

Lebanon

Expedited Project Law on Temporary Controls on Services and Operations of Banks Technical Comments

Thank you for requesting our views on this draft law (DL). We recognize that this DL aims to formalize and resolve several critical aspects affecting the current state of transactions in the banking system, in particular those related to safeguarding the banking system, to protecting depositors, and preventing discrimination in their treatment. While we provide comments on the specific provisions of the law, it is difficult to assess the merit and overall impact of the DL without the context of a comprehensive macro-economic reform plan (such as the "Lebanese Plan") that would allow us to see how these provisions fit in the overall strategy to address current macroeconomic imbalances, debt sustainability and financial stability.

Overview

It is difficult to assess the macroeconomic impact of this DL without an understanding of the macroeconomic framework and other policies and reforms that would support it. In particular, it is unclear whether this DL would intensify or ease the current de facto restrictions related to current account and capital transactions. It is also unclear what future exchange rate regime would guide such transactions and how the provisions in the DL would affect the supply and demand for foreign exchange and the balance of payments in general, as well as how this DL would fit with a strategy that restructures and resolves the banking system. Specifically:

- ***The current DL appears to formalize the existing de facto restrictions; however, it still leaves a number of critical aspects unclear.*** Several provisions would continue to rely on individual banks' discretion, while at the same time, the DL does not appear to regulate banks' transactions on their own account, with potentials for foreign exchange leaks.
- The DL would de facto eliminate withdrawal limits on domestic currency (DC) (Art.6), while preserving those in foreign currency (FC). ***This would likely result in a significant and sustained depreciation of the parallel/bureau exchange rate or***

further repression in this market.

- Several provisions (Art.5, 6, and 7) indicate that withdrawals and conversions from FC to DC and payments of consumer and mortgage loans would be done on the basis of a "market-determined exchange rate" but up to a maximum, which seems likely to be determined by commercial banks (unspecified in Art 10). Recent attempts to restrict transactions in the bureau market--to set an exchange rate (by declaring a 30 percent premium) and to impose certain sanctions on illegal traders-- have de facto paralyzed such market and thus limited any scope for a market-determined exchange rate. ***In current conditions, these provisions would leave considerable discretion to commercial banks, exacerbate the lack of a well-functioning and transparent parallel market, and risk discriminating against depositors, particularly small and medium-sized ones (more below).***
- ***Plans for a future exchange rate market are critical to assess the impact of this DL.*** For example, creating a unified foreign exchange market for all current account transactions would require other measures to complement this DL, including regarding the fresh funds.

Against this backdrop, it will be important to consider the consequences that this DL would have on inflation and the exchange rate, as well as on macro-economic and financial stability.

Further Technical Comments

An Institutional View on Outflow Controls

The Institutional View (IV) provides the framework for Fund policy advice on the liberalization and management of capital flows. According to the IV, capital outflows should generally be handled with macroeconomic and financial sector policies. Capital flow management measures (CFMs) on outflows may be useful when a balance of payment or financial crisis is imminent to support a broad macroeconomic adjustment package and provide breathing space until the policy adjustments take hold, but they should not substitute for warranted macroeconomic adjustment. Since it is not clear from the draft Law whether the measures to be introduced that are designed to restrict capital outflows (i.e., CFMs) aim to support the necessary macroeconomic and financial sector policy adjustment or substitute for them, we are not in a position to advise the authorities on whether the measures would be considered appropriate under the IV.

While outflow controls should generally be broad-based (cover all transfers abroad), they should also be tailored to country-specific circumstances.

Providing such tailored advice is difficult in the absence of sufficient information on the macroeconomic and financial sector policy adjustments that will be implemented to address to root causes of the crisis. Thus, our comments make general observations and raise concerns about some of the provisions without necessarily being able to point out possible other more appropriate measures.

Financial stability

Internal transfers and bank liquidity. Allowing withdrawals of Lebanese pounds and freeing domestic transactions and transfers of funds between banks could result in substantial flows of funds to banks perceived as being stronger. The authorities should monitor for this risk and have contingency plans ready for possible illiquidity in some or several institutions. If this risk is perceived as substantial, a more cautious approach to liberalization may be more appropriate.

