligations such as long term negotiated debts or bonds issued. A relaxation of the limitation on the maximum equity investments that term-credit banks are permitted to hold may take the form of setting a composite ceiling such that the total may not exceed 75 percent of the bank's own equity plus 10 percent of the total liabilities which have maturities of longer than two years.

Term-credit banks should also be capable, subject to certain well defined conditions, of retaining a controlling share of the capital of companies whose activities would complement the bank's own — such as a management consulting firm, an investment banking company, an investment brokerage firm, or the like.

The term-credit banks are also enjoined by the law to lend only against real collateral or bank guarantees, and in the case of a real collateral the loan may not exceed 50 percent of the assessed value of the mortgaged assets. Obviously the 50 percent ratio is too restrictive for project loans or for loans to borrowers who are highly credit worthy in their own right. In the latter case the term-credit banks are placed at a distinct disadvantage in their competition with the commercial banks for prime customers.

The text of the Law is not clear as to whether the collateral requirement applies equally to the banks' investments in negotiable notes and bonds. If it is so interpreted, the bank's role in the capital market, both at the domestic as well as the regional levels, would be seriously curbed.

It should also be both possible and desirable to encourage

the term-credit banks to develop the full line of merchant and investment banking activities, including underwriting of securities, financial planning and counselling, trust services, foreign exchange operations, etc... The Law defines the objectives of the term-credit banks so restrictively that they may not be allowed to undertake activities, such as the ones just enumerated, which are not explicitly mentioned in the Law. Broadening the term-credit banks' scope of operations so as to include merchant and investment banking activities would improve the viability of these banks and enhance their potential role at the regional level. For, as previously mentioned, the financier in the emerging situation of the Middle East will have to perform a broader role than a purely financial one if he is to answer to the real needs of the region.

The Law allows these banks a tax holiday for the first seven years, and thenceforth to deduct from their taxable income the equivalent of 4 percent of their paid-up capital. The tax exemption applies only in relation to the income earned on operations within Lebanon. Obviously in the context of the potential international role of these banks, the discrimination against foreign operations is hard to justify.

Finally, the legal provisions governing the credit facilities which may be made available to the banking system by the Central Bank do not distinguish between commercial and term-credit banks. In view of the inherent dissimilarities in the requirements of the two categories and in the maturity structures of their loan portfolios, the terms and conditions under which the Central Bank's loan facilities are made available to each category should be fundamentally different.

## C — INSURANCE COMPANIES

There are now 87 insurance companies in Lebanon, of which 72 are foreign — operating in Lebanon through branches or agencies — and 15 are locally incorporated. Some of the leading companies in the latter group are partly owned by foreign insurance companies. Relative to its population Lebanon enjoys one of the highest densities of insurance companies in the world. Whereas the density of insurance companies per one million in-

habitants is slightly over 30 in Lebanon, it is about 25 in Kuwait 22 in the U.S.A., 13 in the U.K., and less than 9 in France.

With the existing high density of insurance offices in Lebanon, competition is apt to compel them to develop their business on a regional scale. The main obstacle facing them in developing their regional business is clearly the fact that they are barred from establishing offices in most of the countries of the Middle East, either because the insurance industry is nationalized (Egypt, Syria, Lybia) or because under the existing regulations entry of new firms is not allowed at present (Kuwait, Jordan).

Perhaps the taxes and duties to which insurance policies are subject are an additional factor jeopardizing the competitiveness of the Lebanese companies in other countries of the region. Now life policies are subject to a 3 percent stamp duty which, in the interest of promoting their use as a saving device, should probably be abolished. Non-life policies are subject to a 6 percent municipality tax in addition to a 3 percent fiscal stamp duty (from which foreign contracts are exempt).

In order to preserve a healthy situation in the insurance industry, it would be imperative to regulate entry into the industry and institute an effective system of supervision, which now does not exist although it is provided for in the legislation.

Insurance companies may play a significant role in the capital market if the latter could be properly developed. Because of the under-developed state of the securities market in Lebanon, the insurance companies tend at present to invest too much of their reserves in real estate and construction.

#### **D — THE BOURSE OF BEIRUT**

The Bourse of Beirut seems to have defied all efforts to develop it since its establishment in 1920. The total volume of activity transacted on it, which seems to reflect closely the general conditions in the economy, reached a high of about LL. 81 million in 1964, dropped to an average of only LL. 8 million per year over the 1968 - 71 period, then rose to LL. 52 million in 1973. Only 43 corporate stocks are now listed on the Bourse.

