WHO WILL FOOT THE BILL?

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BREAKING THE BANK: ALTERNATIVE PATHWAYS TO LEBANON'S BROKEN BANKING SECTOR

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HOW CREDIT UNIONS CAN BRING MORE ACCOUNTABILITY TO LEBANESE FINANCE

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EXECUTIVE SUMMARY

The explosion that ripped through the heart of Beirut in early August took with it more than lives, dreams, and property. This calamity, caused by gross state negligence, also destroyed any remaining hope that Lebanon has a future without fundamentally reshaping its current institutions.

As the nation's capital recovers, an opportunity presents itself to imagine and construct a fairer and more resilient system—not least in the financial sector, which lies at the heart of the current crisis. With their life savings in tatters, the Lebanese people need alternative options for storing value and running Lebanon's finances.

Although the battle to preserve the wealth of small and medium depositors has not started well, a brighter and more equitable future for Lebanese banking could be around the corner. With enough economic vision, Lebanon's financial meltdown may have created a critical mass of angry depositors, which can forcefully advocate for an alternative model for saving and lending. Financial cooperatives, coexisting alongside a reformed commercial banking sector, may be exactly what they are looking for.

Credit unions and other types of financial cooperatives have the power to diversify Lebanon's homogeneous banking sector. This would serve Lebanon well in the rocky years ahead; research shows that when banks do poorly, credit unions often do much better.

Credit unions are also better than banks at providing marginalised groups with financial services. Lebanon suffers from poor financial inclusion, with a mere 45 percent of adults in Lebanon owning bank accounts. However, despite the obvious need, credit unions have never existed in Lebanon.

Due to calculated disinterest, state and political elites never allowed financial cooperatives to appear in Lebanon's economic ecosystem. This retrograde attitude defies trends in other corners of the world, from the United States to Senegal, where cooperative banks have brought much-needed accountability, democratic principles, and resilience to financial shocks. Instead, faced with a crumbling national currency, the Lebanese are desperately searching for new stores of value—but they are met by obstacles at every turn.

Investing in physical assets can be unsustainable; vulnerable to theft and unexpected market collapse, the trend for luxury cars and real estate is likely to be short-lived. Optimists argue that the increased trade in cryptocurrencies such as Bitcoin, for example, could herald an equitable exit from Lebanon's nightmarish currency.

But cryptocurrency is only an option for a group of Lebanese who are practically on the verge of extinction: those fortunate enough to have expendable income in foreign currency. Without extensive reform to the Electronic Money Transfer (EMT) sector, cryptocurrency cannot hope to offer the Lebanese the kind of respite it did during other financial meltdowns, such as in Venezuela.

Only breaking with tradition will allow the country to end the current economic crisis. It is now up to depositors to campaign for a more equitable path for finance in Lebanon.

INTRODUCTION

For nearly all of the 20th century, Beirut served as a bank to the region. When the French entered the city in 1919, they chose to print the new local paper currency—the Syrian lira—from an office in Beirut's Ain el-Mraisseh district.[1] After independence in 1943, bankers cemented the city's legacy as a free-wheeling, laissez-faire business hub aiming to attract investment from the powerful players du jour. This legacy's keystone was the infamous 1956 Banking Secrecy Law, which allowed the sector to balloon throughout the 1960s. Today, the banking sector contains around 60 commercial banks, making Lebanon one of the world's most densely banked countries per capita.[2]

In late 2019, the banking sector imploded [See: Extend and Pretend, 2019]. The ensuing financial chaos had a disproportionately harsh impact on small and medium depositors in Lebanese banks. These accountholders suffered due to the unfair application of informal capital controls from October 2019 onwards, while wealthier bank customers likely whisked away their money to offshore accounts. Money that remained inside Lebanon has been converted to Lebanese lira at an unfavourable rate, slashing lifetime savings across the country. These catastrophic developments have left Lebanon's dwindling middle class with a conundrum: where to store their money.

Many have already decided that stashing cash at home is safer than keeping it in banks, causing the sale of "cash-in-safe" insurance policies to sky-rocket.[3] However, keeping cash under the mattress is neither sustainable nor safe. More thefts and robberies were recorded in the first half of 2020 than in the whole of 2019, according to Lebanon's Internal Security Forces.[4] Some Lebanese are already looking elsewhere for new stores of value, such as cryptocurrency and physical assets. But these forms of investment have their own drawbacks. Moreover, they are more accessible to the lucky few with access to foreign currency that arrived in Lebanon after October 2019, known locally as "fresh" US dollars. In reality, they are exclusive solutions to a problem which affects all depositors, particularly small and medium depositors.

