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Credit for Small-Scale
Enterprise Project

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EXECUTIVE SUMMARY

This analysis was undertaken to determine whether there is a need (unrequited demand) for formal credit in the small-scale enterprise (SSE) sector in Lebanon and, if so, what might be done to satisfy such demand. The findings and recommendations of the study are summarized in the following paragraphs.

The vast majority of all enterprises in Lebanon are relatively small, particularly as measured by level of employment. More than 98 percent of all Lebanese non-agricultural industrial and commercial enterprises (some 62,000 SSE) employ fewer than 10 persons. Among this group, credit requirements generally fall below the level of LL200,000, typically the smallest commercial loan most banks are willing to consider. Loans of smaller magnitudes provide too little return to the commercial banks for the administrative costs of processing them. Moreover, enterprises with lower credit requirements are generally incapable of meeting the creditworthiness standards (including, for example, substantial collateral requirements) of Lebanese commercial banks. The handful of long-term credit (development) banks in the country lack the financial resources and administrative capability to serve SSE clientele.

In effect, the bulk of the Lebanese SSE sector has little, if any, access to formal credit markets. SSE is consequently forced to rely on personal and family resources and on credit offered by comptoirs and moneylenders on terms sometimes exorbitantly expensive but always more costly than commercial market rates. These circumstances inevitably curtail the growth and development of the sector and divert resources from potentially more productive use and allocation by the formal credit system. This situation has been exacerbated by the many years of domestic and foreign conflict in Lebanon, with much of the sector either physically damaged or destroyed and/or depressed by stagnating economic conditions. Traditional sources of SSE credit have also largely dried up.

In sum, the SSE sector has a vast, unsatisfied need for formal credit for both rehabilitation and further growth and development. Although it is not possible to quantify precisely the magnitude of credit required, the sector could absorb without difficulty a minimum of $10-15 million in commercial credit in the next two years.

The commercial banking sector represents the only existing institutional vehicle in Lebanon able to provide credit to the SSE sector on a broad geographical and sectoral basis. A program operated through the commercial banks could also be implemented on the basis of full cost recovery, that is, in a businesslike, commercial manner. The alternatives, creating a specialized, new institution ab ovo or expanding an existing financial institution, would be too costly for the likely resources available, would delay implementation of the program for possibly two years or more, and might require continuing subsidy.

The analysis also concluded that the vast majority of SSEs could absorb formal credit usefully and productively without technical or management assistance. Only the most geographically remote and/or the most unsophisticated SSEs would be unable to take advantage of an SSE credit program run through the commercial banks. Many of these would in any case require the kind of organizational and technical assistance that must be provided on at least a partly subsidized basis.

Many commercial banks expressed both an interest and willingness to participate in a program to provide SSE credit, if a means could be devised to overcome the problems of creditworthiness and if administrative costs of processing SSE loans could be reduced. Clearly, these problems represent the primary obstacles to the provision of formal credit to SSE in Lebanon. A review of the legal, regulatory, and policy environment disclosed no impediments of that nature to an SSE credit program.

To remove the existing barriers to formal SSE credit, the study recommends that an SSE Credit Fund be established that would offer commercial banks two options for satisfying credit requirements: a guaranty window to insure against default by SSEs and a window for discounting loans to small borrowers. The guaranty window would substitute for the lack of creditworthiness and would also reduce the administrative costs of processing small loans. By offering to discount term loans (say up to five years), the Fund would make it possible for small borrowers to have access to needed longer term credit. The discount window would conversely permit commercial banks to convert medium-term loans into liquid assets. Both windows would give the banks the option of holding an interest-earning asset instead of idle cash.

The Fund itself would take the form of a bank account in the name of and under the responsibility of a government agency, probably the Central Bank. One or more financial agents, such as the development banks or a newly established institution, the Societe Financiere, for a fee would administer the Fund program for the government by setting up guaranty and discount windows to which the commercial banks would be given access. As conceived, commercial banks would initiate the program by making SSE loans according to eligibility criteria set by the Fund. The banks would thereafter present such loans to the financial agent, either to purchase a guaranty of repayment or to request the Fund to discount (buy) the loan. In either case, the banks would be required to assume some risk to ensure the diligent and proper selection of borrowers.

The Fund should be organized as a revolving loan fund disbursed in a manner designed to avoid decapitalization. Interest rates should, if possible, be maintained at commercial levels. Potential borrowers, who already pay higher than commercial rates, appear _ipso facto_ capable of borrowing credit on strictly commercial terms.

Many details and issues relative to the establishment of the Fund as conceived require further research, clarification, and refinement. This work, which can be done at the project paper stage, will require a four-person team for approximately one month each.

ACKNOWLEDGEMENTS

This study was undertaken principally in Beirut during a period of approximately four weeks, from March 21 - April 16, 1983. The work was immensely challenging and interesting. It was also greatly facilitated by the professional as well as administrative assistance and support of the USAID mission in Lebanon; by the forthright helpfulness and cooperation of the Lebanese government, the private sector (particularly the banking community), and academia; and by the understanding and insights of the President and staff of the Save the Children Federation of Lebanon.

Under normal circumstances, there would be little more to say by way of acknowledgement. But these are not normal times in Lebanon, as evidenced by the tragic loss of life at the U.S. Embassy on April 18, 1983, only two days following our departure. Among the many dead that day were Bill McIntyre, Deputy Mission Director, Tom Blacka, Controller, Al Votaw, Housing Officer, and Rudana Sohyoun, who helped us with most of our secretarial requirements. During our stay in the mission, we had come to know each of these individuals as friend and colleague and would like to record here, however inadequately, our own personal sense of loss.

William T. Irelan
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I. INTRODUCTION AND BACKGROUND

A. The Economic Setting

In the decade before the civil war (1965-74), the Lebanese economy was strong and growing. The GDP averaged an 8 percent annual growth rate, industry was expanding at a 13.1 percent annual rate, and industrial exports grew at a 26 percent annual rate between 1966 and 1973. However, the economy was shattered by, and has yet to recover from, the disruptions of civil war, political instability, and invasion which have beset it since 1975 (see Table 1). The Beirut Chamber of Commerce and Industry estimates, for example, that production has not yet recovered its pre-civil war level.[1] Employment in the industrial sector has fallen from about 120,000 before the war to 45,000-50,000 at present.

The major effects of the war include large population movements, physical destruction of production facilities, interruption of access to markets, and loss of government revenues, especially from port operations, at a time of necessarily increased government expenditures.

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1. L'Economie Libanaise et Arabe, No. 362, January 1983, p. 80.

Table 1. GDP at 1974 Prices
(Billions of LL)

1974	8.1
1975	6.8
1976	2.9
1977	4.8
1978	4.7
1979	4.8
1980	5.0
1981	5.1
1982	4.0

Source: 1974-1980: Central Bank estimates.
1980-1982: Beirut Chamber of Commerce estimates.