Prioritization of import payments

We have several concerns with the provisions in Article Four, Section 5 giving priority of transfers for selected imports. As a general point, while such a measure might be needed temporarily under specific circumstances, it is distortionary, and we

note that once the exchange rate reaches a market clearing level for current transactions and the controls on capital transactions are adequately enforced, such prioritization becomes unnecessary.

- **The provision is unclear and gives excessive scope for interpretation and discretion.** For

instance, there is no definition of "basic foodstuff" or "primary commodities for agriculture". It is critical to ensure that a measure as drastic as prioritization of import payments is targeted, clear and transparent so that it can reach its objectives. Further, the possibility to make ecommerce payments with credit cards without qualifying the imports seems to be inconsistent with the objective.

- **The measure distorts incentives, which can widen the spread between the official and parallel market exchange rates, especially when prioritized payments have access to a preferential rate.** Prioritization may inflate demand for import payments as residents attempt to take advantage of the spread by over-invoicing imports or forging documents for priority imports and selling the foreign currency in the parallel market.

- **The banks' liquidity or foreign currency positions may be negatively affected.**

The requirement for banks to allocate foreign currency for prioritized imports equal to 0.5 percent of their total deposit volume in all currencies creates the following concerns:

- It is not clear from the provision how this requirement will operate or be monitored, for example, if banks need to meet this limit every day, or on average over a week or a month.
- From an operational perspective it is unclear how banks can ensure that there will be priority import payment demand at least up to the threshold set in the provision.
- Requiring banks to provide foreign currency up to 0.5 percent of their total deposits for certain purposes may create currency and liquidity mismatches beyond the permitted prudential limits exposing the banks to exchange rate and liquidity risks. Such requirement should anyway be subject to banks' compliance with sound credit underwriting processes and prudential requirements.
- Finally, banks have no discretion in managing deposits that are designated "free funds". Hence, the requirement to include free funds in the base for calculating the 0.5 percent requirement further increases banks' balance sheet risks and may be

unnecessarily onerous.

"Fresh funds"

The proposed treatment of fresh money may increase incentives for converting pounds to foreign currency further widening the spread between the official and the parallel market rate, unless these are unified at market clearing level.

Depositors will be able to withdraw pounds from their account and buy foreign exchange in the parallel market (albeit paying the spread between the official and parallel market rates) and deposit the proceeds as fresh funds, or transfer the funds from abroad as fresh funds. This possibility may increase demand for converting pounds to foreign exchange and thus put pressure on the exchange rate.

The definition of fresh funds should be clarified. Art.3, First point, states that fresh funds are transfers from abroad *and* foreign exchange deposits that banks received after the cutoff date. It is not clear whether a transfer of funds from another domestic bank would be counted as "deposits received" and therefore fresh funds, regardless of original deposit date of the funds. This gives rise to the potential problems noted below.

Enforcement actions against potential circumvention may be difficult. If depositors are free to make transfers of foreign currency deposits within the domestic financial system and such transfers are considered fresh funds, customers may undertake large transactions (e.g. purchase of land or property) and the seller of the asset record the funds received as "fresh funds", granting them immediate full access. Without strict controls and detailed information, such transactions could be fabricated (e.g. with a commitment to reverse the transaction or match with a similar one in the other direction) simply in order to gain free access to funds to remove them from the financial sector.

Banks may become unable to meet withdrawal and transfer demand if all funds deposited since November 17, 2019 become fresh funds. The draft Law permits the free use of foreign currency funds deposited in the banks after November 17, 2019, if the use of these funds is currently restricted. Unless the banks have sufficient liquidity to provide foreign currency for the potentially large withdrawals (transfers abroad) once the current restrictions are lifted, they may become unable to service their clients, potentially triggering a bank run. This provision should be considered in light of the banks' liquidity position to avoid that withdrawals become destabilizing.

If the motivation for allowing the free use of new foreign currency inflows is to

attract new FDI or other investments, the measure is unlikely to be successful. The current provisions in the draft Law permit only the transfer abroad of the amount originally deposited; any proceeds such as interest or dividend if the funds are invested in stocks remain restricted reducing the attractiveness of the investment.