Before Lebanon's financial crash, bankers lauded the country's plethora of banks as giving depositors greater choice and better services for their savings. Despite their claims of variety, there was always something conspicuously lacking in Lebanon's financial landscape: financial cooperatives, such as credit unions. The financial crash provides an unparalleled opportunity for these much-needed member-owned saving and lending systems to flourish. But how could these member-owned institutions help the Lebanese, and why have they never existed?

ANALYSIS

CREDIT TO THE UNION

Plenty of different organisations can be grouped under the umbrella term "financial cooperatives," including credit unions, building societies, cooperative banks, and savings and credit cooperatives. Like banks, financial cooperatives provide financial services—such as savings accounts and loans—for depositors. Yet, unlike banks, financial cooperatives are owned by the same people they intend to serve. For this reason, financial cooperatives place a strong emphasis on social solidarity, referring to their depositors as members, not customers.[5]

Guided by the principle of "one member, one vote," financial cooperatives offer their members greater control over their money than traditional banks. Every member has an equal vote in all decisions affecting the cooperative, making the cooperative directly answerable to its members rather than simply profit-driven executives or shareholders.[6] Financial cooperatives promote financial inclusion, typically boasting better customer service and lower fees than commercial banks. Importantly, however, financial cooperatives do not seek to replace commercial banks—historically, they have offered an alternative for depositors (especially in rural communities) who have trouble accessing credit through the commercial banking system [See **Box I: A Short History of Financial Cooperatives**]. Indeed, many economists argue that they complement banks, helping diversify the financial sector and providing stability in times of recession.[7]

than bank customers. Since credit unions are generally smaller scale than banks, they also have fewer physical branches, making them less convenient for in-person visits. Smaller credit unions are often less able to invest in technology, for instance, meaning that their online and mobile services are sometimes under-developed.

Cooperative business models are remarkably resilient in times of crisis—such as the ones Lebanon is currently experiencing. Banking is no exception. Forms of financial cooperatives have proven that they can withstand banking crises, economic recessions and conflict better than the traditional commercial banks.[12] This is largely thanks to the risk-averse nature of financial cooperatives; unlike banks, credit unions do not aim to maximise their profits. Instead, to keep their non-profit status, they are legally obliged to re-invest any surplus funds into the cooperative or distribute it among members.[13] Neither are cooperative decision makers rewarded for risky behaviour like their banking counterparts. Credit union CEOs receive two-and-a-half times less performance-based compensation than their counterparts at banks. This impacts board room

BOX I: A Short History of Financial Cooperatives - The first cooperatives banks were recorded in nineteenth century Germany.[8] After initially reacting with suspicion, German federal authorities eventually created legal structures based on those used for already functioning agriculture and retail cooperatives. This financial cooperative model was easily imitated and spread elsewhere in Europe.[9] But similar concepts existed elsewhere, independent of the German model. From as early as the 14th century, the Japanese Tanomoshi-ko – literally meaning trustworthy community—provided financing to the poor without collateral or interest payments.[10] In Arabic-speaking countries, a similar system of rotation savings known as a jama'ieh has long provided a basic alternative to commercial lending. However, these small-scale associations never received the state backing necessary to grow bigger than several dozen members. Today credit unions serve poorer segments of society across the world, often acting as an entry point into the formal financial system.[11]

Financial cooperatives do suffer certain drawbacks compared with traditional banks. Credit unions offer fewer financial services or "products," meaning that members have fewer saving and borrowing options

