How to Put the Collapsed Lebanese Banking Sector on the Right Track?

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RESEARCH ARTICLE

How to Put the Collapsed Lebanese Banking Sector on the Right Track?

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Abstract

The revival of Lebanon involves regaining trust in its banking system. Starting by highlighting the main banking sector’s inefficiencies in Lebanon, as well as the bad investment practices that have led to the current financial crisis, a full business model that could restore confidence in the Lebanese banking sector, and increase its profitability in the foreseeable future is proposed. This new business structure tackles three main areas including, cost reduction, liabilities management, and income generation, is suggested with evidence on how this model could play a major role in the upcoming recovery period and lead to positive financial results.

Keywords: Restructuring, Lebanese banking sector, Cost reduction, Liabilities management, Income generation

1. Introduction

Once referred to as the “Switzerland of the Middle East,” Lebanon now faces its worst crisis since the civil war. Lush mountains and snow-capped peaks aside, the country owes this title to its renowned banking sector, famous for its strict banking secrecy law adopted in 1956. Data collected by Lebanon’s Central Bank (Banque du Liban - BDL), as well by private banks operating in Lebanon, shows that the banking industry was one of the most profitable economic sectors in Lebanon following the end of the Lebanese Civil War in 1990, and as per Schimmelpfennig and Gardner (2008) it can be attributed to two main factors, firstly, local banks financed the majority of the State’s and Central bank’s debt, secondly, the high remuneration strategy adopted to attract the country’s widespread diaspora. In addition to the banking secrecy law, the primary role played by the banking sector in boosting Lebanon’s GDP in the pre-war era can be attributed, in part, to the massive influx of petrodollars coming in from neighboring Arab and Gulf States, a laissez-faire economy, and a flexible exchange rate system. According to Nessimian (2019), if this huge capital inflow was well deployed and employed in long-term development plans, it would have had a favorable influence on the entire economy, and led the country to prosper, especially by attracting investors and generating employment possibilities.

However, after the war, Lebanese banks began to lend money to the State at a rate of return much higher than the interest rates paid to depositors. Gaspard (2004), advocated that the unrealistic levels of interest rates paid by the government to the banking sector were one of the main reasons that drowned our country in debt. As a result, local banks were no longer interested in investing in the private sector. Marot (2018) stated that this created a “crowding out effect”, the large return of sovereign debt hindered the private sector’s vitality, local banks began to predominately lend the public sector and losing interest in the private sector. Additionally, given that the country had just emerged from a 15-year civil war, few people were willing to invest their savings in long-term projects and instead preferred depositing them at local banks in exchange for exceptionally high interest rates. This increased the deposit base of local banks, as well as the latter’s investments in government bonds. Local banks also placed a large part of their deposits at the Central Bank. In fact, according to Moubayed and
Zouein (2020), it is estimated that 75% of all deposits in local banks are invested within the State. With very little credit going to productive sectors, such as agriculture and industry, the Lebanese economy became more rentier than productive. They abetted for financing the obsolete services sector at the expense of the productive, profitable sectors (Talha, 2003). In 2020, the share of the services sector amounted to 86.36% of the total GDP compared to 7.34% for the industry sector and 2.25% for agriculture. With the adoption of a currency peg system against the US dollar, the exchange rate was no longer a reflection of the country’s economic growth. Rather, the financial sector became oversized relative to Lebanon’s economy, while productive sectors all but vanished.

With the unfolding of the current economic crisis and the decrease in the inflow of remittances from the Lebanese diaspora, coupled with the little financial aid from Gulf countries and the West, Lebanon’s currency peg, which was described for more than 20 years as an anchor of financial and social stability, has become a burden for the country. Baumann (2019) argued that the currency devaluation, which the Lebanese banking sector tried to elude since 1992 through the currency peg, veiled long-term fundamental problems. In fact, the Lebanese pound is rapidly losing its value despite a series of measures imposed by the Central Bank in hopes of stabilizing the exchange rate. While the official exchange rate remains at LBP 1507.5 per US dollar, the black-market rate has reached an unprecedented LBP 24,000 to the dollar.

Today, the lack of confidence in the banking sector, due to its inability to give depositors their money back after the State became practically insolvent and defaulted on its internal and external debt, the lack of foreign currency inflows, the rapid devaluation of the Lebanese pound against the US dollar, the lack of solutions or actions, the fiscal deficit, the soaring inflation, economic contraction, unemployment, the political standstill and several other factors have all contributed to the crash of the Lebanese banking sector. The World Bank (2021), through its Lebanon Economic Monitor, ranked the prevailing turmoil among “the top 3” most acute crises that occurred worldwide since the mid-nineteenth century while highlighting that there is no apparent watershed shortly.

One of the most essential reforms that must take place to put Lebanon’s economy back on the right track is restructuring the ailing banking sector, which will be paramount to ensuring long-term growth and to building a productive economic model. The ultimate purpose of such a process will be to fully recapitalize banks, restore their solvency and regain public trust. Banks must rush to implement a considerable restructuring agenda ensuring a reasonable distribution of losses among economic agents, build new business models, and take advantage of the upcoming period to find a way out of the turmoil.

