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Libya in Transition:
Reforming the financial sector to spur economic growth

by Mark Dempsey

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Introduction:

A functioning private banking sector is crucial to the economic growth of states in transition. States in the midst of radical change, even states which are engulfed in violent conflict, such as Iraq and Afghanistan, are capable of developing working banks and financial institutions. Such institutions can add an element of stability to an otherwise volatile situation. This paper examines the current situation of banking and finance in Libya, a country undergoing a constitutional crisis, and argues that even in the current climate reforms can take place.

The political background is far from simple; the Libyan legal system is in a state of flux. The General National Congress (GNC), Libya's interim legislature, was elected in July 2012 and given an 18-month mandate to ensure that a constitution was drafted and to guide the country towards general elections. However, the GNC's term expires in February 2014 and protracted political tensions and militia violence have delayed efforts to organise elections for a constitutional assembly, meaning that a new constitution will not be ready in time. At the time of writing, GNC spokesperson Omar Omeidan predicted an extension to the February deadline. This would leave Libya in a legal vacuum.

In the meantime, the GNC continues to delay decisions on infrastructure and investment, which has the effect of further weakening public trust in the GNC. The political isolation law—legislation designed to vet members of the old regime—has proved controversial in its implementation. Though intended as an improvement, in practice it deprives fragile transitional institutions of bureaucratic talent, and is used to play political games. Initial, piecemeal efforts to liberalise the Libyan economy have also faltered, creating greater risk and dissuading financiers from investing.

Recently, the Central Bank of Libya added to the uncertainty for financial institutions by declaring that all such institutions must become 'sharia compliant' by 2015. This decision will discourage investment and economic growth: few Libyan banks or agencies have the capacity to operate solely as Islamic institutions and will find it difficult to make the conversion by 2015.

Major lenders, such as the Sahara Bank, are now uncertain as to what will happen to their existing loans. This uncertainty further impedes confidence in the management of Libya's financial sector.

Currently, state-owned banks dominate the financial landscape of Libya, although a series of partial privatisations occurred in 2007.[1] These banks, though heavily capitalised, have ceased lending.[2] Bank lending failure can be attributed to three factors:

1) the lack of a Libyan land registry;

2) the lack of a Libyan credit bureau;

3) inadequate central bank regulation.

However, there are means by which the situation can be improved. Libya can learn from the experiences of other resource rich states emerging from centralised regimes. The experience of Iraq, for example, shows that political interference in banking regulation can thwart economic progress.[3] Based on research in Libya as well as on the author's own experience working in the Central Banks of Iraq, Jordan and Lebanon, this paper will recommend financial, banking, and central bank reforms.

Background: The Libyan economy since the revolution

After four decades of economic mismanagement and a chronic lack of investment under the Gaddafi regime, Libya's post-revolutionary government needs to focus on security, reconstruction of infrastructure, and rejuvenation of the economy. In 2011, Mahmoud Jibril, the leader of the National Forces Alliance (NFA),[4] estimated Libya's reconstruction requirements at US$400 billion. To put this figure in perspective, the Special Inspector General for Iraq Reconstruction (SIGIR) estimated Iraq's reconstruction needs at US$100 billion in 2003.[5] According to Brown University's 'Costs of War' project, that estimate has been far exceeded, and reconstruction costs are now conservatively estimated at US$2.2 trillion.[6]

The Libyan revolution cast into stark relief the economic inadequacies, as well as the political inadequacies, of the Gaddafi regime, though there were some signs of economic growth. Since United Nations (UN) sanctions[7] were lifted in 2003, Libya had been on a steady upward economic trend. Economic activity had increased steadily for seven years to 2010, when average real GDP growth was approximately five per cent, with annual consumer price inflation (CPI) averaging less than four per cent. Official foreign assets increased from US$20 billion end-2003 to $170 billion end-2010.[8]