As the Bourse forms the subject matter of another paper,

we need not discuss it in detail here. It is sufficient to point out here that the future of the Bourse will depend to a large extent on the following considerations :

a) The development of the Bourse is directly related to the development of medium and large-size corporations with widely held shares (the reverse is also to some extent true. The underdeveloped state of the Bourse has not been conducive to a widespread development of such corporations). Most corporations are closely held. The shares are thus either not listed on the Bourse or, if listed, their price is liable to be influenced by the action of a few individuals. The most important factor hampering the development of large-size corporations is perhaps the taxation system in application, under which all corporations are subject to a progressive income tax. This system inflicts a heavy penalty on size. It thus tends to negate economies of scale and, in the process hamper industrial development in the country.

b) The Bourse also suffers from the fact that confidence in the published financial statements of corporations is still lacking. The auditing profession as well as disclosure standards are not regulated.

c) Proposals have at one time or another been advanced to introduce additional lines of activity to the Bourse, including trading in gold bullion and certain foreign stocks. The Bourse is apt to play a more positive role in Beirut's projected international financial center if such proposals are accepted.

## **E — THE BONDS MARKET**

The bonds market in Lebanon is still very rudimentary. The issues which the market has so far witnessed include the following :

a) Three corporate issues are known to have been floated: one by the Ciments Libanais in 1966 (LL. 10.8 million at 8%) and two others by a power company, Nahr-Ibrahim, the first in 1971 (LL. 600 thousand at 9%) and the second in 1972 (LL. 550 thousand at 9%). All these issues are now listed on the Bourse.

b) A number of bond issues, for up to 3 years, were made by the Treasury. As previously mentioned, a total of LL. 284 million was issued between 1967 and 1972, and since 1972 there has

been a net redemption of Treasury bonds.

c) In addition to two straight loans denominated in Lebanese pounds, one in 1972 for the State Bank of India (LL. 15 million) and the other in 1973 for Algeria (LL. 55 million), three international bond issues were made in Lebanese pounds, namely those of the International Bank for Reconstruction and Development (LL. 75 million), the European Investment Bank and Renault (LL. 50 million each).

Except for some occasional trading on the Ciments Libanais bonds and some over-the-counter transactions on the EIB and Renault issues, no active secondary market for any of the foregoing issues has developed. Application for listing of the EIB and Renault issues at the Bourse of Beirut has been filed. The application has been accepted by the Bourse but not yet approved by the Ministry of Finance.

Obviously the prospects of the bonds market will depend largely on the development of a secondary market, the use of the corporate form of enterprise in business, and the governments' recourse to the bond market in raising investment funds. Bilateral (government to government) financing is likely to keep much of the demand for investment funds on the part of governments in the Middle East out of the bonds market. The financing provided by the Funds (the Kuwait, Abu-Dhabi, and Arab Funds) is likely to have a similar effect.

## **1 — CORPORATE BONDS**

In order to encourage the issuance of corporate bonds, it would be necessary to take a number of actions :

a) Ways should be devised in order to stimulate the demand for such securities. One way to achieve this would be through the Central Bank's role as a lender of last resort in accordance with Article 102 of the Money and Credit Law. If ever the Central Bank imposes a liquidity ratio on the banks, corporate bonds that satisfy certain conditions may be proclaimed as an acceptable element. Finance companies which undertake investment banking operations and which stand ready to make a market for the corporate securities they help in floating may be ac-

corded special credit facilities by the Central Bank.

b) The legal system affecting bond issues should be made flexible enough as to be amenable to innovations which may be forthcoming to accommodate the rapidly changing demands in the financial markets. Evidently the issuance of such familiar varieties as convertible bonds and mortgage bonds is associated with major legal problems.

As has been previously mentioned, one of the problems that weigh most heavily on the minds of the policy makers in the capital exporting countries of the Middle East is the attrition to which their investments are exposed on account of currency devaluations and inflation in the industrial world. In their quest to minimize these risks they have shown a new interest in denominating their claims in their own currencies and in making real estate and equity investments. Consideration is being given in Arab financial quarters to the possibility of introducing an Arab unit of account, the Arab dinar, as one way to ward off the risk of currency devaluations. Incidentally, already a loan of \$ 25 million has been arranged in 1973 by Hambros and has been subscribed to by the oil exporting countries with repayment linked to a basket of Gulf currencies (1).