In an effort to boost liquidity by attracting dollars from abroad and preventing capital outflows, the Central Bank issued the circular no.154 instructing local banks to raise their capital by 20% and repatriate 3% of the liquidity from correspondent banks. However, many banks have struggled to meet this requirement, as no shareholders or investors are willing to inject fresh dollars in a sector that is no longer profitable. Some reports have even indicated that banks have been purchasing large amounts of dollar banknotes from the black market to increase their liquidity. This would partly explain the rapid devaluation of the Lebanese pound in recent weeks.

According to the latest plan published by the Central Bank in circular No. 158, depositors will be compensated using the remaining required reserves in foreign currency along with banks’ deposits with correspondent banks over one year, which will increase the money supply that will weigh heavily on the exchange rate. In light of this brief overview, this study aims to outline a new business structure that could restore confidence in the banking sector and increase its profitability in the upcoming period. However, rather than placing this liquidity at BDL in the form of reserves, where it is likely to slowly deplete hard currency reserves on subsidies, it would have been far more beneficial for the economy if it were injected in the form of investments. It is high time for Lebanon to gradually lift subsidies on government services and essential products and strengthen its national currency and its citizens’ purchasing power through a thriving economy that was widely discussed in our previous study published in May 2020, entitled “The Economic and Financial Crisis in Lebanon: Major Problems and Reform Plan.”

This will require a complete revamping of the banking sector and a redesign of banks’ investment strategies and their relationship with BDL and the government. In the first part, we will highlight the banking sector’s main inefficiencies and poor investment practices that have led to the current financial crisis. In the second part, a restructuring business model will be proposed, addressing three main areas in the banking sector: cost reduction, liabilities management, and income generation. Hence, we will illustrate how this business model could play a major role in the upcoming recovery period and lead to positive financial results.
2. The Lebanese banking sector at a glance

Monetary policy is seen by Central banks as an effective strategy for preventing any downturn in the economic activity by controlling the major macroeconomic factors like preserving low levels of inflation, and unemployment using tools like interest rates, government securities, and banks' required reserves. After 15 years of civil unrest, the government decided to rebuild the country by offering attractive remuneration in order to attract foreign depositors. These rates not only contributed to an increasingly rising debt but also hampered the development of the business sector because banks tended to invest in Treasury Bills, at the expense of risk diversification.

Since 1997, the Central Bank, along with the Government, pegged the Lebanese Lira to the Dollar at the rate of LBP 1507.5 against the U.S Dollar. This parity generated an arbitrage opportunity allowing investors to earn enormous/significant profits through betting on the disparity in the interest rates without being disclosed to the currency risk. As per Poddar et al. (2006), BDL’s monetary policy can be defined by two key objectives: firstly, the disparity between interest rates on foreign-currency deposits paid by Lebanese banks and those on international markets, aiming to increase the financial inflow to cover the deficit and foreign debt, and secondly, the interest rate differential between the Lebanese pound and the US dollar incentivizing LBP deposits. In order to protect the Lebanese Pound, BDL’s high-interest rates policy has resulted in a rising liquidity shortage or tightening on both the government and private sector due to the high costs of funding or rates while deepening the deficit and aggravating the weak fiscal policy. The Central bank performed as a financial intermediary/middleman charging the banking sector massive interest rates while granting the public sector liquidity at a cheaper price. According to Saidi (2020), this policy resulted in cumulative losses for the Central bank valued in April 2020 at over $46 billion and still accumulating.

In 2016, BDL initiated its financial engineering schemes when a swap operation occurred between the Ministry of Finance and the Central Bank, the Ministry of Finance first exchanged $2 billion worth of Eurobonds for the corresponding value of debt in Lebanese lira. In return for fresh dollars, and at an unspecified rate, the Central Bank subsequently marketed the $2 billion Eurobonds to Lebanese banks. The World Bank (2016), warned that this operation may have increased the reserves in foreign currency, however, such practices may worsen the macro-financial vulnerabilities due to, by that time, our weak financial system and an absence of clear economic reforms.

The second financial engineering scheme started in 2017, when banks that deposited USD with the Central Bank were remunerated with a 6.5% interest rate and were entitled to an LBP loan from BDL equivalent to 125% of the initial USD deposit at a 2% interest rate. This same amount can be redeposited at the Central Bank at a 10.5% interest rate.

In March 2019, the Central Bank's loans to commercial banks unexpectedly and sharply plummeted to $14 billion (LL 21 trillion equivalent) after a continual and steady rise from $5.6 billion in January 2017 to $35.4 billion in February 2019. $21 billion worth of loans were erased. This amount is deemed substantial as it surpasses the annual government budget. While claiming that it was done to eliminate the disparity between the Central Bank's assets and liabilities yet, the reason behind this process is unknown but coincided, by that time, with the release of the quarterly financial data of the commercial banks (see Fig. 1).