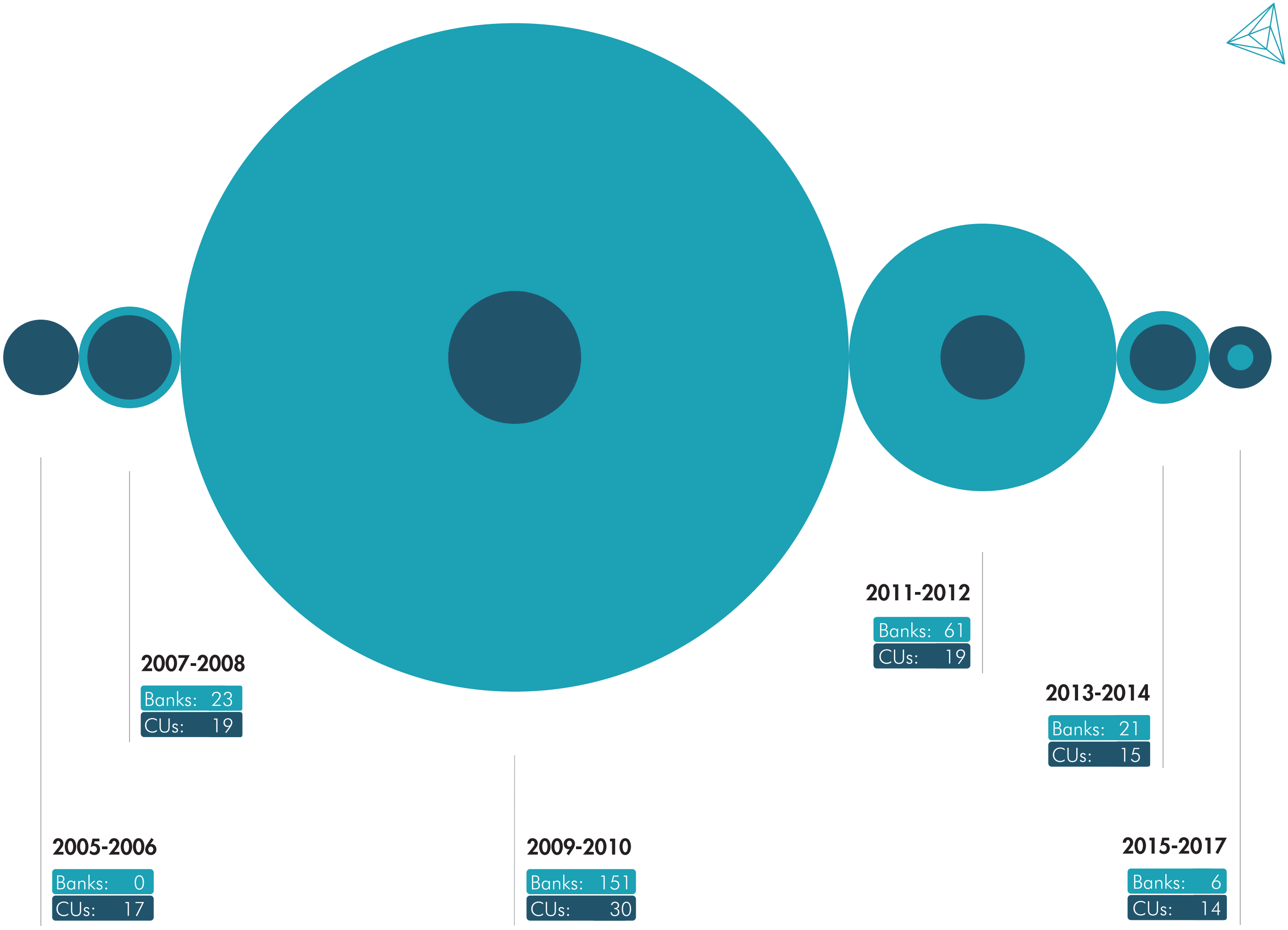


Figure I: CU failure rate vs bank failure rate Sources: Van Rijn, Jordan & Li, Kangli, Credit Union and Bank Subprime Lending in the Great Recession, 2019.

representation; 52% of credit union CEOs are female, compared to only 4% of commercial bank CEOs.[14]

The 2008 financial crash exhibited the resilience of financial cooperatives. Credit unions in the US, for example, engaged in five times less subprime lending—a key contributing factor to the financial crisis—than their commercial counterparts between 2003 and 2006.[15] As a result, they were four times less likely to fail than banks during the financial crisis (2008 to 2013) [See Figure I]. Credit unions' impressive performance owes little to federal bailouts. The bulk of the Troubled Asset Relief Program (TARP) went to commercial banks, which received over $200 billion of asset relief, compared to credit unions' meagre $69.9 million.[16]

This resilience promotes confidence in financial cooperatives, encouraging depositors to switch from commercial banks to their cooperative counterparts in times of recession and crisis. In the wake of the 2008 Financial Crisis, many western depositors switched to credit unions, which they rightly assumed were less likely to take risks with their deposits. On a single day in 2011, approximately 40,000 Americans joined credit unions in an act of consumer activism, transferring around $80 million of funds away from banks. In the years following the crash, banks lost more market share to credit unions than they had done in the years prior to the crash; between 2007 and 2011, US commercial banks' market share of deposits shrank from 85.8 percent to 84.4 percent.[17]

