

How One Country Skirted the Banking Storm

While others heard siren call, Lebanon's bank governor steered safely past temptation.

BY ERIC L. LEWIS

With banking behemoths from New York to Hong Kong teetering in an ocean of red ink, banks in little Lebanon are enjoying a record year. Profits are expected to hit \$750 million, while the country's gross domestic product will reach its highest point in many years.

How has the financial system in Lebanon, unlike those in the United States and all too many in Europe and Asia, avoided the toxic swirl of derivatives and securitized debt that has swept the international economy to the abyss? The answer is simple. Lebanon has a banking regulator who understands that his first job is to minimize the risk of financial disaster.

Lebanon is not an obvious candidate for paragon of financial responsibility. Its public debt is huge. It is still rebuilding an infrastructure shattered in the 2006 war between Hezbollah and Israel. Syria has just departed after more than 20 years of occupation. And the combustible mix of Hezbollah activism, Syrian and Iranian support of terrorism, and ongoing sectarian tension is hardly a spur to foreign investment. (No doubt, the estimated \$1 billion that Iran pumps to Hezbollah helps buoy the economy.) Nevertheless, a healthy banking sector is so unusual today that it is worth investigating whether the Lebanese example has salutary lessons for the rest of the world.

HE DOESN'T GLOAT

In my international financial institutions practice, I periodically visit with central bankers to discuss systemwide issues. Recently I was able to sit down with Riad Salame, the governor of the Central Bank of Lebanon, to discuss how Lebanon has been able not only to weather the storm

but to transcend it. Meeting in his thickly carpeted office high above the scarred Beirut skyline, Salame exudes a quiet calm and resists the urge to gloat. He has been governor for 13 years, through war, occupation, assassinations, political crises, and dozens of financial ups and downs.

Salame, who had been mentioned as a candidate for president during the recent political crisis, traces Lebanon's anomalous prosperity to a simple and straightforward regulatory action that he took three years ago. He prohibited Lebanese banks from investing in structured credit products, the toxic assemblage of subprime debt that Secretary Henry Paulson Jr. is now figuring out how to excise from U.S. bank balance sheets.

Why did Salame bar his banks from investing in U.S. subprime mortgage securities when regulators everywhere else not only allowed their banks to own these securities, but allowed them to count them for capital maintenance purposes as identical to Treasury bills? His explanation is straightforward. He thought that these securities were too complicated. If it was that difficult to understand what was backing them, they constituted an unacceptable risk on the books of banks, whose primary functions are to accept deposits, build the economy through lending, and collect loans and repay depositors through prudent deployment of resources.

By contrast, U.S. regulators assumed that banks, with sophisticated modeling and data analysis, knew how to manage their risk. But no one understood the sliced and diced tranches of debt, synthetic products, and interlocking derivatives that created a black box of combustible risk.

Indeed, Salame does not allow his banks to invest in any real estate outside Lebanon. He says the domestic real estate market is one that both he and the banks he regulates understand. Unlike virtually every other central

banker, he is humble enough to know what he doesn't know and to understand that lack of understanding should inspire caution.

NOT PERFECT

To be sure, Lebanese financial regulation is not something to transport wholesale to Wall Street. Fiscal policy is a mess, as the country's budget process is neither transparent nor reliable. Since this critical area of economic activity is difficult to measure, sound fiscal and monetary policy are elusive, and inflation and currency fluctuations are serious problems. Lebanon also remains a center for strict bank secrecy, reflecting the strong cultural value placed on privacy but also facilitating the movement of illegal cash.

Post Sept. 11, however, Lebanon has been drawn into international regimes against money laundering and terrorist finance by the USA Patriot Act. Unlike Dubai or Cyprus, Lebanon is no longer a significant destination for money launderers. Like many other smaller developing systems, however, it is working to bring its money laundering detection and enforcement infrastructure up to world standards.

But the first obligation of a financial regulator is to ensure the safety and soundness of his or her own financial system. When banks fail on a massive scale, the result is disastrous not only for the economy but also for financial transparency. In the absence of reliable banks, countries fall back on *hawala*, the traditional system of money changers in the Middle East and much of the developing world. The system then becomes entirely opaque, terrorist financing and money laundering flourish, and economic activity stagnates. Lebanese banking regulation may not be perfect, but I suspect mattress sales are much slower in Beirut than Boston.

ONE BIG THING

Why did central bankers around the globe get it wrong when Salame got it right? The answer lies in the ideology of regulation.

In Isaiah Berlin's fox and hedgehog dichotomy, global central bankers were foxes. They knew (or thought they knew) many things—how to keep the economy on a constant path of growth, how to control inflation, how to unleash the entrepreneurial creativity of financial institutions, how to prevent money laundering, and many other objectives. Some of which were achievable and compatible, and others of which were not.

In the United States, under the long reign of Federal Reserve Chairman Alan Greenspan, the effort to mitigate

risk fell victim to an overarching principle of market veneration. For 18 years, Greenspan worked to undo the regulatory architecture that had been put in place in the 1930s in response to the bank failures of the Great Depression. In the world according to Greenspan, American banks needed to be freed from restrictions that impeded them from competing globally with British, European, and Hong Kong banking giants.

As Greenspan recently admitted, his obdurate refusal to regulate derivatives, particularly credit default swaps, played a significant role in the ongoing financial meltdown. But this was not just a "mistake" as Greenspan said. It was a reflection of a regulatory ideology that views the role of the state as cheerleader for unfettered capitalism rather than guardian against its excesses. It presumes that those taking risks have the knowledge and incentive to manage them.

The Lebanese Central Bank was the hedgehog: It focused on one big thing, preventing a tsunami from destroying the banking system. It felt no need to boost Lebanese banks into the global first division of financial players or to assure that bank stocks were market darlings. There was a time in America too when banks were boring players and bank stocks were quiet, steady performers. All of this dullness not only ensured against meltdown, but also made the Lebanese banking system a haven for capital from throughout the Middle East region.

Lebanon's good fortune points to the simple idea that the primary function of the banking regulator is disaster prevention. It is not to encourage ever more high-stakes games in the casino, but to make sure that the banking industry preserves and protects the public trust.

Sen. John McCain, in his final neo-populist transformation, railed against greed on Wall Street. But it is Wall Street's job to maximize profit for shareholders, and it is business executives' role to keep as much for themselves as shareholders will allow. The capitalist incentive is always to increase risk. Self-regulation must be chimerical in a system that creates powerful incentives against self-restraint.

It is the regulatory state that has to set and enforce the rules for banks and understand and limit the risks that they are permitted to take. The new administration could do much worse than look to Lebanon as a model for prudent regulation.

Eric L. Lewis is a partner in the Washington, D.C., office of Baach Robinson & Lewis, specializing in international financial institutions, complex international insolvency matters, public international law, and serious fraud cases.