Zougheib (2020), explored the challenges, and risks faced by Lebanese banks, the author employed the Data Envelopment Analysis (DEA) technique to assess their efficiency, the main findings of this research proved that the government itself poses the greatest threat to Lebanese banking institutions, due to the high level of loans provided to the sovereign, highlighting that it is critical for banks that the state retains control over its resources. At the end of 2019, the commercial banks' assets at the Central Bank were valued at over 60%, while before the introduction of the financial engineering operations, or at the end of 2015, this ratio was around 44%. Hence, it is conspicuous that these schemes have substantially increased the exposure of our commercial banks to the Central Bank. This is a clear indication of the banks’ risk management inefficiencies, as they followed a concentrated investment strategy without diversifying their portfolio, in return for high yields, and while neglecting the private, and productive sectors.

Awdeh (2019), stated that a Central bank can influence economic growth by altering the deployment of credit facilities, especially by inducing and circulating greater capital into business activities to finance the private sector. However, in 2019, around 25% worth of loans were devoted to the private sector using the commercial banks' broad deposit base; approximately 40% of this proportion was allocated to real estate investments (including 19% for mortgages, 16% for construction, and 5% for real estate and rent services), along with 23% and 12% to
finance businesses, and personal loans, respectively. Thus, even for the private sector’s loans, there was not enough diversification, and most of the investments were placed in real estate-related sectors.

In 2019, the deposit base reached 302% of GDP; it reached its peak in 2017. These values are substantially high compared to international benchmarks; however, it was a consequence of the banking system’s overreliance on high remuneration to tempt depositors. The figures above reveal that our banking sector’s deposit base compared to the GDP is among the highest in the world. Additionally, the Lebanese banking sector recorded the highest value of deposits to assets when compared to the international and regional benchmarks. Another wasted opportunity, as if a proper long-term development plan was well implemented, it would have led the whole country and economy to thrive (see Figs. 2–4).

This created an opportunity for the banking sector to finance economic activities and boost economic growth. However, due to investment mismanagement and high-yield policies, as well as an unproductive and inefficient government, have led to the current shutdown in the system. In their study, Moubayed and Zouein (2020), stated that the collected deposits in foreign currency that were placed at the Central bank in return for exceptional profits, resulted in “disintermediation”, increased financial suppression, and raised interest rates on the LBP denominated loans which hindered our economic expansion, and increased the levels of non-performing loans.

As per the latest published data, Lebanon’s Non-Performing Loans as a percent of all bank loans registered 33% at the end of 2020, compared to 15.19% in the previous year. According to the World Bank (2021) Lebanon Economic Monitor (LEM), considering the absence of significant
reforms, a sustained degradation of the consumer loans is anticipated. It is expected that this ratio has increased and will continue to increase owing to several factors but most importantly due to the high level of unemployment affecting the productivity of individuals and eroding their purchasing power.

This level is alerting as in two years it has only surpassed the average NPLs level compared to countries that faced similar banking crises (according to the financial data of countries that encountered comparable banking crises to Lebanon, the Non-Performing Loans Ratio increased on average by 20% throughout an average period of 5.3 years), highlighting the importance of implementing significant restructuring measures. According to Ari et al. (2020), that examined the dynamics of Non-Performing loans during 88 banking crises, mitigating the risks and trying to resolve NPL issues before the downturn are critical for the recovery phase (see Figs. 5 and 6).

Throughout the years, the Central bank collected an adequate amount of foreign currency reserves, in order to maintain the currency peg, reaching nearly $36.77 billion in October 2017, around 75% of our country’s GDP, which was one of the main reasons that increased the confidence in our banking system (Awdeh, 2018). However, the financial system has recorded significant gaps between the total number of deposits and the remaining foreign currency reserves at BDL. Despite the latest decrease in deposits, the system’s gap has considerably widened due to the massive drop in reserves. The remaining reserves reached critical levels, and they are not sufficient anymore to pay back the depositors or to support imports. A restructuring plan is needed to stop the gap without printing additional LBP to
finance the losses, as this will have major consequences on the LBP exchange rate. Confidence in the banking sector must be restored in order to encourage investment and capital inflows (see Fig. 7).

The central bank gross reserves are now close to $15.7 billion, where net reserves are negative, as Banque du Liban owes banks way more than the remaining reserves. At this level, the remaining reserves are referred to as “mandatory minimum reserves” and defined as the 15 percent of deposits required by banks to be held at the central bank. Thus, the first 85 percent has been spent. The role of the mandatory reserves is ostensibly to protect the banking sector from a shock that is similar to the Intra Bank collapse in 1966. Today, every single Lebanese bank is Intra, so they are no longer sufficient to bail out the system. According to the balance of payments report, published monthly by BDL, an average of almost $1 billion per month is walking out of the country from the central bank. If this continues at the same path without making drastic changes in the monetary policies, BDL’s cash reserves will be consumed within 16 months. At that point, we would have to sell gold, which would buy us another, 17 months approximately, based on the value of gold holdings as of the last BDL balance sheet report.

Serious actions must be taken to stop the bleed and restructure the whole banking system in order to ensure an efficient and smooth recovery.

Based on the World Bank’s (2020) latest published data, the graphs clearly show that the banking sector in Lebanon is over-sized compared to the Arab world, MENA Region, and the rest of the world. While the number of branches per 100 K adults has smoothly decreased in the past years, the numbers are still considerably higher than regional and international benchmarks. This implies that the banking sector encounters significant costs that should be readdressed (see Figs. 8 and 9).