The phenomenon did not only occur in the US. In Caribbean nations, where financial cooperatives were already well established, credit unions' annual growth was almost double that of commercial banks in the build up to and immediately after the crash.[18] Brazil and Europe saw similar trends.[19, 20]

Democratic principles lie at the heart of financial cooperatives' tendency toward risk aversion. If a credit union does make a poor investment, the cooperative's membership structure makes the board of management answerable to all depositors equally. By way of illustration, the Navy Federal Credit Union (NFCU, the largest credit union in the United States) gives all depositors equal voting power on many issues affecting the union—including electing the board of directors.[21] In contrast, Lebanon's largest bank by assets, Bank Audi, apportions voting power to shareholders who do not always represent the interests of depositors [See Figure II].[22]

CALCULATED DISINTEREST

If crisis equalled success, credit unions should already have a bright future in Lebanon. However, the Lebanese have never been able to enjoy the benefits of cooperative banks, for a simple reason: they have never existed. In truth, Lebanon's lack of financial cooperatives is standard for all 22 of the Arab league states, where institutionally backed credit unions have never flourished.

The distribution of today's financial cooperatives suggests that, given the right political and institutional backing, credit unions and similar models can prosper in a wide variety of markets, geographies, and income levels. Countries with the highest credit union membership rates, for example, are remarkably diverse. They include not only developed Western economies such as Ireland, Canada, Australia, and the United States but also in Latin America, the Caribbean, and developing countries like Benin, Senegal, and Kenya.[23] Asia has the second lowest credit union penetration rate (4.34%)—Arab states add zero credit unions to the continent's tally [See Figure III].

Like most Arab league states, Lebanon lacks an appropriate legal framework supporting financial cooperatives. In Lebanon, the closest thing to a legal framework for credit unions is currently found in three piece of legislation: the Code of Money and Credit, the Cooperative Law (Law No. 17199 of 1964), and

BOX II: WOCCU, Theory and Reality - The World Council of Credit Unions (WOCCU) recommends that countries enact a specific law for credit unions, since their specialisation in financial services makes them significantly different to commercial banks and other cooperative societies and microfinance institutions.[24] In other words, general banking regulations are ill-suited to cooperative banks.[25] Even generic cooperative laws like Lebanon's Law 17199 are inadequate since credit unions require deposit-safety measures to safeguard their members' deposits. Any law governing financial cooperatives would need to enforce a minimum capital base to absorb and cover unexpected losses.[26] Most countries with successful credit unions and cooperative banks adhere to the WOCCU's model law: either through a specific financial cooperative law or a general cooperative law, which specifies provisions for financial institutions.[27]