It is estimated that since 1975, 100,000 Lebanese workers, about a fifth of the total labor force, have emigrated to Gulf and African oil-producing countries. Some 250,000 Lebanese, half of the labor force, now are working in these countries. Remittances of workers abroad amount to $1.5-2.0 billion a year, some 40 percent of GNP, and measurably cushion the impact of the hostilities on the living conditions of much of the population.[1]

The Council for Development and Reconstruction (CDR) estimates that reconstruction expenditures of $12-15 billion will be needed, including at least $2 billion of damages directly connected with the 1982 Israeli invasion. This will require substantial capital imports if the rehabilitation of the economy is to be achieved within a reasonable period. With conditions of security and political stability, there is confidence that the private sector can and will do the job. Without such conditions, the private sector will hesitate to make the necessary investments.

The private sector remains somewhat uncertain about the prospects for political stability and security and is with-

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1. There is a dearth of statistics in Lebanon and the reliability of those available is suspect. There has been no population census since 1932. Tax records were destroyed during the civil war. The records of the national statistical office (Direction Centrale de Statistique) were lost after that office was twice bombed. Some statistics on the banking sector are collected by the Central Bank (Banque du Liban). The Central Bank uses some estimates -- for example, that 1982 GDP is about LL14 billion -- for internal working purposes. Many of the quantitative estimates which have been most useful for this study have been found in scholarly analysis by the academic community. Although little confidence can be placed in the precision of many of the numbers, the statistics employed in this analysis appear sufficiently accurate to support the conclusions reached.

holding major investments until the situation clarifies. The effects of the government's tenuous control over the country are illustrated by its inability to control ports and to collect customs revenues. It recently has regained control over the Beirut port, but illegal imports continue to enter the country, particularly in the south. Illegal imports from and through Israel are undercutting the domestic market for Lebanese agricultural and industrial goods, and depriving the government of valuable customs receipts. Overland routes to traditional Arab markets are interdicted. A consequence is that Lebanese bankruptcies are said to be occurring at a record rate. In this atmosphere of uncertainty, commercial banks are restricting credit. This reinforces the prevailing gloom in the industrial sector.

B. Problem Analysis

The supply of credit is an important factor in any economy. It is particularly important in Lebanon at present as society undertakes to recover from eight years of civil unrest and destruction. The origin of this study lies in the question of whether there is an unrequited demand by small-scale enterprise (SSE) in Lebanon for credit from the formal credit markets; and if there is, what can be done to satisfy this demand.

The study has found that there is a huge unsatisfied demand for credit by SSE. SSE in Lebanon has never had access to the formal credit markets -- commercial and investment banks; but the shortage of credit to SSE is especially acute now because traditional informal sources of SSE credit largely have dried up. SSE traditionally has financed itself to a large extent from personal savings and from loans from family and friends. These sources have been drawn down under prevailing wartime conditions and are no longer available to SSE. Alternative sources available -- the comptoir[1] and the money lender -- are prohibitively costly.

The study begins in Chapter II by defining and quantifying the SSE target group. SSE is defined as firms that employ fewer than ten people and have credit requirements not exceeding LL200,000.[2] This includes more than 98 percent of the commercial and industrial firms in Lebanon, which means that less than 2 percent of all enterprises in Lebanon has access to credit from the banking system.

The study next attempts to translate the number of SSE into an estimate of the effective demand for credit. It is estimated that an effective demand exists for at least $10-15 million, largely for the rehabilitation of SSE, during the next two years.

The study examines in Chapter III the institutional context in which a credit mechanism for SSE would operate; and in Chapter IV it analyzes the regulatory and policy context within which a credit mechanism would function.

Finally, the analysis leads to the recommendation that a mechanism be set up to deliver credit to SSE. The mechanism is a "Fund" which would guaranty and rediscount loans to SSE by the private sector. The Fund is designed to compensate for and overcome the traditional reasons that commercial banks have been unwilling to lend to SSE.

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1. The comptoir is an unregulated personal finance business. See Chapter III.
2. The present exchange rate is $1.00 = LL4.15. The exchange rate is a freely fluctuating market rate. It has been fluctuating between LL3.74 and LL4.25 per dollar during 1983.

A detailed analysis of the proposed "Fund" in Chapter V concludes that it is feasible and recommends that the Fund be established. Nevertheless, there are issues which require more intensive review than is possible in this study. These issues are defined and discussed in the concluding Chapter VI.

II. NEEDS ASSESSMENT

A. Definition of SSE

SSEs are defined as enterprises which do not have access to formal credit markets. In Lebanon, this corresponds to firms whose credit requirements are LL200,000 or less and which employ fewer than ten people. Commercial banks normally deal only with larger loans.[1] Firms with credit requirements higher than LL200,000 typically employ ten or more people. Within this definition a wide range of enterprise types is to be found, from light manufacturing industries, metalworking and repair works to corner grocers, shoemakers, tailors and the entire gamut of retail trading and other commerce and services.

B. The Target Group of SSE

1. Industry

This SSE target group includes 89 percent of the total number of industrial firms according to the 1964 Industrial

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1. Small branch banks on occasion grant accommodation loans to regular clients in amounts as small as LL50,000. They rarely make isolated loans this small, however, to new clients.

Census. The 1970 Industrial Census showed that the total number of industrial firms with more than four workers increased to 2,862 (compared with 2,099 in 1964); and the percentage of firms with 5-9 workers grew from 1,078 (51 percent of the total) in 1964 to 1,884 (66 percent of the total) in 1970 (see Table 2).

The predominance of SSE, however defined, in the industrial sector is quite clear, which is understandable considering the comparative advantages of the Lebanese economy. Lebanon would appear to have a comparative advantage in labor-intensive products oriented to the domestic market.

The absolute growth and increase in the relative importance of SSE between 1964 and 1970 suggest that SSE normally is flexible and responds to market opportunities. This is consistent with two other fragments of information:

- A study of the effects of the 1975-76 civil war showed a decrease of approximately 300,000 in the non-agricultural labor force. About 200,000 of these emigrated and the balance, it is suggested, was absorbed by the informal sector.[1] (The informal sector is included in the working definition of SSE employed in this analysis.)

- Although operating in a mainly laissez-faire atmosphere, larger scale industry has benefited from fiscal incentives since 1967, from customs advantages, and from special credit facilities.[2] The cumulative effect of these benefits can be seen in measures of effective protection. A recent study concludes that protectionist policies were undertaken in the 1964-70 period, particularly with respect to textiles, leather, clothing, food and agricultural products, and furniture.[3] Considering

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1. Nadim G. Khalaf, "Manpower Movement and the Lebanese Conflict," Banque du Liban, Bulletin Trimestriel, No. 11, December 1981.
2. Nasr, op. cit.; see also Chapter IV.
3. Girair Achdjian, "La Notion de Protection Effective et son Application au Liban," Banque du Liban, No. 19, 1982.