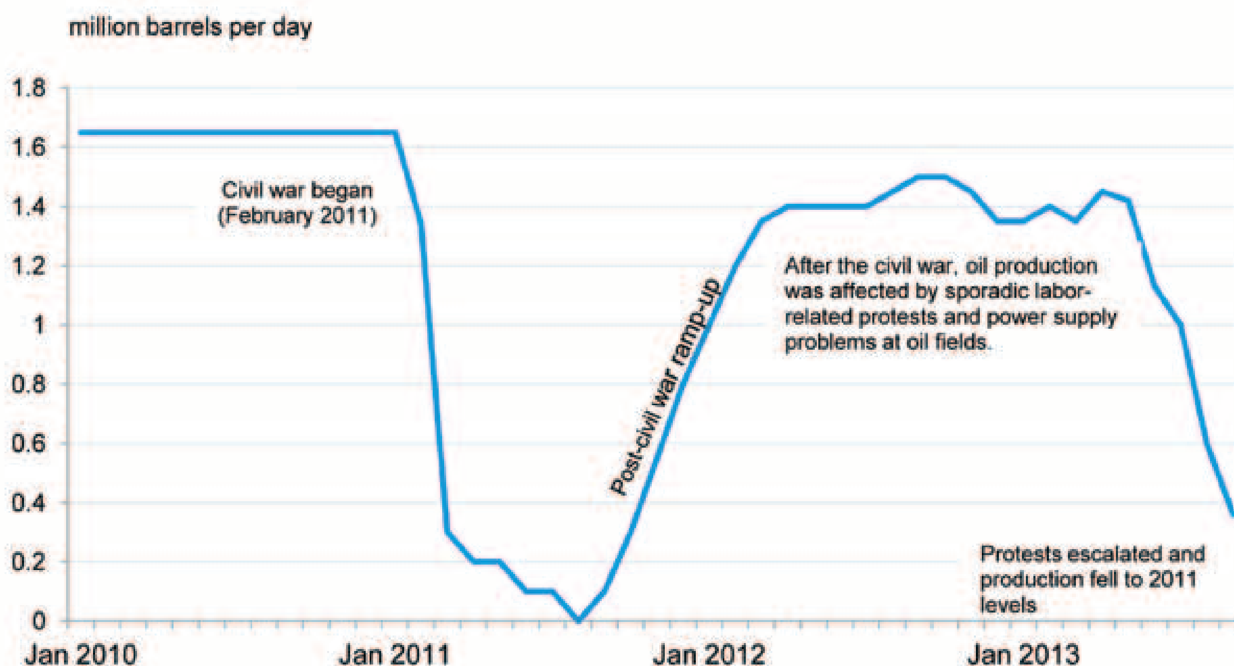
Yet Libya was then and still remains one of the most hydrocarbon-dependent states in the world, with its exports among the least diversified in the world. Oil revenue accounts for over 65 per cent of GDP and 95 per cent of revenue. The dependency on hydrocarbons makes economic performance vulnerable to oil price shocks. As in Iraq, it also makes government forecasting and fiscal management very difficult.[9]

Oil production has plummeted from a pre-revolution high of 1.6 million barrels per day (bpd) (see Fig. 1). Labour strikes at the major oil fields of Sidra, Ras Lanuf, and Brega and attacks on oil facilities in Mellitah, Ghani, and Dahra by militant groups have dramatically slowed production. By 2013, the blockades at oil terminals had become the single greatest drag on Libya's economy. Production levels fell to 400,000 bpd, a loss of about one million bpd, or US$700 million a week, in August 2013.[10] As a result, Libya's National Oil Corporation (NOC) declared force majeure to exempt it from honouring its oil-delivery contracts.

Libya's liquefied natural gas (LNG) production remains below Gaddafi era level, though the country's rank as a producer and reserve holder is less significant for natural gas. As of January 1, 2013, Libya's natural gas reserves were estimated at 54.6 trillion cubic feet,[11] making it the fourth largest natural gas reserve holder in Africa. New discoveries and investments in natural gas exploration are expected to raise Libya's reserves in the near term, and to interest outside investment in the long term.

The oil industry strikes themselves are politically driven. In Cyrenaica, Libya's eastern province, home to the bulk of the country's oil production, federalists are demanding more returns from local oil revenue. Calls for greater political autonomy in Cyrenaica are also increasing as insecurity persists.

FIG. 1: CRUDE OIL PRODUCTION IN LIBYA—JANUARY 2010 TO SEPTEMBER 2013[12]



Source: US Energy Information Administration, Short-Term Energy Outlook

The chart above illustrates how oil levels have oscillated since before the fall of Gaddafi.