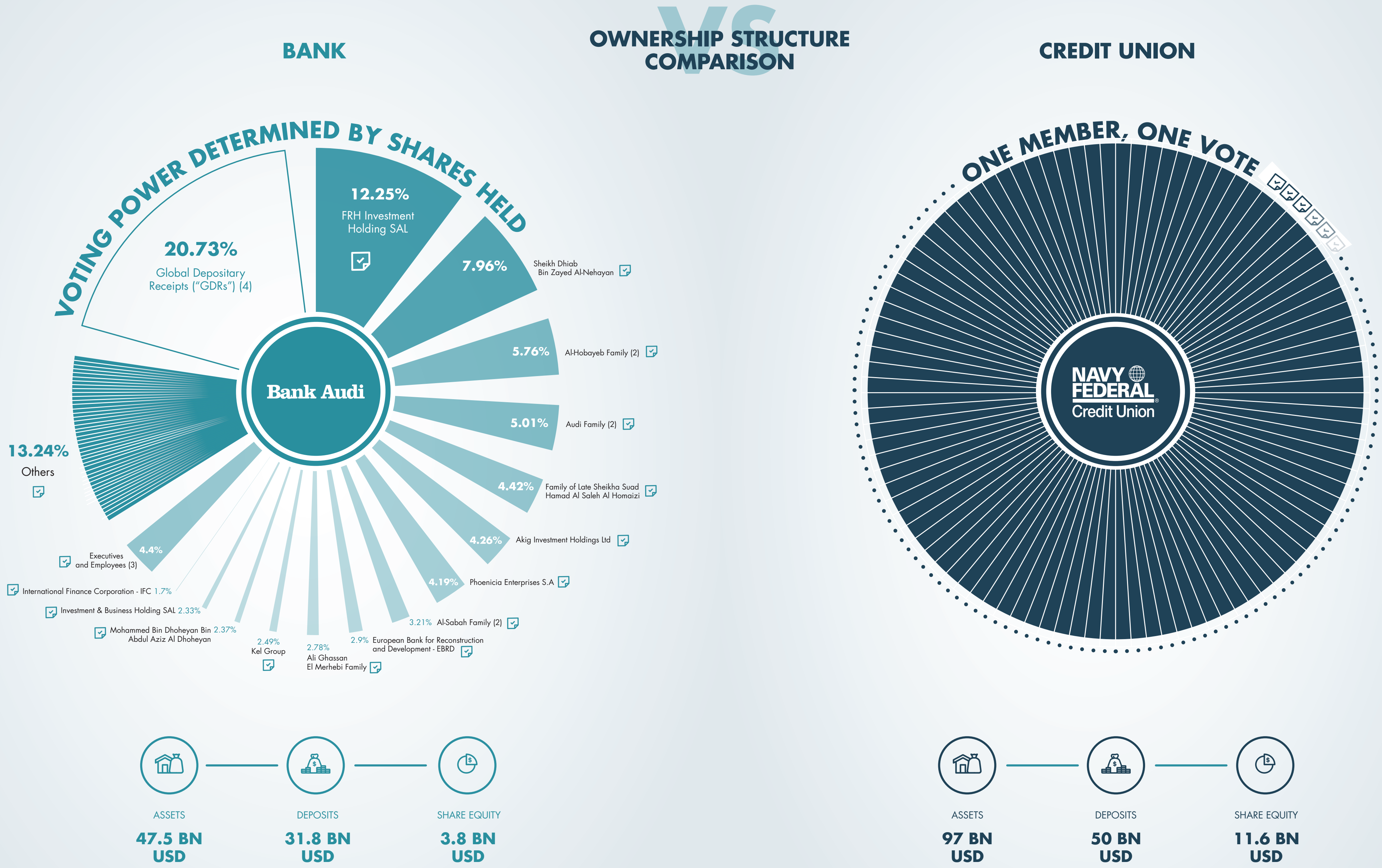
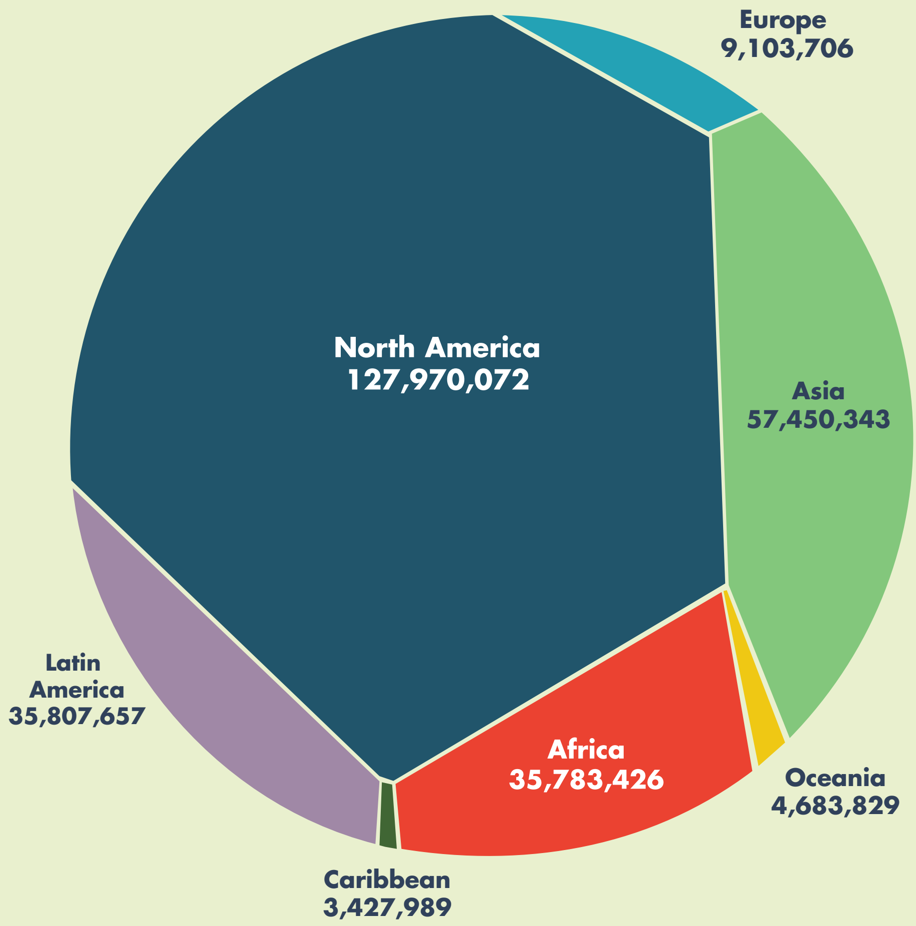


Figure II: Bank Audi vs. Navy Federal Credit Union ownership structures

Sources: Code of Commerce, Legislative Decree 304 of 1942, Bank Audi Group Shareholders, Common Shares as of March 31, 2020
Navy Federal Credit Union, Members' Voting Rights.