The table below points out the high operating costs or cost margins of our Lebanese banks throughout the years. These numbers must be reconsidered, the banking sector must implement significant measures in order to reduce these high costs as it cannot remain operating accordingly especially with the persistent loss of income (see Table 1).

The banking sector has always been one of the key drivers of economic growth, and a vital financing source, particularly in the early phases of economic revival, especially through its ability to gather deposits, grant loans to customers, finance important

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Fig. 7. Reserves excluding gold v/s foreign currencies deposits (Million of USD) - May 2021.

Fig. 8. Commercial banks branches per 100,000 adults.

Fig. 9. Automated Teller Machines (ATMs) per 100,000 adults.
business activities such as agriculture, and industry, and many more, and their figures can be significant to track the economic growth. However, by checking the numbers of our banking sector, represented in the table above we can clearly perceive a severe drop-down in financial performance, highlighting the effect of the crisis that started showing in the financial figures of 2019 (see Table 2).

The capital adequacy ratio, which measures the bank’s capital with respect to its risk-weighted and credit exposure, slumped from 17.8% in 2018 to 10.28%. This decrease is alarming as it denotes a higher risk of failure. A similar metric is the equity-to-asset ratio that fell to 8.43% in 2019, down from 9.6% to 8.9% in 2017 and 2018. The capitalization metric also referred to as the financial leverage ratio, measures how far an institution operates on its equity. In the case of our banking sector, it increased from 10.5 times in 2017 to 10.85 times in 2018, reaching 11.52 in 2019. Higher financial leverage is alarming as it aggravates the risk of insolvency (see Fig. 10).

Two of the most important profitability and return measures used are the return on average equity and average assets. The ROAE which measures the firm’s performance to its average outstanding shareholders’ equity, unfortunately, came negative; it registered −8.3% in 2019, way below international benchmarks as the MENA region average in 2018 was 11.6%, emerging markets 15.3%, and worldwide 13.7%. Simultaneously, the return on average assets of the Lebanese banking sector, which measures how productive a company is with the resources it has, reached 0.72% in 2019, compared with an average of 1.6% for the MENA region, 2.0% for emerging markets, and a worldwide average of 1.7%. Undoubtedly, the repercussions of the prevailing financial crisis started to be portrayed through the figures of 2019, as the key metrics came negative and way below the international benchmarks (see Figs. 11 and 12).

The total number of banks operating in Lebanon is 61, divided between 44 commercial banks, 14 investment banks and 3 specialized banks. Our banking sector heavily relies on commercial banking with a limited focus on investment banking that could be used efficiently to manage the banks portfolios and generate a reasonable income. Even, most of those divisions of the existing investment

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### Table 1. Management efficiency of Lebanese banks (2019).

<table>
<thead>
<tr>
<th>Year</th>
<th>Cost per average branch (US$ million)</th>
<th>Stair expenses per average staff US$ 000s</th>
<th>Staff expenses to general operating expenses (%)</th>
<th>Cost to income (%)</th>
<th>Cost to average assets (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>2.01</td>
<td>45.8</td>
<td>54.6</td>
<td>49.7%</td>
<td>1.51%</td>
</tr>
<tr>
<td>2013</td>
<td>2.10</td>
<td>48.4</td>
<td>55.6</td>
<td>51.8%</td>
<td>1.5%</td>
</tr>
<tr>
<td>2014</td>
<td>2.18</td>
<td>51.3</td>
<td>56.4</td>
<td>51.5%</td>
<td>1.48%</td>
</tr>
<tr>
<td>2015</td>
<td>2.19</td>
<td>50.7</td>
<td>55.8</td>
<td>50.3%</td>
<td>1.44%</td>
</tr>
<tr>
<td>2016</td>
<td>2.56</td>
<td>54.0</td>
<td>52.1</td>
<td>44.3%</td>
<td>1.59%</td>
</tr>
<tr>
<td>2017</td>
<td>2.46</td>
<td>53.3</td>
<td>54.5</td>
<td>48.3%</td>
<td>1.4%</td>
</tr>
<tr>
<td>2018</td>
<td>2.38</td>
<td>53.6</td>
<td>56.5</td>
<td>50.48%</td>
<td>1.26%</td>
</tr>
<tr>
<td>2019</td>
<td>2.23</td>
<td>49.7</td>
<td>55.7</td>
<td>52.19%</td>
<td>1.20%</td>
</tr>
</tbody>
</table>