Table 2. Size Distribution of Industrial Firms, 1964

No. of employees	No. of firms	Value added (LL millions)	No. of employees	Average no. of employees
0-4	7,459	98.3	n.a.	n.a.
5-9	1,078	28.8	7,250	7
10-24	693	54.5	9,981	14
25-49	187	52.1	6,525	35
50 and more	141	176.9	21,228	151
Total	9,558	410.6	44,984	21 (average)[a]

a. The problem of fragmentary statistical data is evident here. A 1975 study by the Direction Centrale de Statistique, based on a 1971 industrial survey, reported 18,118 industrial establishments which employed a total of 125,000 workers, including 53,425 permanent, full-time employees. These figures imply an even smaller average number of workers per firm than does Table 2. Samir Nasr, Le Financement de L'Industrie, September 1982. (A report to the Central Bank.) The sense of the prevalence of quite small SSE, however, is enhanced. Again the same study is cited in another article, which adds that 15,256 (84 percent) of the 18,118 firms employed fewer than five workers. Fernand Sanan, "Le Financement de L'Industrie au Liban," Le Commerce, November 16, 1981.

Source: Direction Centrale De La Statistique, Recueil de Statistiques Libanaise, No. 9, 1973, except for the category of 0-4 employees. The latter is from Centre d'Etudes et de Recherches sur le Moyen Orient Contemporain (CERMOC), Etat et Perspectives de L'Industrie au Liban, May 1978, Annex 9.

> that in 1975 only 15 industrial firms were capitalized at more than LL1.0 million, it seems clear that the benefits of protection accrued to a relatively few, larger firms and probably very little to SSE.

The tentative inferences which can be drawn are that SSE is flexible, operates in a competitive environment, and expands and contracts in response to market signals.

Again, there are some partial data on industrial licenses and capitalization, 1978-81. Calculations based on the data in Table 3 show that the plants licensed during this period averaged more than nine workers each (13-35 average number of workers per plant) and were relatively capital-intensive (LL121,000-245,000 investment per job). These are not SSE.[1] These firms for the most part have access to the formal credit market.

2. Commercial, Agricultural, and Industrial SSE

At this point, it can be concluded that SSE, as defined for this study, includes most of the industrial sector. The target group for the proposed project, however, is not the industrial sector only. It also includes commercial establishments and SSE in the agricultural sector.[2] The data on non-farm, commercial enterprises can be derived from tax

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1. Data published for 1982 show that 20 new industrial firms were licensed with an average investment of LL290,000 per job and an average employment of 20 workers per establishment. Industrial Affairs (in Arabic), No. 2, January 1983, p. 33. The deterioration of the investment climate is evident in these figures.

2. Small (and other) farms, as farms, are excluded. The Fund proposed in Chapter V of this study would finance small-scale enterprises which provide services and products to farmers and farm communities.

Table 3. Industrial Investment, 1978-81

	No. of licenses granted	Capitalization (LL millions)	No. of employees
1978	64	239	1,975
1979	138	740	4,890
1980	77	373	1,524
1981	31	54	410

Source: B. Labaki, _Le Commerce du Levant_, 1982, as shown in Nasr, _op. cit_.

information. Small enterprises are assessed a lump sum tax on the basis of an annual visit by a tax inspector. Tax evasion is difficult for any establishment with a fixed location. Based on the registry of all firms, the tax records for the period 1972-74 show a total of 60,000 commercial enterprises and industrial firms:[1]

No. of Employees	No. of Firms
0-4	54,000
5-9	5,000
10 and over	1,000

These statistics show that over 98 percent of non-agricultural establishments are embraced in the definition of SSE. While the exactness of the figures may be suspect, they are consistent with what might be expected: that commerce and services would absorb more workers than the industrial sector in Lebanon.[2]

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1. Interview with Mr. Joseph Torbey, Commissioner, Income Tax Department, Ministry of Finance. The tapes containing tax records for later years were destroyed in the fighting.

2. The only crosscheck identified is based on the estimated sectoral distribution of the non-agricultural labor force. (See N. Khalaf, _op. cit._) For 1971, it is estimated that 106,663 workers were in industry, 101,698 in commerce (including hotels and restaurants), and 186,158 in services (including housing and administration) out of a total estimated labor force of 474,814. If (a) the average number of workers per establishment were the same in these three sectors (firms should have fewer workers in commercial and service SSE), (b) if the entire labor force in commerce and in services were included in our target population (housing, hotel, and administration workers should be excluded), and (c) if the 18,118 industrial firms reported in 1971 is accepted as accurate, then the total number of firms in the industrial, commercial, and service sectors would be 67,531. Again, the statistics, while suspect, present a consistent general picture of the dimensions of the target group universe.

C. Effective Demand

The foregoing exercise is an attempt to get some idea of the size of the target group. The best estimate is that it consists of a population of some 59,000 non-agricultural firms and perhaps an additional 3,000 SSE in the agricultural sector -- a total of 62,000 SSE.[1]

The size of the target population itself, however, can only provide clues to a potential demand for credit. What is needed is to translate this into effective demand. Although this cannot be done with any precision on the basis of the data available, it is possible to establish some basis for a reasonable judgment that certain levels of credit provided would be disbursed rapidly. Table 4 illustrates the types of tradeoffs which could occur with a total of $10.0 million (i.e., approximately LL41,000,000) initially available.[2] (As will be demonstrated in Chapter V, such an amount could also leverage money from the commercial banks through guarantees and partial discounts.)

The percentage of the target group which can be reached initially is quite small. The percentage of the rehabilita-

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1. This crude estimate is based on the assumption that 10 percent of workers in agriculture are engaged in SSE activities. Labor force estimates for 1971 are from N. Khalaf, op. cit.

2. The $10.0 million figure is used for illustrative purposes only. It represents a sum large enough to justify the administrative effort of establishing a special SSE credit program and one sufficient to engage the participation of a substantial number of financial intermediaries (i.e., probably commercial banks) in the delivery of the credit to ensure broad geographical and sectoral coverage. At the same time, it is small enough to be within the range of potentially available donor and government support of the initial phase of program implementation.

Table 4. Illustrative Loan Alternatives

Average amount of loan (LL)	No. of loans (first round)	Percentage of target group
10,000	4,100	6.6
25,000	1,640	2.6
50,000	820	1.3
100,000	410	0.66
150,000	273	0.44
200,000	205	0.33

tion needs of the target group which can be addressed, however, is significantly larger. Not all SSE suffered direct damage in the war. The Middle East Economic Consultants estimated an 80 percent loss in industrial production at the height of the civil war and a lingering 20 percent reduction in capacity four years later in 1980.[1] The 1982 invasion occasioned additional damage, especially in the south and around Beirut. A survey by CERMOC showed that 41 percent of the industrial firms suffered a decrease in production because of the civil war;[2] and a recent survey of 164 industrial firms showed that the reason most often cited for sub-utilization of capacity was the lack of bank financing.[3] (The second obstacle most frequently listed was lack of security.)

If 20 percent of the target group needed rehabilitation credit, up to a third of the need could be met in the first round of lending. While there is no way, short of a quite sophisticated and costly survey, to anticipate with precision the effective demand for the proposed Fund, the illustrative numbers lead one to think that credit offered to SSE in the amount of $10 million would be disbursed quickly.