Western financial quarters are now toying with the idea of introducing index-linked bonds — an innovation which is contrived to make available in the market inflation-proof bonds. Alternatively, some protection from inflation can be provided by a familiar instrument — the convertible bond — which has been gaining popularity in the Euro-bond market in the last few years. The drawback of this instrument to the Arab investor is that the conversion deprives him of the fixed-maturity feature of the bond. At any rate the Lebanese commercial law, which requires that all the authorized capital of a corporation be subscribed from the beginning, does not permit the application of the convertible-bond mechanism on a wide scale.

The Lebanese market should be adaptable enough to adopt similar, and possibly more ingenious, innovations. One may think,

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(1) Richard Johns, « Middle East Finance, Surge of Funds to the Euromarkets », *FINANCIAL TIMES*, April 16, 1974, p. 21.

for example, of a possible alternative to index-linked and to convertible bonds in the form of a bond that incorporates certain features of equity investments, which are to a large extent inherently inflation proof. Such a bond would have, as conventional bonds have, a fixed maturity date and maturity value, but instead of paying a fixed interest rate, would participate in the realized income of the issuing corporation. Such a « participating bond » — if we may so call it — should not be confused with the familiar « income bond » which is sometimes utilized in the reorganization and rehabilitation of companies in order to minimize the risk of default during anticipated periods of lean earnings. Whereas an income bond is paid a fixed rate in relation to its par value, provided only that enough income has been earned, a « participating » bond would share in the income realized as a share of stock would, but on the basis of a pre-determined proportion of the total (possibly with a guaranteed minimum interest rate).

A participating bond of the kind proposed here would, in addition to dealing with the inflation problem, appeal to the recently established Islamic Development Bank which, in accordance with the strictures of Islam, may not charge interest. In view of the pre-eminence of Saudi Arabia as a potential source of funds, the importance of accomodating such religious scruples is evident.

## **2 — GOVERNMENT BONDS**

In order to promote the development of a Government bonds market, the Government — before borrowing from external sources, as it has repeatedly done to finance specific projects — should try to issue bonds in Lebanon, possibly in various currencies.

Autonomous agencies and municipalities may also be encouraged to issue bonds for the purpose of financing some portion of their capital budgets.

An attempt should be made to lengthen the maturities of the bonds beyond the 3-years mark so far observed in Treasury bonds.

An attempt should also be made to expand the demand for such bonds by possibly :

a) supplying the market with liquidity along the lines previously suggested in connection with corporate bonds ;

b) designing the bonds so as to appeal to the general public rather than just to the banks ;

c) developing a secondary market for these bonds, possibly through some intervention from the Central Bank at least in the initial stages.

### **3 — INTERNATIONAL ISSUES IN LEBANESE POUNDS**

Issues by foreign borrowers in Lebanese pounds have been discouraged by the monetary authorities, purportedly so as to preclude the Lebanese pound from developing an international status which would render it vulnerable to frequent waves of destabilizing speculative activity.

Of course international issues in Lebanese pounds would not be the only factor which might whet the speculators' interest in the Lebanese pound in the future. But if the prevention of such issues will help — possibly as one out of a package of preventive measures — to keep the Lebanese pound away from the scene of international speculations, it would be worth attempting. In times when the banking system is possessed of lethal excess liquidity, however, some such issues may be allowed, possibly subject to prior authorization from the Central Bank.

The latter suggestion should not provoke any misgivings. Under article 8 of the Swiss Bank act « authorization by the National Bank is required for capital export in the form of public issues or bank credits, if the latter exceed 10 million and their terms exceed two years. The National Bank examines an application for permit from the viewpoint of the money and capital market, and submits it to the three interested Federal departments in order to be able to take account of objections or conditions suggested by general economic policy » (1).

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(1) Max Iklé, *Op. Cit.*, p. 98.

## F — THE QUASI-PUBLIC BANKS

Although the Banque de Crédit Agricole, Industriel et Foncier (BCAIF) and the National Bank for Industrial and Touristic Development are restricted to local financing and have consequently very little to do with international finance (except perhaps as potential beneficiaries), a few remarks about the possibilities of improving their efficiency might be in order.

In so far as both banks are authorized to finance industrial and tourism projects, their areas of operation overlap. As agricultural credit falls within the domain of BCAIF's activities and outside the domain of the Development Bank's activities, it would be advisable to reinforce BCAIF's line of agricultural credit so that with time BCAIF will grow into a predominantly, if not exclusively, agricultural development bank.