### Table 2. Lebanese banking sector growth rates.

<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>8.4%</td>
<td>11.4%</td>
<td>8.8%</td>
<td>13.4%</td>
<td>NA</td>
<td>7.6%</td>
</tr>
<tr>
<td>2013</td>
<td>9.6%</td>
<td>15.1%</td>
<td>9.6%</td>
<td>8.5%</td>
<td>NA</td>
<td>0.2%</td>
</tr>
<tr>
<td>2014</td>
<td>9.3%</td>
<td>11.0%</td>
<td>8.5%</td>
<td>10.8%</td>
<td>NA</td>
<td>9.1%</td>
</tr>
<tr>
<td>2015</td>
<td>4.8%</td>
<td>5.6%</td>
<td>4.5%</td>
<td>6.9%</td>
<td>NA</td>
<td>6.9%</td>
</tr>
<tr>
<td>2016</td>
<td>5.9%</td>
<td>2.0%</td>
<td>3.6%</td>
<td>9.9%</td>
<td>NA</td>
<td>12.6%</td>
</tr>
<tr>
<td>2017</td>
<td>6.8%</td>
<td>2.3%</td>
<td>3.3%</td>
<td>6.6%</td>
<td>NA</td>
<td>4.3%</td>
</tr>
<tr>
<td>2018</td>
<td>7.8%</td>
<td>−3.8%</td>
<td>2.0%</td>
<td>0.4%</td>
<td>NA</td>
<td>−5.0%</td>
</tr>
<tr>
<td>2019</td>
<td>−11.2%</td>
<td>−16.5%</td>
<td>−6.7%</td>
<td>−15.8%</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>


![Fig. 10. Capitalization metrics.](image-url)
banks are inactive in Lebanon, and many potential services that could increase the banking sector’s return on investment could be introduced within the new banking model as they could play a leading role in the upcoming era, creating a strong recovery potential for the Lebanese banking sector.

Numbers confirm that banks’ incomes are mostly generated from commercial banking activities with around 86.4% of their revenues classified under interest and fee income. This shows that a lower weight is given to investing activities, as high-interest rates environment attracted the banks to fully invest in the public sector. This structure should be reconsidered and more diversification is required to enhance the sector’s risk–reward profile (see Fig. 13).

3. Methodology

After addressing the inefficiencies of the banking sector compared to international and regional benchmarks, restoring confidence in the banking system is crucial to rebuilding our nation and economy. Banks must hasten to implement a significant restructuring agenda ensuring an equitable distribution of losses among economic agents, build new business models, and take advantage of the upcoming period and as per our analysis three main areas must be tackled including, cost reduction, liabilities management, and income generation. Thus, in the upcoming part, we will elaborate a detailed restructuring proposal addressing the topics mentioned above.

4. Results and discussions

4.1. Cost reduction

There is a broad consensus about the downsizing of the banking sector as the number of existing banks is high. A smaller banking sector in a smaller economy would undoubtedly result in some improvements. It is achievable through mergers, which will be performed by introducing new legislation under the Central Bank guidance. According to the authorities and analysts, the banking sector must be halved or reduced by 50%.

Nonetheless, the main determinants of the size of the banking sector are the business environment, market behaviors, economic circumstances, and the rivalry among banks, not the government. In addition to the economic downturn, the banking sector is currently influenced by several market factors, such as the deterioration of the deposit base and the number of loans allocated to the private sector, but most importantly, the loss of confidence in this sector. These drivers will force banks to assess which scenario brings more value to their institutions along with the central bank’s intervention, whether by merging with other banks or leaving the market. Thus, will contribute reasonably to identifying the sector’s size.

In addition to the size of our banking sector, the number of branches is considerably high compared to other regions. In picking up a practical analysis with a detailed statistical analysis, it shows that the number of branches in Lebanon is comparable to other developed banking systems. Therefore, the opportunity to reduce the number of branches is essential (see Fig. 11).
to the country's size, which engenders higher operating costs. One of the cost-cutting measures and a helpful way to reduce these unwanted expenses is to evaluate, and pare down inefficient branches to cope with this turmoil, strengthening banks’ revenues, and improving their capital. As mentioned previously, the number of branches per 100 k adults is approximately 22 branches in Lebanon, which is substantially high. Therefore, it must be reduced by a minimum of 50% to meet international standards and benchmarks. Instead, banks need to reduce physical branches, expand their digital products and services, such as online accounts, and shift towards intelligent branches. When reaching a low margin, these digital technologies play a major role in ensuring long-term sustainability through an efficient cost management strategy.

Moreover, the overwhelming number of personnel and their allocated benefits negatively affect the banking system’s overall operational costs. Hence, to increase the sector’s efficiency, unlock cost savings, and minimize expenditures, this number must be reconsidered by reducing staff and their benefits while preserving and seeking talented employees, to help their institutions to succeed and generate higher revenues. Nonetheless, these actions can be seen as a double-edged sword as they may generate unfavorable outcomes by increasing unemployment rates and impeding the productivity and efficiency of the remaining employees. This economic downturn highlighted the importance of improving our reliance on digital channels in the banking sector and investing more in technology at the expense of people, branches, and real-estate as if employed efficiently; it is a powerful way to cut down on staffing costs (see Fig. 14 and 15).

A study done by McKinsey & Company in 2019, on the US banking sector revealed that banks that reduced the workforce significantly and maintained only talented and competent teams were well-positioned and more prone to prosper. A fast fall in the number of employees (red line of the first graphic) generates a 39% growth in sales (red line of the second graphic). Lebanese banks must take similar proactive steps, such as keeping only able employees, in order to maximize future income.