More persuasive than illustrative numbers, however, is the judgment of knowledgeable people in the banking community and in the public sector, and the experience of the Save the Children Federation (SCF) in lending for very small rural and urban enterprises. The bankers, both in commercial banks and in the specialized banks, and public sector officials uniformly expressed the opinion that there is a substantial

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1. *Study on the Socio-Economic Situation in Lebanon*, February 1980 (a study for AID).
2. *L'Industrie Libanaise et les Marches Arabes du Golfe*.
3. Nasr, *op. cit*.

demand for credit, on market terms, by SSE; that this demand cannot now be satisfied by the formal credit system; and that there would be no problem in moving LL40-50 million in a two-year period were an appropriate mechanism or program facility available to manage the effort.

In the SCF portfolio, 566 rural SSE loans averaged LL8,530, equal to an estimated 41 percent of total project cost. One hundred eighty-seven urban SSE loans averaged LL10,735, equal to 24 percent of total project cost. Much more could have been lent if the SCF had had more staff and more resources. The SCF management and staff attest to an unsatisfied credit demand on terms approaching market rates.[1] The limitation of staff and resources has prompted the SCF to restrict their activities in an effort not to raise expectations that cannot be satisfied.

D. Non-Financial Needs

In most developing countries, the principal needs of the SSE sector are typically technical as well as financial. A combination of development assistance inputs normally is required. These may range from credit, technical and management assistance, and vocational training to assistance in market development, procurement and aid in organizing the sector to advocate and obtain aid from appropriate government agencies and private financial institutions. As already indicated, the target SSE sector in Lebanon faces a broad need for formal credit. It remains to be determined (1)

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1. The SCF limits loans to a maximum of LL15,000 in rural areas, LL20,000 in urban areas. Interest rates are 8-15 percent, depending on whether the loan is for rehabilitation or development, is an urban or rural loan, and on the period of loan (up to five years).

whether the target sector faces non-financial needs, and if so, (2) the extent to which the satisfaction of any or all of such needs is a prerequisite to the rehabilitation and continuing development of the sector.

1. General Background

In approaching both of these questions, it is important to note that Lebanon cannot be classified as a developing country as such, although many sectors face rehabilitation and developmental needs consequent to the eight years of civil war and international conflict recently experienced. The SSE sector is well-established and in many respects the backbone of the national economy, providing the vast majority of employment opportunities and a large share of GNP.

The SSE sector has apparently also proved adaptable to economic disruption and dislocation attendant to wartime conditions. One observer has estimated that the informal sector (i.e., the lower end and largest element of the SSE scale) has possibly absorbed as many as 100,000 dislocated and unemployed workers into its labor force.[1] Although it is doubtful that many of this number have found full-time gainful employment, it seems plausible that large numbers have been provided with employment opportunities they would not have otherwise obtained. Altogether, the Lebanese SSE sector is not only extensive, but also appears to be fundamentally well-developed and resilient.

In sum, Lebanon does not face the task common to most developing countries of stimulating the development of the SSE sector because an active and vigorous sector already

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1. Khalaf, _op. cit._, p. 10.

exists. Rather, it must meet the urgent needs of reconstruction and rehabilitation of the sector. It can, therefore, be inferred that the SSE sector in Lebanon does not face the same generalized need for intensive technical and management assistance provided in such typical community development programs as those evaluated in the USAID Pisces study involving primarily the establishment ab ovo of small-scale income generating projects.[1] However, the issue must be examined in its component parts before firm conclusions can be drawn.

2. Technical and Management Assistance

From the information obtained from bankers and other knowledgeable individuals, it does not appear that the SSE sector suffers from any truly constraining lack of technical or management capability. At the very lowest end of the scale, the capability to operate profitably small retail operations, repair shops, and light manufacturing concerns is well-established. Bookkeeping and other management techniques may be lax, but the former can essentially be attributed to tax considerations and the latter to the lack of a practical requirement for any great level of sophistication.

The SCF program offers somewhat contrary evidence, at least with regard to small borrowers in the rural areas.[2] SCF provides a "supervised credit" scheme in which borrowers are identified, assisted with loan applications, their projects assessed for financial and economic viability, the collection of loans monitored and repayment assured through peer group pressure. Credit is provided in the context of an

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1. USAID, "Program for Investment in the Small Capital Enterprise Sector," September 1981.
2. Such loans average LL8500.

integrated community development effort of which the main element is community organization. Technical assistance is provided by a team of SCF staff, all trained in technical aspects of agriculture. Most technical assistance is consequently provided in the rural areas and essentially in the form of agricultural extension work. The focus is on improving farm production practices and thus output. Some technical help is provided to SSEs engaged in agriculture related to industry and commerce. Little technical assistance is being provided to borrowers in urban areas. In sum, the SCF program provides technical assistance, but primarily related to farm production, which is outside the sphere of the identified target population.

It can therefore be concluded with some certainty that the lowest level of the identified target group (enterprises with fewer than five employees and credit requirements averaging LL10-15,000) does not appear to require technical or managerial assistance in order to operate their relatively simple enterprises at a profit. The indigenous economic infrastructure and commercial and entrepreneurial skills seem sufficiently advanced as to obviate any major concern for such issues at this smallest enterprise level.

At the higher end of the scale of the target population (enterprises with fewer than ten employees and credit requirements from LL50-200,000), some need for technical and management improvement may exist. These SSEs generally consist of technically and/or organizationally more complex operations. As a result of government protectionist policies, as well as the disruption in operations resulting from the civil war, many will have fallen behind the technological and management advances that have occurred in recent years. These larger operations, however, generally appear to have the capability to respond to these problems on their own, once the appropriate policy framework is in place and peacetime conditions prevail.

Other SSEs of this size and type may only be larger versions of the relatively simple operations already described at the lower end of the scale of the target group. Like their smaller counterparts, they appear to have no pressing need for technical or management advice.

3. Vocational Training

Lebanon has an extensive and well-developed vocational training system, with educational opportunities being provided both by government and private institutions, the latter including both commercial operations and confessional (sectarian) programs. The government program is operated by the Directorate General of Vocational and Technical Education in the Ministry of Education. All private institutions follow the government's curriculum and examination procedures in order to provide accredited degrees.

The government program, which was established in 1962, provides three levels of training and offers three different degrees. Although centered in Beirut, the program has branches operating in each province which provide training up to the third level. The government also operates the Ecole d'Hotelier as a special school to train all levels of restaurant and hotel management personnel.

At the first level of the system, trainees of the age of 13-14 years with an elementary school education are admitted. The curriculum offers a wide range of subjects including: carpentry I (construction related skills), carpentry II (furniture making skills), metalworking, woodworking, basic secretarial skills (typing, etc.), printing, nurses aides, etc. The program is three years' duration, upon completion of which the graduate receives a Brevet Technique.