The strikes and disruptions to oil exports have severely hampered the GNC's ability to go about the daily business of governing Libya. Unsurprisingly, given Libya's oil dependency, they have also severely harmed the economy: as of October 28, 2013, oil losses are estimated at US$6.43 billion with the IMF expecting the Libyan economy to shrink by 5.1 per cent this year.[13]

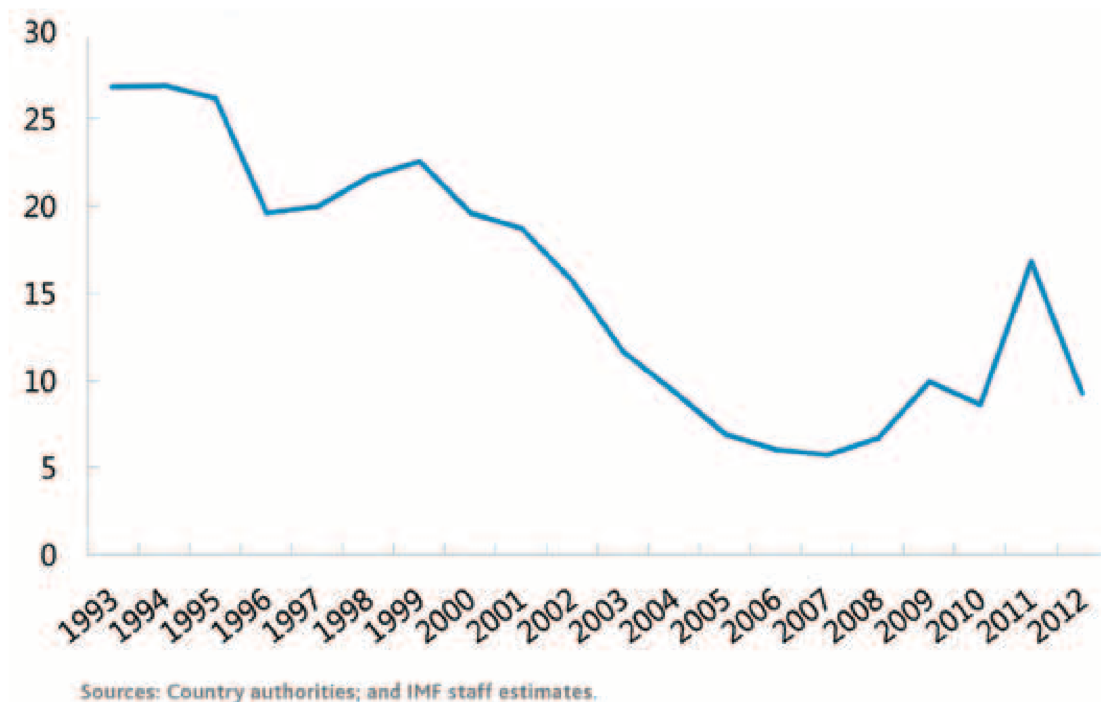
Libyan assets

State owned banks dominate the financial landscape in Libya. Although a series of partial privatizations did take place in 2007, public sector banks still control more than 85 per cent[14] of assets. The extent and diversity of financial services provided are limited. Worse, these state-owned banks, though heavily capitalised, are not lending.

Yet the issue for Libya is not one of limited funds or a lack of incentives. Data collected by the IMF reveals that:

- Assets held at Libya's commercial banks grew from 14.5 billion Libyan Dinar (LYD) (US$11.6) to 65.4 billion LYD (US$52.5) between 2003 and 2010—an increase in excess of 350 per cent.
- Only 13.5 per cent of bank assets were loans to the private sector.[15] (see Fig. 2 below)
- Noting the overall banking environment in Libya, investment advisory firm Arqaam Capital notes that among other things "Banks have extremely robust liquidity positions. Banks have been unwilling to lend due to high NPLs (non-performing loans) in their existing loan books (on average 20 per cent) ..." [16]

FIG. 2: CREDIT TO THE PRIVATE SECTOR AS A SHARE OF GDP [17]



In addition, since the toppling of Gaddafi in 2011, many members of the nation's diaspora have returned to Libya and are working for financial services firms—or setting up their own. Numerous newly returned Libyan exiles have a wealth of experience at some of the best financial institutions in developed economies and can provide technical expertise. In contrast, persistent violence in post-Saddam Iraq has deterred the return of the Iraqi diaspora as well as foreign investors. As a result, the financial sector has not been allowed to develop as originally envisaged. Libya appears to be in a more fortunate position.

However, insecurity in Libya is increasing. On October 27, 2013 gunmen stole US$55 million from a van carrying local and foreign currency for the Central Bank. Such incidents deter investors whose capital will be vital to encourage private sector growth and job creation, and hamper the work of the financial sector overall.