CREDIT UNION MEMBERSHIP ACROSS THE GLOBE



RATIOS OF PARTICIPATION OF COUNTRIES PER CONTINENT/REGION

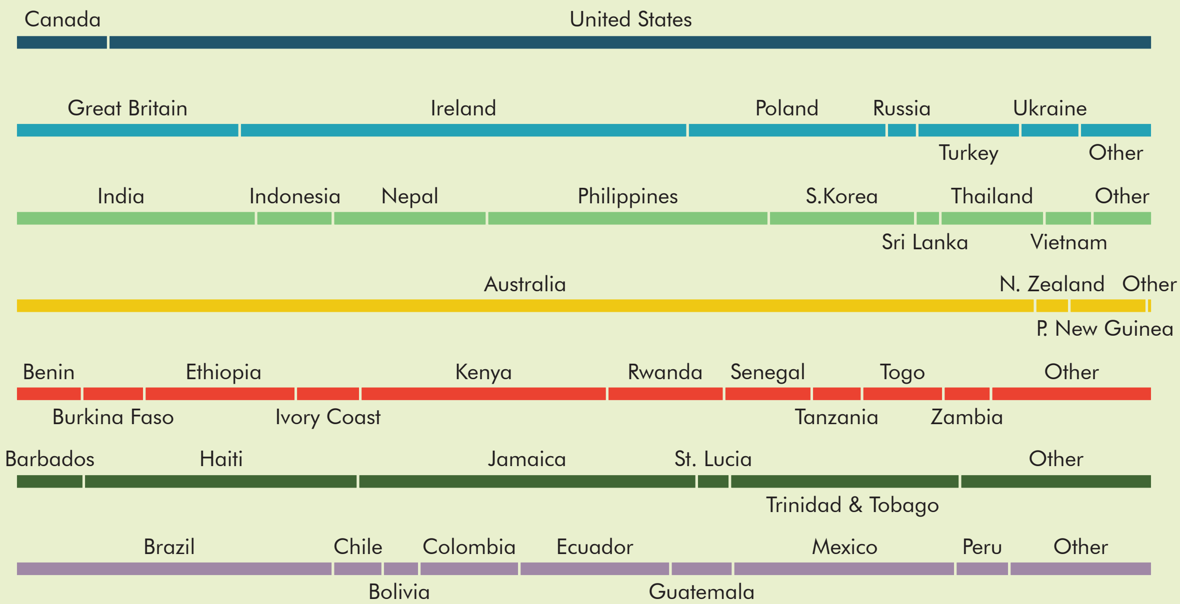


Figure III: Credit Unions across the globe

Sources: World Council of Credit Unions, Statistical Report, 2018.

Basic Circular No. 93, relating to microloans. The Code of Money and Credit asserts that any financial establishment must be licensed by BDL and have the legal structure of a joint stock company.[28] The legislation lacks specific provisions and incentives for financial cooperatives and credit unions to flourish, as outlined in **Box II - WOCCU, Theory and Reality**. Similarly, Lebanon's cooperative law is largely useless for establishing financial cooperatives, since it does not legislate for types of cooperatives such as financial cooperatives and credit unions.[29] Instead, the law provides almost exclusively for agricultural cooperative structures.

"The BDL has shown little interest in changing the status quo, which favours traditional banks while excluding alternative financial service providers."

As for the BDL's Basic Circular No. 93, this legal framework effectively prohibits Microfinance institutions (MFIs) from accepting deposits and therefore constrains the sector's ability to branch out into services offered by financial cooperatives.[30] The circular emphasises that only Lebanese banks may accept deposits, while MFIs and other non-profit financial institutions must make loans to borrowers using funds deposited at commercial banks.[31] The BDL has shown little interest in changing this status quo, which hamstrings MFIs and favours traditional banks while excluding alternative financial service providers. Indeed, the state's disinterest in financial cooperatives seems carefully calculated to ensure that profit-making banks will retain their hegemony over the lucrative financial sector.