Proposed limits and restrictions

Proposed transaction limits look comparatively high. While the appropriateness of the limits proposed in the draft law is difficult to assess in the absence of information on the macroeconomic context and the banks' liquidity, we note that similar restrictions imposed much lower limits in other crisis countries at the time when CFMs were introduced. In Cyprus, individuals were allowed to transfer funds abroad without supporting documents up to €2,000 a month per person per credit institution; a limit of €5,000 a month per person applied on credit card transfers abroad, and a limit of €5,000 a quarter for student living expenses on the basis of supporting documents. Individuals could transfer the cost of medical treatment and tuition fee for study abroad without limitation. In Greece, depositors were allowed to transfer €500 abroad without documentation up to a monthly limit set for the banks, all other personal transfers were subject to the authorities' approval. In Iceland, an initially high limit was reduced to an annual limit of ISK 3 million for donations, gifts, students' living expenses, and other similar transfers.

Depending on the severity of the circumstances, prepayment of existing external loans may need to be restricted; however, the consequences should be carefully considered. In the context of depreciation expectations, borrowers may decide to prepay foreign currency denominated external loans to mitigate exchange rate risk. Hence it might be worth considering whether prepayment of existing external debt be limited. We note that such a limitation may give rise to an exchange restriction subject to Executive Board approval if the loan contract permits prepayment.

Impact on banking resolution and insolvency proceedings

The impact on the Draft Law on any prospective bank resolution or insolvency proceedings should be carefully considered. The Draft Law and its implementation modify the financial relationships between the banks and its creditors and debtors. Should concerns arise about the viability of banks in Lebanon and if a bank becomes

subject to a resolution or insolvency proceeding, the application of a Law that permits or restricts certain transactions will have an impact on the treatment of the bank creditors. As it is not clear how the measures introduced in the Draft Law are linked to any restructuring strategy of the banking sector, it is difficult to envision the implications of the draft Law on any bank resolution or insolvency proceeding which may be commenced after the entry into force of the Draft Law, and to fully understand the associated legal risks.

Treatment of bank transactions on their own account

The scope of the Law seems unclear, especially in relation to transactions that banks can enter on their own behalf, and whether there are some prudential measures contemplated. The reading of several articles in the Law (Art. 2, Art. 4, and Art. 7) indicates that the purpose of the Law is to regulate transfers abroad for personal, business, education, economic, trade, industrial, agricultural, medical, and technological reasons. Yet there is a question whether the Law covers transactions made by the bank itself. For instance, can a bank buy financial instruments and securities abroad, including also in view of issues associated about liquidity and risk management? Additionally, the prudential requirements, such as capital requirements and investment limits, also may have implications on transactions by banks.

Removal of measures

Removing withdrawal restrictions from foreign currency accounts will be difficult and may take longer than anticipated. The draft Law seems to limit transfers abroad and withdrawals in foreign exchange from foreign currency accounts. While the calibration of the measure is not specified in the draft, it is worth considering that any limitation will result in contingent liability with respect to bank liquidity and the exchange rate as long as it exists. Thus, the removal of these limitations would need to be carefully planned and implemented to avoid the potential financial stability and macroeconomic consequences of a sudden surge in withdrawals once the restriction is lifted.

Documentation requirement

The documentation requirements should be made more specific. Transfers will be verified by banks to ensure that only permitted transfers are executed. To ensure an

evenhanded treatment of all transactions across the banking sector the specific documentation requirements should be explicitly detailed in a publicly available circular or other adequate legal instruments.

Jurisdictional concerns

The draft Law appears to impose restrictions on current account transactions that are inconsistent with Lebanon's obligations under the Articles of Agreement. The proposed law, once adopted, gives rise to exchange restrictions inconsistent with Article VIII, Section 2(a) of the IMF Articles of Agreement because, as we understand it, it provides for a direct governmental limitation on the making of payments and transfers for current international transactions including trade related cross-border payments, remittances, and some debt payments.¹ Specifically, Article 4 includes hard ceilings on certain invisible transactions (including tuition fees, living expenses, and medical expenses), does not allow for repatriation of certain investment income (e.g., remittances of profits, dividends, or interest); does not allow for the payment of debt entered into after this law becomes effective, and mandates that banks prioritize import payments by allocating a certain amount for essential imports.