Missing property rights, missing a credit bureau

Insecurity alone does not explain why Libyan banks are not lending. Far more important are the government's (and society's) suspicion of the private sector, which has resulted in the absence of a land registry system and a credit bureau. The prejudice against the private sector is a relic of the Gaddafi era: at the moment, 85 per cent of the Libyan working population are public sector employees.[18]

The chaotic state of property titles is also a Gaddafi legacy. In the 1970s, Gaddafi imposed a redistribution of property,[19] which was intended to ensure that each Libyan household had sufficient access to residential and agricultural property for their own subsistence needs. Tenants of apartments became owners; landlords received no compensation. The GNC has pledged to return those properties to their original owners but the complexity and sheer number of property claims makes the task difficult. The legal and practical implications of resolving property rights disputes are also significant. If, for example, properties are returned to their original owners, it is unclear as to who will compensate existing owners who purchased property legally without knowledge of the expropriation.

Until the question surrounding property rights is resolved, the banks will not allow property as collateral when ownership of a property is under dispute. Yet at present shortages in housing supply in Libya mean that property values are high: equity value in these properties can make for high-quality collateral for loans. The establishment of a land registry and settling of ownership disputes is something that the government needs to address as a matter of urgency. Although not strictly in the purview of the Central Bank, its leaders should be pushing to resolve this issue.

The ambiguity over property rights stops banks that have surplus liquidity from lending to the public at large and to small and medium sized enterprises (SMEs) in particular.

In addition to the lack of legal clarification around property rights, the lack of a credit bureau restricts banks from having the data to make risk management decisions on potential borrowers. In a developed country, the credit bureau would operate as an independent legal entity: a credit bureau's objective is to research and collect individual credit information and sell it for a fee to lending institutions such as banks, mortgage lenders, and other

financing companies; thus helping lenders to more accurately assess the creditworthiness of potential borrowers. Following the partial liberalization of the financial sector in 2007, Dun & Bradstreet created the basis for credit bureau in Libya.

The lack of a credit bureau is not necessarily a Gaddafi legacy—many countries in the Middle East and North Africa lack them. But the post-revolutionary, post-Gaddafi era is certainly the ideal time to create one. Ironically, Gaddafi's national identity card project created the rudiments of a database which could be used for this purpose.[20] Despite complications with this project it could now form the basis for a centralised credit data bank.

As Libya progresses in building on previous credit bureau work there are many lessons to be learnt from other emerging markets. The African Development Bank Group published a report in October 2012 that produced findings from its experiences of working in 42 African countries. The report emphasises the importance of design and internet penetration if a credit institution is to have maximum impact on access to finance.[21]

Central banking reform

In addition to broader issues of property and credit, central banking legislation and banking regulation in Libya also need to be updated and reformed.

The Central Bank of Libya is the monetary authority in Libya and has the official status of an independent and autonomous body. The bank has branches in Benghazi, Sabha, and Sirte where it delivers cash, which in turn is distributed to the wider commercial banking network. The government appoints the governor. The bank has broad control over the banking sector with an ownership stake in a large number of the state owned banks, which make up to 85 per cent of Libya's banking assets. That the Central Bank owns or has ownership stakes in a number of state owned banks is not appropriate and does not reassure the private sector that their interests will be fairly represented. A complete divestiture of bank ownership would resolve this problem.

The Central Bank oversees Libya's financial system, which is composed of a network of 15 commercial banks, the majority of which are state or partially state owned; four specialised credit institutions; five insurance companies; and a recently established stock market. There are five privately owned banks in Libya and they possess approximately 15 per cent of the banking assets.

The Central Bank's stated objectives are "to maintain monetary stability in Libya and to promote sustained growth of the economy in accordance with the economic policy of the state".[22] More specifically, the bank's responsibilities include issuing and regulating banknotes and coins; maintaining and stabilizing the Libyan Dinar, not difficult now given that the LYD is pegged to the IMF's Special Drawing Rights;[23] supervising and monitoring both private and public sector banks; supervising foreign exchange; and advising the state on the formulation and implementation of financial and economic policy.

However, the Central Bank lacks the tools to influence monetary policy. Instead, efforts are focused on non-core activities such as banking supervision and provision of information technology services to state-owned banks. These activities interfere with its primary mandate of implementing policies to promote economic growth and can be outsourced.

Set governance priorities

For a new banking environment to succeed, the new governance infrastructure must begin with a radical change in the relationship between the Central Bank and the state banks. The IMF[24] suggests that:

> "Good regulatory governance … cannot be sustained without good public sector governance. Good public sector governance is one of the main preconditions for good regulatory governance (and through it, for financial system soundness) and includes the absence of corruption, a sound approach to competition policies, an effective legal and judicial system, and an arm's length approach to government ownership."