CO-OPTION OVER COOPERATION

Non-existent legal frameworks regulating financial cooperatives in Lebanon belie a more deeply rooted problem: Lebanon's political economy. Cooperatives in general do not fare well in political systems dominated by narrow elite groups, which hoard the country's resources and income.[32] This is because well-organised associations wield political bargaining power, threatening elite interests, which both tarnishes efficient market functions and social welfare. Regions that boast powerful cooperatives have long used their position to leverage political power; Italy's Trentino region, for example, won considerable autonomy from the central Italian government after WWII, partly thanks to its well-established agricultural cooperatives.[33] While European states tolerated such concessions, Arab governments are far more reluctant to grant legitimacy to such movements. And nowhere could ruling elites in post-WWII Lebanon feel more threatened than in the country's once-lucrative financial sector.

In the newly independent Lebanon of the mid-20th century, ruling elites were quick to tighten their grip on the country's most valuable asset: the banks. Between 1945 and 1960, the number of Lebanese banks exploded from 9 to 85.[34] Politicians of all stripes framed the banking boom as a nationalist project, aimed at protecting native capital and serving Lebanese citizens. But in fact, this narrative turned out to be a myth. These new banks served the economic interests of post-colonial elites and local politicians, many of whom held important positions in these so-called "local" banks.[35] For example, three-time Finance Minister Pierre Edde was also the head manager of Beirut Riyadh Bank. The Association of Banks in Lebanon (ABL), established in 1959, was another product of Edde's work. It created a powerful banking lobby representing the interests of not only local elites but foreign investors—it is no accident that the association represents banks in Lebanon, and not Lebanese banks.[36] Indeed, almost every cabinet since the 1960s has contained a minister or indeed a prime minister who was either a significant shareholder or CEO of a Lebanese bank.[37]

The keystone in Lebanon's booming banking sector was undoubtedly the infamous Banking Secrecy Law of 1956 [See: Coming Clean: 2019]. The legislation effectively established Lebanon as a global tax haven, by prohibiting bank staff from disclosing to authorities each account's owner, contents, and other related information.[38] The law served the interest of local banks by attracting an impressive inflow of domestic and foreign capital—between 1950 and 1961 total deposits increased by 467%.[39] When, in 1963, the Code of Money and Credit attempted to give the newly-established BDL powers to override the Banking Secrecy Law, the ABL used its influential lobby to hollow out the proposed law.[40] The ABL challenged early drafts of the Code of Money and Credit until it suited them—eventually the government allowed private banks to list clients with numbers not names, reflecting the banking sector's growing control over political affairs.[41] A promising step toward removing banking secrecy came earlier this year, when the cabinet approved a draft law to lift banking secrecy.[42] In time, this avowedly laissez-faire attitude to banking gave rise to a political class intimately involved with the ownership and management of banks. A 2016 paper by the Economic Research Forum found that 18 out of 20 banks with total deposits above $1 billion have major shareholders linked to political elites and their direct families, while three in four major banks have individuals linked to politicians as their chairperson.[43] These political and economic elites have never fostered a regulatory environment that would allow financial cooperatives to challenge their grip on domestic deposits, or give greater political clout to depositors.

> *"Elites have never fostered a regulatory environment that would allow financial cooperatives to... give greater political clout to depositors."*

And yet, despite the lack of institutional support, many Lebanese are already saving money using informal, decentralised vehicles. Financial cooperatives known as rotating savings or credit associations (ROSCAs) are in operation across the country, especially in rural areas. Known in Arabic-speaking countries as a "jama'ieh," members pool their money and collect a weekly or monthly lump sum, which encourages depositors to save and lend. Problems with the jama'ieh model only begin to occur when membership grows beyond the size of a community.[44] At this point, the jama'ieh needs codified laws to organise and oversee the cooperative's activities rather than community trust. Of course, these financial cooperative laws are the very same regulations that political elites are loath to pass.