- The draft law provides for several hard limits which inhibit making of payments and transfers for current international transactions, but does not specify whether bona fide requests beyond these limits can be approved. If this were possible, what is the criteria for approval?
- If this law is passed with exchange restrictions inconsistent with Lebanon's obligations under Article VIII, Section 2(a), the authorities can request the temporary approval. The Executive Board may decide to temporarily approve the retention of exchange restrictions if the following 3 criteria are met: (i) It is temporary (this is usually evidenced with a timetable for removal within a relatively short period, usually one year); (ii) it is non-discriminatory (among members); and (iii) it was adopted to address a balance of payments problem.

¹ [https://www.imf.org/external/SelectedDecisions/Description.aspx?decision=1034-\(6/27\)](https://www.imf.org/external/SelectedDecisions/Description.aspx?decision=1034-(6/27)).

Anti-money Laundering/ Combating the Financing of Terrorism (AML/CFT)

Mention is made in Art. 2 of international AML/CFT legal requirements; however, the draft law does not contain any further provisions relating to AML/CFT. While the international Financial Action Task Force (FATF) standards do not contain requirements or prohibitions to restrict the flow of cash or foreign exchange, if countries decide to implement such restrictions, then the international FATF standards require that countries mitigate AML/CFT risks that arise from the introduction of such measures (FATF Recommendation 1, and FATF Immediate Outcome 1, and related Recommendations and Immediate Outcomes).² These mitigating measures differ from country to country, depending on the risk and context of each country. However, without such mitigating measures (included in this draft law), Lebanon's ML/FT risks and vulnerabilities may increase. Moreover, in addition to these possible increased intrinsic risks, the draft law could have a negative impact on the upcoming comprehensive MENAFATF AML/CFT assessment, which will be used by FATF to determine the status of Lebanon (e.g., regular, enhanced follow-up, or "gray-listing"). It is thus very important that authorities assess and understand possible ML/TF risks and vulnerabilities flowing from this law and take all necessary mitigation measures. The following are possible measures that authorities could consider, among others:

- **The law could provide for compulsory reporting of relevant (cross border) transactions (beyond the usual "suspicious transactions").** A wider set of reported transactions (FATF Recommendation 20) will give the authorities (the Financial Intelligence Unit, FATF Recommendation 29) the opportunity to investigate transactions that are below the regular reporting threshold but appear to be connected to the same person (FATF Recommendation 29, 30, and 31). A wider set of reportable transactions would among others include (i) transactions related to Politically Exposed Persons (relevant also to fight corruption) (FATF Recommendation 12 and 20), (ii) cross-border transactions with high-risk countries (FATF Recommendation 10, 19, and 20), and (iii) transactions related to high-risk businesses (FATF Recommendation 10 and 20). Authorities could also consider (if technically feasible) implementing a system where all cross-border transactions are reported to the Financial Intelligence Unit, similar to the system in place in Australia.
- **Existing financial secrecy provisions prevent relevant domestic law**

enforcement bodies from investigating all suspicious transactions (FATF Recommendation 9,29, and 31). Such financial secrecy provisions should be addressed in general, but also to ensure that all competent authorities can effectively address abuse of the restrictions that this draft law aims to put in place.

- **“Cash courier” declaration requirements and enforcement could be strengthened (FR #32).** As the transfer of money through the payment system is restricted, criminals may increase the use of cross border cash smuggling. The authorities should consider tightening cash declaration (e.g., thresholds), raising sanctions for non-compliance, and increasing resources for implementation.
- **Beneficial ownership should be known.** Where companies or other legal entities are the originator or beneficiary of a transaction regulated by this draft law (FR #24,25), the beneficial owner of the legal entity should be known by the originating, intermediary and beneficiary financial institutions (FR #16). This will increase the usefulness of reported transactions (FR #20). Measures should be taken to ensure compliance with such requirements, including to reinforce sanctions for non-compliant financial institutions (FR #10,35).