The second level of the program involves three years of study leading to a degree of Baccalaureate I (Bac Technique). Courses include higher training in the basic vocational subjects offered in the first level plus drafting (industrial and engineering), car mechanics, electrical wiring and installation, electronics (radio and TV repairs), data processing (keypunch, etc.), bookkeeping, etc.

The third level of the program, which offers a Baccalaureate II degree, provides one additional year of specialization in such fields as electricity, electronics, metallurgy, topography, executive secretary training, and nursing. Obtaining the Baccalaureate II degree qualifies a trainee for admission to a university program.

There are 17 government and 113 private technical and vocational schools in Lebanon with about 15,500 students enrolled for officially recognized degrees. Another 13,000 trainees are enrolled in private technical training centers offering private technical aptitude degrees. In sum, approximately 29,000 trainees are enrolled in technical and vocational training courses in the country. Of the 17 government schools, five are located in the suburbs of Beirut, four in North Lebanon, four in South Lebanon, two in Mount Lebanon, and two in the Beqaa. Of the 113 private institutes, 86 are concentrated in Beirut and its suburbs.[1]

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1. Iskander and Baroudi, "The Lebanese Economy in 1981-1982," Middle East Economic Consultants, Beirut, Lebanon, 1982, pp. 197-198.

Graduates of these vocational and technical schools were, prior to the war, reportedly in great demand and employed by enterprises at all levels of the enterprise spectrum. Accordingly, it can reasonably be concluded that the vocational training needs of the target SSE population were, at least before the war, being relatively well served. Although this conclusion would appear to apply without serious question in Beirut and other urban areas, it may not be entirely true with regard to the more rural areas where the institutional infrastructure for vocational training is considerably less well-developed.

Because of the war, many skilled and semi-skilled workers have left the country, including many foreign workers. As conditions stabilize in the post-war period, demand for this type of labor will increase with resultant pressure on the SSE and other sectors. This demand may well be met, however, by the government's apparent planned expansion of its vocational and technical school system. According to an existing plan, the government will raise the level of graduates of its schools to 11,500 from a level of 5,350 in 1975 and train thousands more through evening and summer courses and specialized on-the-job training.[1]

4. Marketing, Procurement, and Quality Control

To a large extent, the target group to be assisted by a SSE credit program would be serving a local market. This would be true almost without exception with respect to the lower end and largely the case with the higher end of the

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1. "Study on the Socio-Economic Situation in Lebanon," op. cit., pp. 76-77.

scale. Most of the target group is well-established and commercially viable, which leads to an inference that these SSEs do not fundamentally face any serious marketing or procurement problems. The marketing of artisan products is being aided by both government and private groups, such as Artisans du Liban and Artisanat Libanais. Problems associated with wartime disruptions undoubtedly exist, but these will disappear as peacetime conditions return.

Some of the larger SSEs involved in exporting manufactured goods may be able to use assistance in market development, procurement, and quality control, but the evidence seems to indicate the contrary. Small as well as large exporters appear to have considerable skill and experience in developing markets throughout the region and in Europe. Export businesses are frequently developed through the use of licenses from international firms and quality control maintained through continuing association with the parent manufacturer. The importation of raw materials for processing and resale is well-established practice. High standards of quality appear to be achieved even by those entrepreneurs operating without the benefit of license agreements. The issue of quality control in particular would not appear to be of great import to the bulk of the targeted enterprise population, most of which consists of commercial and trading operations where quality of product is not an issue.

In short, the problems of marketing, procurement, and quality control usually associated with SSE in developing countries appear negligible in Lebanon.

5. Organizational or Advocacy Assistance

Many SSE development projects aim to encourage the establishment of small, commercially self-sustaining enterprises among people and in societies essentially existing at subsistence levels and outside the cash economy. In such cases, a combination of assistance inputs is required to generate enterprise development.

In addition to credit, technical, management, marketing, and procurement assistance, beneficiaries may need help in organizing units with which government and other institutions can work and which can serve as advocates for the community vis-a-vis such institutions. Cooperatives, where they exist, may serve this purpose. Village development committees have also proved to be a useful organizational form for carrying out these functions.

Where a well-developed SSE sector already exists, as in Lebanon, the need for the organizational and advocacy functions of the intermediary development organization is considerably circumscribed. Such institutions can still, however, provide an important mechanism of access to the target SSE group. For example, the SCF loan program has been implemented through both cooperatives and community development committees, which may constitute pre-cooperatives. The National Union of Credit Cooperatives (NUCC) implements its credit program through cooperatives. The need for intermediary development organizations in the SCF program has arisen from two considerations: (1) the lack of an administrative apparatus through which to implement its programs, and (2) the need for surrogate collateral (i.e., group guarantees) from borrowers not otherwise creditworthy.

In the case of SCF, the establishment of such committees also serves the important objective of community organization. As for the credit program, however, the community organization primarily provides a delivery mechanism, a substitute for collateral and a means (peer group pressure) of ensuring high repayment rates. Were alternative ways of satisfying these requirements available, the need for intermediary community organizations could be obviated for perhaps all but the most remote rural communities.

As described elsewhere in this report, it appears possible to formulate a credit program for the targeted population which could work through the existing commercial banking system, satisfy creditworthiness requirements, and maintain high repayment rates. It is unlikely, however, that the commercial banking system could be counted on to undertake the informational and promotional campaign necessary to launch such a credit program to small borrowers. In this regard, it is instructive to note that many banks and businessmen to this day are reportedly unaware of the soft-lending facilities the CDR has provided for reconstruction aid. Neither the CDR nor the responsible specialized banks have apparently promoted these credit facilities on a widespread basis. Yet if substantial publicity is required to promote a new credit facility operating at the most sophisticated levels, it would likely be even more necessary when dealing with a potential clientele that has had little if any contact with the formal credit system. Views to the contrary have, however, been forcefully expressed.

Also, it is unlikely that a credit system run through the banks would ever reach the lowest level of the identified target group operating in remote, rural areas. To reach this group would require an outreach or extension capability the commercial banks do not have and will likely never obtain. Such groups can only be reached by such organizations as SCF which maintain the necessary outreach capability.

E. Conclusions

This assessment identifies a need (effective demand) for formal credit lying within those small-scale enterprises with credit requirements typically of LL200,000 or less, and which employ fewer than ten people. The target group includes industrial and mechanical enterprises, retail trading operations, commercial and other services primarily found in urban areas as well as rural businesses providing services and products to farmers and farm communities. It comprises the vast majority of all Lebanese enterprise.

Within the target group, many suffered great losses during the past eight years, either direct physical destruction or a debilitating loss of income. Consequently, the need for the rehabilitation and further development of the SSE sector is urgent and large. Analysis indicates that as much as $10 million in credit could be absorbed by the sector within a two-year period, even if offered essentially on commercial terms.