A Central Bank divestiture of interests in Libyan banks would encourage privatizations and make banking assets available to international groups such as HSBC, Standard Chartered, and Citi. Bringing in established international banking institutions will encourage foreign investors, establish a modern banking culture, and bring technology and knowledge to the Libyan market, along with a wider range of products and services. Conditions of the sale of institutions in the privatization process must be transparent and fair value assured.

Alternative governance mechanisms will also need to be put in place to ensure that all banks' boards are also in compliance with regulations. At the moment, several board members of the Central Bank also have stakes in state banks. This would be unacceptable in most countries. For models, Libya could look at the governance rules at the European Central Bank in Frankfurt and the Federal Reserve in the United States. Saudi Arabia's Monetary Agency (SAMA) is a good example in the region.

Define the role of the Central Bank and the Governor

A reform-minded Central Bank Governor has a unique opportunity to revolutionise the Central Bank and leave a legacy on Libyan monetary policy and economic development. The Governor can put in place the monetary tools that will counterbalance the Libyan economy's heavy reliance on government intervention, using interest rates, treasury bonds, and banking regulations. In developed countries, the role of the Governor of the Central Bank has evolved in recent years, from that of an unseen technocrat tasked to maintain a stable economic environment to a highly visible decision-maker pursuing economic growth, controlling money supply, controlling inflation and ensuring overall governance of a country's financial sector. There is no reason why a Central Bank of Libya boss could not play a similar role.

Engage with the private sector in formulating policy

At present, the private sector does not have a stake in policy decisions made by the Central Bank. In most developed countries, they do: private banks can and do advise Central Banks on how to initiate a debt market and can assist in shaping the regulations around it. In Libya, private banks could also offer advice on privatizations. Ultimately, the Central Bank should see the private sector as a useful source of information and guidance; its private sector relationship needs to be bi-lateral with the private sector forming a trusting relationship with the Central Bank. Such a collaborative relationship will take time and patience to build.

Develop a practical plan for the growth of Islamic financial services

The failure to involve the private sector has led to at least one dramatically poor decision. In January 2013 the GNC passed a law establishing exclusively Islamic banking products and outlawing regular banking practices. Once the law comes into effect in 2015, banks will no longer be allowed to pay interest to or receive interest from individuals and companies and state entities will be prohibited from receiving and paying interest. The law, which was not widely consulted, has been heavily criticised. At the moment, the banks do not have the capacity to work as exclusively Islamic financial institutions, and most think they will not be able to do so by 2015. Many have asked why Libya cannot operate a dual banking system rather than an exclusively Islamic system of finance. The IMF agrees, noting in its 2013 Article IV Consultation report[25] that “A recently adopted law banning interest could interrupt commercial bank lending until a new Islamic banking framework is put in place”.

Motasim Elalem, a former regulator with the Federal Reserve who is now partner with corporate advisory Rashad in Tripoli (recently taken over by Arqaam Capital), observes in the *Libya Herald*: “… we already have Islamic windows which offer Islamic banking products. So why the rush? Why not wait until we have elected parliament to deliberate our laws.”[26] Elalem concludes that the Central Bank’s focus on such long-term policy commitments “should be left for another day”.

With the proper infrastructure in place there is significant potential for a buoyant Islamic finance market in Libya.[27] The negative market reaction might have been avoided if the Central Bank had engaged in broader consultations.

As previously noted, the current drive to restrict all banking to Islamic finance products is costly and can slow down economic activity in Libya. The Central Bank Governor can play a pivotal role in steering the rollout of Islamic financial services to create an amalgamation of options that gives Libyan borrowers a wide choice of financial products such as personal loans, mortgages, and business loans. There is no reason why banks cannot offer Islamic products in tandem with conventional banking products, as is the case in the United Arab Emirates (UAE) and Saudi Arabia (KSA). However, it will take time to build the personnel capacity within the financial institutions and until the Governor can ensure the correct supervisory mechanisms are in place to monitor practices at all institutions offering Islamic based products, with the first priority being protection of customer deposits.