The spread of the jama'ieh highlights the failure of commercial banks to penetrate Lebanon's poorer and more remote communities. A staggering 55 percent of Lebanese adults do not own bank accounts, compared to 6 percent in OECD countries.[45] The large number of unbanked Lebanese is particularly striking given the

BOX III: Fool's Gold - In the battle to preserve their dwindling wealth, many Lebanese have resorted to desperate strategies. For some, the easiest way to offload the depreciating Lebanese lira is simply to buy things; at the onset of the financial crisis, the sale of assets such as real estate, cars, gold, art, and other luxury items saw a short-lived spike. But there are several problems with converting savings into physical assets including vulnerability to theft (gold and art), artificially inflated prices (real estate), and gradually depreciating value (cars). Another asset which optimists say can provide a more equitable escape from the plummeting local currency is cryptocurrency. Immune to government interference and manipulation, exempt from fees, commissions, barriers of withdrawal, and selling limits, crypto sounds like a perfect solution to Lebanon's nightmarish currency. However, poor legal clarity around Electronic Money Transfers (EMTs) in Lebanon poses a serious barrier to the purchase and sale of cryptocurrency. To make cryptocurrency a long-term success, EMT legislation and enforcement would need an overhaul [See: Catch Up Time, 2019]. For now, sellers will only part with their crypto assets in Lebanon if the buyer can pay in meaningful currency – in other words, fresh US dollars. This reality means that cryptocurrency, without significant regulatory reform can only offer an exclusive and elitist alternative to traditional banks, which would only entrench existing inequality if widely adopted.

size of the bloated banking sector. Credit unions have an opportunity to bring financial services to Lebanon's poorer and more rural communities, as they have done in other parts of the world. But without serious alternatives to unpopular banks, Lebanese depositors and non-depositors alike have been forced to adopt a number of flawed coping strategies to preserve their wealth [See: **Box III: Fools Gold**].

RECOMMENDATIONS

In the wake of the past year's remarkable upheaval, the Lebanese will have some power to shape the future of its finances. They must understand and demonstrate the value of alternative pathways to banking, which will allow them to advocate for a fairer system. Well managed financial cooperatives can coexist alongside and complement a reformed commercial banking sector.

Financial cooperatives may even be able to succeed in a key area where Lebanese banks have failed: increasing financial inclusion. In the United States, many credit unions have developed specific services and products for African American, Latino, and other minority communities.

In Lebanon, credit unions could fulfil the same role in remote parts of the country. Fortunately, some of the groundwork for establishing financial cooperatives has been done in rural communities in the form of the jama'ieh. MFIs—while serving a relatively small proportion of the population—have also introduced the concept of non-profit lending and principles of interdependence and solidarity to the poorest segments of society.

Financial cooperatives can even learn lessons from Lebanese MFIs. A common challenge for new credit unions is attracting enough depositors to begin offering

> *"Credit unions must avoid rooting themselves in existing sectarian communities. Failure to do so would make them vessels of sectarian soft power, like certain micro-credit providers."*

loans and other services. For this reason, credit unions often begin within a well-established community—such as the military (as with the NFCU) or teachers—where a level of trust already exists. Credit unions, if established in Lebanon, must avoid rooting themselves in existing sectarian communities.

Failure to do so would make them vessels of sectarian soft power, like certain micro-credit providers. Some existing MFIs represent the sectarian interests of a specific party; Hezbollah-affiliated Qard Al Hassan, for example, provides interest-free loans mainly to Shi'a community members.[46] Emkan, established by the Hariri Group, fulfils a similar role for the Sunni community, even if its regional penetration is more widespread in Lebanon.[47]

Much like MFIs, credit unions would also need to negotiate the BDL's poor or inadequate legal regulation. While MFIs are, in principle, non-profit institutions, several have been forced to shed their non-profit status and register as financial institutions with the BDL in order to demonstrate regulatory compliance and attract investors. This is partly because MFIs are currently not obliged to follow lending regulations which apply to financial institutions registered with the BDL.[48]

Whatever legal path Lebanese credit unions take, the greatest hurdles are likely to be political and institutional. Important institutions must include a comprehensive deposit insurance scheme to protect depositors' savings up to a specified value. In some countries, such as Brazil, the central bank takes on this task.[49] But given the BDL's recent track record and the state of its finances, Lebanese credit unions would be well-advised to steer clear of a BDL-backed insurance scheme. In many other countries, cooperative banks themselves organise deposit protection schemes for their members, instead of relying on a central bank. This would be the most prudent approach in Lebanon, at least until the BDL clears its existing liabilities to the banking sector. In these cases, a standard 5 percent of each deposit is usually invested in a collective insurance scheme.

The pressure to create an alternative banking model now falls on those who have lost the most in the ongoing crisis: small and medium deposit holders. Then, the success of financial cooperatives will be defined by trust. For its part, the state must finally give depositors another option to the banks which have failed them. In doing so, the traditional banking sector must yield some of its market monopoly on deposits and allow the growth of more equitable competition.

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FIGURE ENDNOTES:

Figure I:
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