Within the defined SSE sector then, the principal need appears to be one of finance made available on a regular basis and on normal commercial terms. Although some elements of the target SSE group, particularly in the rural areas, could doubtless benefit from some basic bookkeeping and general management help, such assistance would in few cases represent a _sine qua non_ to the effective use of credit and the successful operation of the enterprise. Similarly, assistance in marketing and procurement would not appear to be critical to the successful operation of most enterprises in the target population. A large part, if not most, of the enterprises would be serving local markets; those which wish to market products or services on a wider geographical basis face few difficulties in a country such as Lebanon which is not only small, but has evolved a relatively advanced economic infrastructure. As for export manufactures, the Lebanese have demonstrated a proved capability to manufacture quality products and market them abroad.

There is no apparent need to link vocational training to a SSE credit program. There is a well-developed vocational training program in Lebanon organized on both a public and private sector basis. This system seems geared to respond to the needs of all levels of the economy.

Nor would assistance with product quality control be a major requirement for a successful SSE credit program. The quality of Lebanese products is generally high and even competitive in many international markets. Moreover, the majority of the target SSE group is engaged in retail trade and commercial services where control of product quality is not an issue.

SSE has developed sufficiently on its own in Lebanon so that no organizationl or advocacy assistance is required to get it started or to maintain its viability. Nor are intermediary development organizations required to serve as SSE credit delivery mechanisms except in remote rural areas, assuming a means of involving the extensive commercial banking system can be devised. Some organizational assistance would likely be required, however, to promote the establishment of a SSE credit program for small borrowers. Targeted potential borrowers are not accustomed to having access to formal credit and would need to be informed about an available facility and initially educated in its use. Some organizational help would also be needed to extend the program to remote rural areas.

III. INSTITUTIONAL CONTEXT

A. Government's Organizational Capacity and Policies

1. Policies

Lebanon's economy can be characterized as one of the most open and liberal in the world, about as close to the laissez-faire doctrines of Adam Smith's philosophy as any modern economy can practically be. The private sector has traditionally been left to carry out the functions of producing and delivering goods and services with little interference from the national government. Conversely, the government has provided little help to the development of the private sector.

As a consequence, private associations such as the various Chambers of Commerce, the Bankers Association, and the Industrialists Association appear to exercise great influence on the economy, while the Ministries of Finance, Commerce, Industry, Planning, and until recently even the Central Bank, seem to play a decidedly secondary role. This situation may begin to change as a result of the creation of the Council for Development and Reconstruction (CDR) for the purpose of planning the orderly rehabilitation of the nation's war-torn economy. The CDR represents an institution with the potential to perform the function of a central planning mechanism.

Lebanon has had some previous experience in planning. There is an urban planning agency which apparently dates from the French mandate period. Also, the Ministry of Planning has been functioning since the 1960s. It has, however, evidently little broad national planning to its credit, having focused primarily on infrastructural development. No real industrial, agricultural, or social policy or planning has emanated from that experience. This probably is partly the result of the strong private sector orientation of the economy and perhaps the consequence of a lack of national consensus on matters relating to the distribution of national social and economic benefits.

Lebanon has thus historically had no established policy framework for the development of the commercial and indusrial sectors. The government has, however, formulated, on somewhat of a piecemeal basis, a range of individual policies in support of these sectors, particularly industry. These include: tax exemptions for new industries; protection from external competition; subsidization of certain exports; customs exemptions for certain equipment and spare parts; subsidized fuel and power; international trade agreements; preference purchasing by government agencies; development of technical and professional educational facilities; and assistance to research through the Institute of Industrial Research.

On February 28, 1978, the Council of Ministries approved the Orientational Framework of the Industry Reactivation Plan. This plan aims to encourage establishment of industries in rural areas, develop new export outlets, protect certain industries, foster the growth of joint stock industrial establishments, lower consumer prices, reform customs policies, etc. The CDR as well under Article 18 of its decree is mandated to propose a long-term industrial policy. The government has also taken a number of specific actions to assist industry and commerce recover from the losses suffered in the war, both physical destruction and the financial losses resulting from the decline in economic activity. These include _inter alia_:

- Legislative Decree No. 3 of January 15, 1977, providing for the establishment of a National Institute for the Guarantee of Investments (NIGI). The NIGI guarantees, for all sectors, investment in all new commercial, medical, and industrial firms established after the date of the issue of the decree against war risk.
- Legislative Decree No. 130 of February 11, 1977, allowing for pre-war debts to be repaid over periods ranging between 2-7 years.

A range of other tax and fiscal policies taken following the war are described in the next chapter.[1]

In summary, the government has no clear development plan for commerce and industry. It has instituted a number of random measures and policy actions and delineated some planned objectives for the encouragement of commerce and industry. It has made little attempt, however, to relate or rationalize such actions in an integrated, comprehensive plan or actively to promote the development of specific industries.

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1. See, generally, Iskandar and Baroudi, _op. cit._, pp. 18-20.

2. Central Banking System

The Central Bank (Banque du Liban) was established in 1963 in conjunction with the passage of the Money and Credit Code. It was created first and foremost to assume for the government the responsibility of issuing the national currency, a privilege previously held by a private commercial bank, the Bank of Syria and Lebanon. The Central Bank was also given broader powers usually associated with the central banking function, i.e., to maintain and promote the banking system and to develop monetary and financial markets.

In brief, the Central Bank was granted all the powers necessary to carry out national monetary and fiscal policy. These include intervention on the foreign exchange markets to ensure the parity of the Lebanese pound; the determination of reserve requirements for the commercial banks; the purchase and sale of private and public financial instruments; discount and rediscount operations, etc. The bank is headed by a Governor nominated by the Minister of Finance; monetary and financial policy is formulated by a Central Committee comprising the Governor and three Vice Governors and the Directors-General of the Ministries of Finance and of Economy.

The functions of the Central Bank are partly implemented by public sector agencies attached directly or indirectly to it. The Bank Control Commission is an independent agency established in 1967 to perform the function of bank examiner throughout the banking system. The High Banking Committee was established within the Central Bank in 1967 to implement where necessary recommendations of the Control Commission vis-a-vis particular delinquent banks.

The Central Risk Office is a department within the Central Bank established in 1980 to ensure weekly and monthly reports from all commercial banks on the creditworthiness of clients. The National Deposit Guaranty Institute was created as an independent entity in 1967 to insure deposits up to LL30,000 per depositor per bank. The National Institute of Investment Guarantees and its war-risk insurance role have previously been described.

Since its establishment, the Central Bank has played an increasingly important role in the Lebanese economy. It was particularly active in reordering lax banking practices and restoring confidence in the system following the crisis of the Intrabank collapse in 1966. Many of the aforenoted institutions were created precisely to support the Central Bank's reorganization and regulation of the banking sector in the aftermath of the Intrabank crisis.[1]

The Central Bank and related agencies operating within the central banking system constitute an important and influential underpinning to the Lebanese economy. Were the Central Bank willing, it would be an appropriate institution to which a SSE credit program could be attached. The Control Commission might serve as the monitor of such a program to ensure that its mandate was being honored and funds being properly disbursed.