Address structural imbalance of Libyan banks

The Libyan banking sector suffers from structural imbalances. Libyan banks have:

- A very low loan-to-deposit ratio of approximately 23.4 per cent[28] (as of March 2013) compared to an average of 80 per cent for the region. This ratio may make banks look healthy when they are highly leveraged with deposits at nearly 20 times equity (compared to 10 times regionally and globally).
- There is room to expand the equity base and allow for new entrants into the banking sector, which will make it more competitive and create incentives to loan, invest, and improve service offerings.
- The only monetary policy tool that the Central Bank is currently exercising is the rate on time deposits held with Central Bank. While the one per cent rate is low and ought to be an incentive to profit seeking banks to loan—rather than keep cash—with the Central Bank, the highly leveraged position of these banks means banks can deposit with the Central Bank up to twenty times their equity.[29]

Based on these figures, the Central Bank needs to limit amount of cash that banks can deposit at the Central Bank to encourage more lending. It must also introduce regulations that order banks to increase their equity base—this could be done by partially listing institutions so as to increase the shareholder base.

The remainder of deposits are partly invested as loans but mostly used to finance trade, which earns reasonable fees—making the banks overall attractive investments for stakeholders. The Central Bank can play an important role by adopting a policy that would incentivise banks to both lend and invest more. Such policies can not only encourage more lending but also encourage investments with a long-term view of creating a genuine financial sector and capital markets.

Establish an independent regulatory body for supervision of banks

Establishing an independent supervisory body would free up the Central Bank to concentrate solely on its monetary policy functions. Such a supervisory body, similar to the former Financial Services Authority in the UK,[30] can provide oversight and ensure the soundness of the banking sector. Not only can such an authority ensure banks have sufficient capital to survive external shocks, large oil price fluctuations for example, it can undertake regular on-site banking supervision inspections and ensure sufficient investments are being made in human capital and technology.

Establish an independent banking association, which has a bank-training institute and is funded by the banks

Funded by the private banks, an independent banking organization could represent the interests of the private banks. It could collaborate and advise the Central Bank on policy recommendations and implementation. The association could have a credible academy designed to train all staff on best international banking practices. Qualifications gained could be aligned to international accredited bodies such as the Chartered Financial Analyst Institute (CFA) and the Association of Chartered Certified Accountants (ACCA).

Facilitate better monetary policy

Single Treasury Account

As holder to a large amount of government cash balances it is important that the Central Bank have a single account mechanism designed to manage all government cash resources, independent of its responsibilities to the commercial banking sector. A Single Treasury Account (STA) will improve cash management and control and also facilitate better fiscal and monetary policy coordination.

Debt Market

Although there is no sufficiently liquid or deep enough debt market existent in the region, Libya could set a precedent by creating one, if the Central Bank provides the right conditions for one to prosper (for example, providing incentives to create a market-maker[31] environment to ensure liquidity). The development of a domestic debt market would provide a basis for more effective monetary policy and long term financing to support economic diversification.

As an IMF document examining the challenges and opportunities in post-Gaddafi Libya recently notes: “Fixed-income instruments—including Central Bank bills that are regularly auctioned—could serve as a means of managing short-term liquidity and for institutions to match long-term assets and liabilities.”[32]

An actively traded government bond market could ultimately lay the basis for pricing of LYD-denominated corporate bonds.

Conclusion

Libya is desperately in need of a vibrant private sector. With a population growing at 1.7 per cent a year, and half of the current population under 20 years old, Libya will need to create at least 150,000 jobs a year for the next five years—on top of the 860,000 jobs needed now.[33] As Michel Cousins, editor of the daily newspaper the *Libya Herald* observes "Without those jobs, discontent will rise and security will be at risk."[34]

An IMF study from May 2013 also notes the importance of creating employment opportunities in the private sector in order to reduce hydrocarbon dependency.

"Public sector investment will need to be supportive of the private sector and should be well-targeted to alleviate bottlenecks and well-monitored with a focus on quality rather than quantity."[35]

Ultimately, Libya's banks need to be allowed to use their ample liquidity to stimulate the growth of a private sector. The Central Bank should push for this change, should argue for regulatory and property title reform, and should extend the implementation of Islamic banking law to 2018, allowing banks to operate non-Islamic lending as well. In the meantime, foreign banks should be encouraged to operate in Libya through the formation of partnerships with local institutions or through a system of licences. The ensuing technology and knowledge transfer from these organizations could transform Libya's financial sector and provide a template for others resource rich transition states in the region to follow.

As a priority, the Central Bank must address governance concerns and divest itself of interest in any banks where it has an ownership stake. Officials at the Central Bank cannot have stakes in any of the financial institutions they oversee. Making governance a priority will help the Central Bank win the trust of not only the private sector but also the public at large.

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