Thus, undoubtedly technology holds the key to reducing the overall operational costs and margins. Automation is the key to successful outcomes by targeting banking services and making effective use of the prevailing technologies. This could lead to optimal implementation of cost management strategies, as closing branches and reducing staff solely is insufficient. This is achievable by tackling different areas such as improving online banking and encouraging its use instead of branches and call centers, and expanding the number of “e-branches.” The shift towards intelligent branches, when appropriately performed, has favorable outcomes on the bank’s overall efficiency. Besides reducing real-estate requirements and ownerships, banks can offload basic transactional activities from employees, leading to pruning the workforce, avoiding new recruitment without influencing the overall business activity, and still offering the same services and maintaining their customer base (see Fig. 16).

According to a study published by McKinsey & Company in 2018, e-branches can strengthen the branch’s performance from 60% to 70% in terms of cost-cutting and higher turnover. Given that traditional units have the highest levels of operational expenditures, this shift's influence is reflected positively in significant areas; mainly, by delivering a

![Fig. 14. Branch staff per 1000 active customers.](image1)

![Fig. 15. Total core sales per branch staff, indexed to 2015.](image2)
higher level of sales, diminishing the overall cost per branch, and boosting profit.

4.2. Liabilities management

As mentioned in the first part of this study, 75% of the banking sector's portfolio is invested in the Central Bank, which the latter used to finance the sovereign's obligations. Thus, since the government defaulted, the Central Bank and Lebanese banks must undertake serious measures:

BDL must declare an aggressive restructuring plan portrayed through a severe haircut on banks as we can no longer bend the unvarnished truth, which may be hard to believe for the Lebanese, but is undoubtedly crucial.

As per our numbers, and according to the Central Bank’s latest published data, deposits in foreign currencies account for approximately $107.874 billion as of May 2021. In parallel, there are around $15.708 billion of foreign currency reserves in cash and $5 billion securities that are not liquid, resulting from the participation in the financial markets. The banking sector cannot sustain in a system where the Central Bank has $107.874 billion liabilities, and its existing foreign currency reserves are no longer liable to cover these obligations (see Table 3). Serious actions need to be taken to cease this severe gap without printing more LBP, as this will cause an additional devaluation of the local currency, and which will lead to a major spike in the inflation rate. Therefore, as mentioned previously, the Central Bank should announce a significant haircut on banks by 60–70% as per our suggestion. This percentage might be aggressive, but this is the only way to halt this disparity in order to meet the existing liabilities as numbers become more reasonable.

Banks accumulated significant profits through high yields for the past 30 years. However, this investment strategy proved to be abortive and ineffective in the long run. Therefore, they should bear responsibility and handle the losses by accepting this step (see Fig. 17).

By applying a haircut of 60–70%, we shall be able to lessen or cease the gap between the Central Bank’s liabilities and the remaining foreign currency reserves. In this case, numbers become more reasonable, which in turn will attract foreign investors, as a deleveraging cycle is deemed to be a great time to reinvest and create new investment opportunities. The remaining foreign currency reserves should not be used either to cover losses or to carry on with the subsidies programs. Instead, this amount should be well deployed by investing in diverse financial activities that will lead to a higher expected return in the future (that will be discussed later). This generated return will be used to pay back the remaining amount of the liabilities/deposits. The investment plan should reflect a new vision or strategy to improve the banking sector’s performance by meeting international standards.

As we know, in Lebanon, we suffer from low standards of transparency. Therefore, data are not widely accessible nor published regularly. However, the latest data concerning the distribution of the deposits by tranches were published back in January 2020. We applied these ratios to the current value of the foreign currency deposits provided by BDL as of May 2021. These estimations might not be entirely accurate but could be used to initiate a preliminary restructuring plan.

The Central Bank must announce a standardized liability restructuring program that includes: an aggressive haircut of 60–70% on banks, a standardized haircut and deposits restructuring plan, and a mandatory capital raise that should be well deployed to re-boost the financial system. Following the suggested Central Bank's haircut decision, the banking sector will be automatically split into two categories. A limited number of banks can approve BDL's measures and will be

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2 As per some economic experts, these numbers provided by the Central Bank of Lebanon might be inflated. However, in this study we will base our suggestions on BDL's provided data.
willing to remain operating. However, we expect that 60–70% of banks become insolvent or declare bankruptcy as most of them cannot tolerate such decisions. Therefore, the government takes their ownerships and merges them all, resulting in having one single public bank. Furthermore, the government must follow the same standardized plan to compensate defaulted banks’ depositors. This will be reflected positively on the banking sector by reducing its size.

Below, you will find a detailed explanation of the suggested standardized plan based on deposits distribution by tranches\(^3\)\(^4\) (see Fig. 18):

### 4.2.1. Accounts below $100,000

These accounts constitute about 91% of the depositors. The haircut is not imposed on these accounts; the bank is required to repay these obligations fully, 30% of the amount will be settled in the dollar (around $4.757 billion), and the remaining

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\(^3\) These numbers are based on the analyst’s suggestions and must be revised based on actual data.

\(^4\) For simplicity, one haircut on each tranche was suggested, while in practice, it is more credible to apply a progressive haircut, as it is more equitable for depositors.
amount in LBP at a specific rate and with certain limits to prevent the devaluation of the currency. The payments will occur in multiple installments over a determined period of 5 years with no grace period.