3. Public Sector Organizations

As already indicated, Lebanon has never developed a strong central government, but rather has relied heavily on

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1. See generally, Liban Banques, Profils, "81,82", L'Orient-Le Jour, Beirut, Lebanon.

the private sector to take the lead in organizing and operating the principal economic functions and institutions of the society. Public sector organizations are consequently not institutionally well-developed and largely lack the capability to organize and manage development programs. Public agencies, especially ministries, are also reportedly highly politicized and incur frequent changes of leadership. Potential additional problems include the administrative inefficiencies of government agencies and the ever present system of "wasta" or influence which, within a bureaucratic context, might lead to a progressive dilution of the strict application of eligibility criteria necessary to the proper operation of a credit program.

For all of the foregoing reasons, it would probably be inadvisable to establish a SSE credit program within a public sector agency. Other reasons support such a conclusion. Apart from the NUCC, no single government agency appears to have had much experience in operating a credit program. The NUCC, which is by law limited to assisting cooperatives and tends to deal with larger enterprises, could not and likely would not be inclined to assist individuals in the identified target group. Moreover, an SSE credit program would need to serve enterprises in commerce and industry in both urban and rural areas, thus cutting across the interests of several ministries. Excepting the apparently moribund Ministry of Planning and the CDR, which is a planning and not an executive agency, no public sector agency has the broad mandate required to promote the range of interests that would be involved in serving the credit requirements of the identified target SSE group.

Of the existing complement of public sector institutions, the only one with apparent potential to operate a SSE credit program is the Joint Commission established to manage the AID grant program to the SCF. The Joint Commission, which comprises representatives of the Directorate-General for Cooperatives, NUCC, and SCF, works through cooperatives and intermediary development committees and is authorized to provide loans to individuals. It reviews and approves all loans presented to it by the NUCC and the SCF. The Joint Commission has no experience, however, in processing credit directly to individual enterprises, which form the bulk of the identified target population for a SSE credit program. It has no nationwide administrative structure through which it can administer a credit program in the field, which is why its loans are processed through the NUCC and its existing network of cooperatives and through SCF and its intermediary development committees.

The Joint Commission has gained considerable experience in the area of credit for SSE. It is also interested in expanding its operations and willing to assume responsibility for the envisaged SSE credit program. On balance, however, it would not appear that placing the proposed SSE credit program with the Joint Commission would produce the intended results. It has a programmatic orientation toward cooperative and other forms of organization, rather than individual enterprises, and generally toward agriculture more than commerce or industry. It does not have the staff capability to manage a nationwide program and the agents it works through, NUCC and SCF, lack the capability at present to undertake a credit program for commerce and industry on a national scale. Its authority only exists by ministerial decree, which would restrict commercial banks' willingness to work with it in its present form as a government dependency. Finally, one of its two implementing arms, the NUCC, is being tapped for a principal role in the operation of the proposed new National Agricultural Development Bank, which limits its likely interest in participation in other programs.

The mixed specialized banks (private/public) represent another possible institutional instrument for the administration of a SSE credit program. These include the Banque de Credit Agricole, Industrial et Foncier (BCAIF), the Banque Nationale pour le Developpement Industriel et Touristique (BNDIT), and the Housing Bank, which are meant to provide medium- to long-term credit. The use of such institutions is questionable, however, for several reasons.

These mixed specialized banks have no nationwide outreach capability, i.e., no branch bank system. Their central administrative capacity is limited and would have to be substantially expanded in order to manage a large number of small individual loans. They also have a reputation for lengthy and cumbersome loan application practices. As explained in the following section, the viability of the specialized banks under current legislation is somewhat problematic.

The BCAIF is 40 percent owned by the government and 60 percent by the private sector. Established in 1939, it was the first, and until 1971, the only development bank in Lebanon, i.e., the only bank to offer medium- and long-term credit. The assets of the Bank remain small and it depends largely on government guarantees and advances from the Treasury for credit offered. The BCAIF has one branch in Tripoli; two others in Sidon and Zahleh closed several years ago. Its interests have reportedly traditionally leaned toward larger enterprises with the necessary collateral to secure loans offered. BCAIF's status as a bank is somewhat unusual, not being enrolled on the official list of banks.

The BCAIF, which has proved unable to perform its mandate, is not a likely candidate for participating in the SSE program and was not contacted.[1]

BNDIT was established in 1971 with its shares 51 percent owned by the government and 49 percent subscribed by the private sector. The Bank's role is to finance economic development projects in industry and tourism through medium- to long-term credit. Unlike other specialized banks, BNDIT is limited to financing only development projects, i.e., new investments. However, BNDIT lacks resources of its own and has existed primarily on commissions provided for the management of post-war government aid to industry. In this regard, BNDIT managed a LL50 million low-interest credit program advanced by the Central Bank aimed at reviving industry damaged in the 1975-76 war. It also participated in the management of the LL400 million CDR credit program for the same purpose. In both instances, BNDIT acted as fiscal agent for the government; the actual loans were provided to clients directly by commercial banks. It has no branches and no experience in providing credit to small enterprises. Its administrative capacity is limited. The management of BNDIT, however, indicated a strong interest in serving as an agent to manage a SSE program established according to the CDR credit program model.

The third mixed specialized bank, the Housing Bank, is too specialized to be considered as an instrument for a broad-based SSE credit program.

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1. Although the BCAIF might have been a likely candidate to develop into a national agricultural development bank, FAO has recommended and the government has agreed to establish an entirely new institution.

B. Private Sector Interest and Capacity

1. Commercial Banks

Currently 84 commercial banks are operating in Lebanon. Of these, 66 are incorporated in Lebanon and 18 are foreign, of which five are of Arab origin and the rest international. During the last 8-year period of internal strife and invasion, the commercial banking sector has proved the strongest and most resilient sector of the national economy. Although the tourist and hotel sector has been nearly annihilated and others, such as industry and agriculture, have in some measure had difficulty surviving, the banking sector has expanded rapidly, both institutionally and in terms of total assets.

Indeed, the peculiar conditions created by the war seem in this respect to have benefited the commercial banks. Prior to the war, the structure of the banking sector was relatively centralized. Because the events of 1975-76 led to a total destruction of the central commercial district, banks were forced to decentralize and greatly extend their infrastructure in order to serve clientele that had become isolated and whose movements were circumscribed by the war. From approximately 230 branches in 1975, the system has grown to some 400 branches today.[1]

The consolidated balance sheet of the commercial banks rose during the 8-year period by nearly 33 percent and now stands at about LL62 billion. Most of this increase came from remittances of the approximately 100,000 Lebanese

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1. See generally Liban Banques, *op. cit.*

nationals who left during the period to work in Arab countries.

As a result of the decline in economic activity occasioned by the war and the tremendous increase in deposits, the commercial banks face a serious problem of excess liquidity. Many banks appear to be aggressively seeking outlets for these assets. However, commercial banks' ability to provide term credit is constrained by both law and depositor preferences. By law, loan maturities must correspond to maturities of deposits. Most depositors, individual and commercial alike, are unwilling to block funds for longer than six months at the outside. As a result, term credit offered by commercial banks is restricted to a maximum of about one year. For prime customers, banks roll over so-called "evergreen" accounts on a yearly basis. Most such facilities are beyond the reach of small borrowers; even where granted small borrowers must generally face the prospect of repaying overdraft credit on an on-call basis.