The role of The National Development Bank as a development finance company can be enhanced if some amendments are introduced to the special law and statutes governing its policy. The National Development Bank is not allowed now :

- a) to refinance any part of the existing debts of a borrower
- b) to finance any part of the working capital requirements of a borrower, or
- c) to participate in the equity of any firm except after prior approval from the Council of Ministers, and then only up to 10 percent of the firm's equity.
- d) to accept deposits or borrow funds for shorter than two years.

It should be possible for a development finance company to refinance existing debts up to a certain ratio, say 25 percent of the loan it grants to a borrower. The inadmissibility of this practice under the existing law and statutes sometimes gives rise to cases where the Bank would have to turn down an otherwise eligible customer simply because there is an outstanding mortgage on a project which requires a relatively small amount to release, or to cases where the Bank is unable to accommodate a project because it (the Bank) is unable to help in consolidating the borrower's outstanding debts.

It should also be possible for the Bank to finance the fixed

part of the working capital of an industrial enterprise. The financial plan of an industrial project would not be complete unless it provides adequately for the fixed part of the working capital as it does for the plant and equipment.

The National Development Bank should also be able, as most development finance companies in other countries are, to participate, subject to well defined conditions, in the capital of the companies which borrow from it. The prior approval of the Council of Ministers for each case separately practically rules out this possibility because of the delay and publicity that go with any application to the Council of Ministers.

In seeking to raise funds, The National Development Bank is at a disadvantage in one respect even in relation to the term-credit banks in as much as the latter may accept one-year deposits from other banks and insurance companies whereas The National Development Bank may not accept any deposits for less than two years from any sources. This discrimination against The National Development Bank is difficult to justify.

It goes without saying that the National Development Bank should be kept at par with the term-credit banks in whatever privileges or facilities the latter might be granted.

### **G — THE NEED FOR A MORE FLEXIBLE INSTITUTIONAL STRUCTURE**

The large variety of institutions which exists in the other capital markets of the world need not be duplicated in Lebanon. The banks and other financial institutions may to a large extent fill the gaps by diversifying their own lines of activity. In fact this has been the trend to some extent in other parts of the world. In the United States « the modern big-city bank is a veritable « department store » of banking services » (1). Similarly, « the Swiss banking system, unlike the British system, is not specialized. Practically all institutes are universal banks — that is, banks active in all lines of banking business » (2). The large Swiss banks holding companies in Switzerland, with a total capitalization of

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(1) Robinson and others, *Ibid*, p. 58.

(2) Max Iklé, *Op. Cit.*, p. 65.

« have created financial companies of all descriptions, and have taken financial interest in mortgage banks and trust companies. Furthermore, the three big banks have a stake in international corporations that promote private enterprise in developing countries by granting advances, by participation, and by offering technical advice » (1). The same can be said about the German banks. Even in London « virtually all the commercial banks have greater or lesser participations in the ownership of other specialized banks or financial companies » (2). In fact the trend now is « towards greater diversification in banking, summed up in the now familiar continental expression « universal » banking » (3).

What specialized institutions will be needed in the future can only be decided in the market and by the market. The legal system, however, should be flexible enough to allow for the establishment of various kinds of institutions as the need for them arises. In Lebanon the legislation may have to be reviewed at least in relation to three aspects, namely amalgamations, mutual funds, and holding companies.

The experience with the merger of two banks in the course of the banking reform undertaken in the wake of the Intra crisis has shown that, in the absence of express provisions governing it, the legal process is in fact too laborious and ineffective.

As to mutual funds one would expect that, if Lebanon succeeds in developing its position as an international capital market, mutual funds might play a role in it. The establishment of mutual funds should be regulated by special legislation, and their operations should be properly supervised. The only reference to mutual funds that exists now is that occurring in the law covering life insurance.

The holding company played an important part in the financial development of Switzerland, and its evolution in Lebanon may be significant in terms of the country's potential role as an international capital market. At the end of 1968 there were 8353

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(1) Max Iklé, *Op. Cit.*, p. 76.

(2) A. H. CARNWATH, *Op. Cit.*

(3) Michael Blanden, « Increasing role for the Banks », *the FINANCIAL TIMES*, march 4, 1974, p. 16.

about S.F. 9 billion. These included a large number of companies set up by American concerns since World War II for the purpose of administering and controlling their European interest through them (1).

Fiscal treatment is of the essence in encouraging holding companies. Care should be taken that they are not subjected to double-taxation as they and their subsidiaries are separately taxed. In Luxembourg — a great world magnet of international holding companies — financial holding companies are tax-free (2).