4.2.2. Accounts between $100,000 and $1,000,000

They are around 7.61% of the depositors valued at $39.158 billion. Several measures must be applied, starting with capital control to limit the inequitable foreign currency outflow. Moreover, these funds are subject to a 60% haircut, reducing their value to approximately $15.663 billion that shall be paid in several increments over 10 years with 2 years grace period.

4.2.3. Accounts above $1,000,000

These are high net worth individual investors, constituting approximately 0.84% of the overall number of depositors. These investors are supposed to be knowledgeable and educated but were still willing to take this high level of risk and made considerable profits. The bank must apply a minimum haircut of 80% that way, the value of deposits will be reduced from $52.858 billion to approximately $10.572 billion paid over a period of ten years with 2 years grace period.

Thus, over ten years, along with two years of a grace period, the banking sector’s and government’s liabilities in foreign currency will be around $30.992 billion. As mentioned previously, the existing foreign currency reserves should not be used to finance these obligations. Instead, sustainable banks must compensate depositors using the returns earned through their new investments and financial activities (that will be elaborated in the following part). In addition, the government must reimburse these obligations from its investment in a pool of assets (electricity, oil, and gas if available, Casino du Liban, etc.) that was widely discussed in our previous study published in May 2020, entitled “The Economic and Financial Crisis in Lebanon: Major Problems and Reform Plan.” Note that deposits will be reimbursed after the haircut and no interest shall be paid.

The implementation of this strategy will contribute to the revival of the banking sector, which will attract foreign investors and create investment opportunities in the country.

4.3. Income generation

As mentioned previously, over approximately the past three decades, our banking system was geared towards conventional banking activities. Lebanese banks worked as intermediaries (convenient places to stash and retrieve cash). Tempting clients with high yields, banks created a society with an over-reliance on the traditional banking activities satisfied with the easy and quick cash generated while neglecting risk alternation and diversification. Which, if were taken into consideration, we could have avoided the prevailing crisis.

The Banking sector has to learn from past missteps by expanding its services portfolio to diversify the risk and prevent future comparable crises from regaining investors and customers' confidence while generating a new source of income to compensate old depositors and thrive again. Nonetheless, as mentioned previously, the imposed capital raise and the remaining amount of foreign currency reserves must be invested and deployed to reshape the banking sector to meet international standards and not cover losses.

One of the most efficient ways is to reimagine the banking sector’s structure by introducing new divisions granting us access to international capital markets like investing in equities, fixed income, and derivatives markets and including structured products while emphasizing their importance. To achieve that, banks have to enhance their dealing rooms, especially since banks are already well-equipped but do not efficiently use their investment resources. Additionally, banks should invest in diversified banking activities such as private equity, venture capital, investment banking, real estate, and corporate banking to enhance the risk–reward profile. In the following part, you will find a proposal of the new banks’ structure and their divisions according to the international banking sectors standards.

Our proposed banking structure consists of switching to “Universal Banking” that merges traditional commercial banking services along with investment banking services into a single establishment. The old banking model created a society with excessive dependence on conventional banking activities while neglecting the importance of investment banking activities. Investment banks are gates to financial markets, and a blend of advanced, well-evolved, and established investment banks, along with various profitable products, not only increase the institutions’ return but significantly contribute to the overall economic growth, especially, by increasing liquidity in the market (see Fig. 19).

Additionally, one of the alternatives to compel the banking sector to improve its business models and adopt new digital developments is to invest in FinTech. These are tech companies that present financial products and services. Throughout the years, global FinTech investments have expanded
rapidly and vastly. It grants clients the capability of managing their accounts remotely, starting from simple services such as transferring payments via their smartphones to loan applications through a video conference. Reputable banks and financial companies around the globe tend to invest in these technologies to lower their cost, increase their profitability, and, most importantly, expand their client base.

Below you will find Figures from advisory company KPMG revealing that global FinTech investments registered $105.3 billion in 2020 with a total of 2861 deals (see Fig. 20):

Another way to generate considerable income is by shifting towards algorithmic trading and artificial intelligence, which have been growing dramatically in recent years; financial institutions employed them to obtain an advantage over other market participants. These emerging technologies and the extensive use of automation are considerably improving firms’ operational costs, along with their client satisfaction. Algorithmic trading has proved to generate higher income than manual trading along with lowering the number of personnel and the overall cost.

Hence, we can affirm that our economic recovery must be defined by a prolonged period of development of the economic and business activity especially by creating new investment opportunities. The banking sector must play a crucial role in
financing these investments to contribute to their success. This highlight and emphasizes the idea that the imposed capital raise should be well deployed and put in the right place to reshape our economy and prosper.

Below you will find the estimated average annual return on equity per business segment as per JPMorgan Chase (see Table 4):

As per our plan, you will find below an estimation of our banking system’s return vs. its liabilities in the following part.

Banking Sector’s Liabilities in billions of USD if the suggested plan is applied:

The table above represents the banking sector’s obligations in foreign currency over twelve years, including two years of grace period if the suggested plan is implemented. The first two years, Lebanese banks owe depositors $0.9514 billion (represents their obligations to depositors having less than $100,000 solely), the following three years, the banks’ liabilities increase to reach $3.5749 billion (as the grace period of the accounts having between $100,000 and above ends). Until the end of the plan’s timeline, the banking sector’s liabilities will become $2.6235 billion. This amount decreases starting from the 6th year as depositors having less than $100,000 will be fully compensated (see Table 5).