² Please footnote recommendations for ease of the authorities

Comments to specific articles

- **Art. 1 and Art. 7:** These provisions empower the Banque du Liban (BdL) to issue exceptional and temporary implementation measures for the draft Law, based on the proposal of the Ministry of Finance and the approval of the cabinet. This mechanism appears to be time consuming and may give room to political considerations in the implementation or lifting of any specific measure. Thus, it may limit the ability of the BdL to act swiftly in the subject matters that seem to be under its purview. While the BdL should certainly be accountable for its decisions and actions, a requirement to inform and ex post review may allow for a more expeditious process.
- **Art. 2:** The reference to “international financial institutions” should be clarified.
- **Art. 3:** In addition to ensuring freedom of transaction, “fresh money” qualification also eases reserve requirements for banks. We note that Art. 2 suggests that this term intends to cover money transferred from abroad after 17 November 2019, but language in Art. 3 (“transfers from abroad and deposits FX

that banks received") can be interpreted that foreign currency deposits made by residents after the cut-off date would also qualify as "fresh money". Given the significance of this term, we suggest that the draft Law clarify its definition and cut-off date in line with the authorities' policy intention and in a manner throughout the draft Law. Additionally, the cut-off date is not set consistently throughout Law (in some articles it refers to 17/11/19 -Art. 3- and others to 17/10/19 -Art. 11-).

- **Art. 4.- Second:** One of the exceptions for money transfers abroad include "loans that emerged before this law". Is the intention to allow a payment by the bank to its creditor under a loan agreement, or to permit the bank to transfer money to its borrower in the fulfillment of a credit agreement?
- **Art. 4.- Third:** The unit, comprised of a representative of each of the BdL, Ministry of Finance and the bank, to assess the cases not included in the Law related to transfers of money abroad and allow its execution could pose potential conflict of interest. Furthermore, this mechanism could open the door to transfers of money that could undermine the objectives of the Law. In this context, while it is recognized that exceptions could be granted, it appears advisable to revisit the governance structure and to provide a framework to guide the decisions that would be taken by the unit. Furthermore, there should be adequate safeguards in place, including clear accountability and transparency schemes. The draft Law also remains silent on the consequences of non-observance of that maximum period.
- **Art. 4.- Fourth:** For the application of exceptions, this provision requires that the instructing client does not have a bank account abroad (or is this a mistranslation, and the requirement is that the customer be resident?). As exceptions also include transfers for personal reasons up to certain limit, it is not clear to what extent this requirement is consistent or whether banks can effectively establish this condition, even under 'know your customer' rules. Additionally, the relevance of \$50,000 threshold, in the context of exceptions, should be clarified to avoid ambiguities and state that this is an aggregate amount, since some exceptions already include specific caps.
- **Art. 5:** The draft Law should indicate whether any provisions or restrictions apply to the conversion rate of transactions in foreign exchange within Lebanon through operations such as transfers, checks and cards, to "LL deposits to dollars".
- **Art. 8:** Sets the procedure regarding "cards"; however, it does not specify whether

this provision will be applicable to credit, debit or both cards.

- **Art. 9:** It would be advisable to assess the legality (including consistency with the Constitution) of prohibiting a client that has a foreign exchange account in the bank where they have a loan from withdrawing or transferring the amount unless the loan is settled. In addition, the Law is not clear if such accounts will benefit from the "fresh money" treatment.
- **Art. 10:** The draft Law should specify the regime applicable to retail loans, i.e. those other than the consumer loans and personal renewable credit lines.
- **Art. 11:** It is unclear how the suspension of contractual deadlines will apply from the period of "17/10/19" to the date in which the Law is issued.
- **Art. 13:** Typically penalties should be established in law to be effective.
- **Transitional issues:** The Law lacks of a transitional period for its implementation, this will be particularly relevant for the institutional set-up (e.g., putting in place the unit referred to in Art. 4) and for the banks to adjust their operations to comply with the draft Law (e.g., "banks will open an account special and new or sub account to an account opened previously..." Art. 3).