According to our analysis, the banking system needs a minimum of two years to kick off. Thus, the first two years’ obligations will be reimbursed using the existing required reserves, which is around $15.708 billion (as per BDL’s publications) along with the amount generated from the mandatory capital raise; we assume the banking sector was only able to raise $3 billion. Therefore, the remaining reserves, along with the capital raise account for around $18.708 billion, is the source to finance or settle the first two years’ liabilities; we have to deduct them from the prementioned value. The remaining amount, which is around $16.805 billion, represents the estimated capital to be deployed and invested in the banking sector in order to meet international standards.

The suggested plan is split into two phases, the pre-operating, and implementation phases. The banking system needs time to thrive and revive again. Therefore, in the first two years, that are part of the pre-operating phase, banks will only encounter and settle losses. Then, following these two years, a new banking model will be fully implemented through the efficient and rational use of the previously mentioned capital deployment which is around $16.805 billion. By then, the banking sector will begin to repay its liabilities using the revenue generated from its new investments while preserving additional profits from the third year until the end of the suggested plan.

Below you will find two tables revealing the estimated annual return and P&L if this plan is implemented based on two scenarios:

Scenario I: The Banking sector’s estimated annual return and P&L in billions of USD if the profit is reinvested (see Table 6):

Based on international numbers, the expected average annual return is around 22.34%, which was used along with the estimated capital to be deployed in the banking system to calculate the sector’s average cumulative yearly return.

The banking sector’s estimated P&L between the third and the fifth-year renders between $0.1797 billion and $0.2288 billion. Starting from the 6th year, the estimated profits increase as the account below $100,000 will be fully compensated to reach around $1.4565 billion at the end of year twelve.
Table 6. The Banking sector’s annual return and P&L if the profit is reinvested (in billion of USD).

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<td>Total liabilities</td>
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<td>P&amp;L (in $ billion)</td>
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<td>$−0.9514</td>
<td>$0.1797</td>
<td>$0.2198</td>
<td>$0.2288</td>
<td>$1.1822</td>
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<td>$1.4558</td>
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Table 7. The banking sector’s estimated annual return and P&L if the profit is not reinvested (in billion of USD).

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Scenario II: The banking sector’s estimated annual return and P&L in billions of USD if the remaining profit is not reinvested (see Table 7):

The same method is applied as the previous table but what differentiates it is that the profit is not reinvested or cumulative. The expected average annual return (22.34%) was employed along with the estimated capital to be deployed in the banking system to compute the sector’s average yearly return, which amounts to $3.7546 billion.

The estimated profit between year 3 and year 5 is around $0.1797 billion. As of the 6th year, the banking sector’s yearly profits reach approximately $1.1311 billion till the remainder of the plan’s duration since, as mentioned previously, the account below $100,000 will be fully reimbursed.

Disclaimer

Due to the low transparency standards and the lack of published data, the numbers employed in this study are based on the available secondary data as well as our estimations. The provided restructuring plan is based on the latest data provided by BDL and should be reconsidered when adopting the plan based on accurate available data, and the banks should conduct a complete feasibility study to check the best areas to invest in to attain the ultimate goal outcomes.

5. Conclusion

According to the latest World Bank Lebanon Economic Monitor (LEM), Lebanon is sinking, and its economic and financial crisis is possibly to rank in the top 3 most severe episodes since the mid-nineteenth century. Therefore, the USEK Business School Student Chapter took the initiative to develop a new business structure that could restore confidence in the banking sector and generate reasonable income in the upcoming period, especially in these existential moments.

The study proposes a banking sector restructuring plan encompassing three main areas. A cost reduction area that recommends downsizing the banking sector, reducing the number of branches and labor costs as well as moving towards e-banking. A second area that covers liabilities management, proposes an aggressive haircut decision and the distribution of deposits in foreign currency by tranches. And a last and very important area that can increase the banking sector’s return on investment, income generation. This area calls on re-imagining the banking sector as well as its structure by defining a new banking model and introducing new divisions, granting us access to the international capital markets, derivatives markets, and structured products.

According to our suggested plan, and analysis, the banking sector needs time to thrive again. The pace at which the banking sector recovers is determined by the readiness to handle the situation rapidly, and efficiently deploy capital. Briefly, the proposal is divided into two phases, the pre-operating phase that duration is two years where banks are only required to cover and reimburse their obligations, following this phase, using the capital raise that shall be well deployed for the integrating of a new banking model, and starting from the third year till the end of the suggested plan the banking sector will begin repaying its creditors through the income generated from its new investments while retaining additional earnings. Thus, solutions exist and small depositors shall be protected, however, bold actions and thoughts are needed.

In conclusion, any business model for any new division or area to be implemented must include a full business plan and a feasibility study. The banking system needs time and will encounter and
settle many losses at first. Only a reform minded government, which embarks upon a credible plan toward financial and economic recovery, while collaborating with all stakeholders, can revoke further sinking of Lebanon.

Conflict of interest

No conflict of interest only disclaimer as stated previously.

References