Thus, commercial banks currently have little involvement in servicing the credit needs of the target beneficiaries of a possible SSE credit program, although they clearly have the capacity to do so. In discussing with commercial bankers the possibility of participating in an SSE credit program, the response was mixed. Many said they would have no interest in such small accounts, others were undecided, and several indicated considerable interest in participating.

The degree of interest shown by commercial banks appears to relate inversely to their size. Large banks are not interested in small accounts which would be unable to turn over the credit offered on a regular basis (i.e., quarterly), would have no need of other banking services, such as letters of credit and letters of guarantee, and which would in any case not meet creditworthiness standards. Small banks, however, appear generally interested.

Since the small banks number some 40 out of the total, it would appear that a SSE credit program could be run successfully through the commercial banking system. Given the large network of branch banks around the country, the commercial banking system also has the potential to operate a program on a nationwide basis, a service no other institution or set of institutions can presently offer.

2. Private Specialized Banks

There are currently two private specialized banks, i.e., banks offering medium- to long-term credit. These include the INFI Bank and the Finance Bank. Of two other private specialized banks previously active, one, the Near East Bank, was absorbed by a commercial bank and the other, the Union Bank, was liquidated. The future of the specialized banks, both private and mixed, is in question as a result of the regulations under which they operate. This situation bears most directly on the private specialized banks in which the government has no financial interest to protect.

Under current regulations, specialized banks enjoy certain tax and other advantages vis-a-vis the commercial banks. However, they are limited to accepting individual deposits of two years or more, or 18 months and longer for certificates of deposit, and bank deposits of one year and longer. Moreover, loan repayments cannot begin earlier than two years following the date of the loan. Since individuals in Lebanon rarely deposit funds in long-term accounts, particularly under the conditions that have prevailed in recent years, the specialized banks have been unable to obtain resources of their own with which to carry out their stated developmental function. Between 1974 and 1980, for example, the combined capital of the private specialized banks declined from 21 percent of the total capital of banks to 5 percent of that total.

The specialized banks have sought relief from their difficult position by requesting policy changes, public sector deposits and soft-loan facilities. Thus far there has been little public response from government and the future of these banks is consequently unclear. The consultant mission learned informally, however, that the government is in the process of formulating changes in policy.

Like the mixed specialized banks, the private specialized banks have no branch system and lack staff capability to administer a SSE credit program. They would appear, however, to be well placed to serve as an agent to manage such a program through the commercial banks, assuming their fortunes improve. Both private specialized banks noted that participation in a government-sponsored credit program would help to improve their image and assist their efforts to obtain policy and regulatory change.

The INFI Bank was established in 1973 and is 35 percent owned by the Bank Audi Group, 40 percent in equal parts by five foreign financial institutions, and 25 percent by individual Lebanese. It is reputed to be the best managed of all the specialized banks, owing most probably to its close affiliation with the large Audi Group and the considerable foreign participation. Senior management indicated a strong interest in participating in any SSE credit program that might be established.

The Banque de Financement (Finance Bank) was the first private specialized bank, having been established in 1972. It is wholly owned by the Intra Investment Company. Having experienced little success as a specialized bank, it has applied for permission to be reconstituted as a commercial bank. Senior bank management nonetheless indicated a serious interest in serving as a financial agent for an SSE credit program.

3. Comptoirs and Moneylenders

The comptoir system in Lebanon appears to be an institutional form of the traditional moneylender system. Individuals or a collection of individuals establish small financial institutions from their own capital resources which lend to individuals for personal consumption or small business purposes. Rates are high, even exorbitant, ranging currently from 20-40 percent. Comptoirs are known to resort to deceptive interest calculations that defraud and exploit the unsophisticated and the unwary. Yet banks have traditionally been willing to discount notes from the comptoirs and the government even honors contracts that permit monthly payroll deductions from the incomes of government employees indebted to the comptoirs. A SSE credit program could serve the important purpose of providing the small borrower with an alternative to the confiscatory practices of the comptoir system. Although the comptoirs suffered heavy defaults in the past eight years, knowledgeable observers indicated that the system would be back at full strength as soon as conditions permit.

C. Save the Children

The SCF program has previously been described. Evaluations of both the SCF program and its institutional relations are currently being undertaken by a professor from the School of Business Administration at the American University in Beirut (AUB). These evaluations had not yet been completed at the time of the consultant mission and could not be reviewed. This was particularly unfortunate with regard to one issue being evaluated, i.e., the possibility of expanding and further institutionalizing the SCF program.

Nonetheless, the consultant mission had considerable contact with the SCF management, visited SCF beneficiaries in Sidon, and reviewed SCF records extensively. The basic impression gained was that the SCF program has been imaginatively conceived and exceedingly well implemented. It appears in every respect to be a model example of the integrated community development philosophy at work. In the judgment of the consultant team, it deserves full support from government and international agencies, particularly as a means of bringing the development process to some of the most disadvantaged and remote elements of society.

The team does not, however, recommend that a national SSE credit program be based in the SCF or organized around its program for the following reasons:

- SCF undertakes the provision of credit from the perspective of an integrated community development approach. That approach assumes a substantial amount of organizational effort at the community level and that credit is only one element of a larger package of developmental activities, e.g., in health and social welfare. Research indicates that credit could be delivered to the bulk of the target SSE population without the need for extensive promotion and organization. Moreover, the need for surrogate collateral and repayment "insurance" which SCF's local organizations provide through group guarantees can be circumvented by a combination of bank guarantees and co-signatures. Finally, although the integrated community development approach is praiseworthy, it is not a necessary condition to the productive use of credit by the large majority of the target group.

- Since credit alone is considered to be the most fundamental need of the target group, the essential requirement for a SSE credit program is an effective delivery mechanism. SCF does not possess the necessary infrastructure to operate such a program on a national basis. Only the commercial banking system offers the requisite outreach capability.

However, an SSE program run through commercial banks would not exclude SCF participation. SCF could not only participate, but with its considerable prior experience in SSE credit would be better prepared initially to make effective use of such a program than most commercial banks. If, as suggested elsewhere, a SSE credit program offered a discount mechanism, SCF could like any bank discount its loans with the program and free up capital resources for further lending, thus greatly leveraging funds already available to it.

D. Agricultural Development Bank

The government is currently initiating the process of establishing a national development bank for agriculture, the Banque Nationale de Developpement Agricole (BNDA). The purpose of this bank is to provide medium- to long-term credit for agricultural development, primarily to small farmers. It will finance farm production inputs, such as seeds, fertilizers and pesticides as well as capital equipment for farming operations. It will also provide credit for agro-industry. BNDA will most likely work largely with cooperatives through the NUCC and possibly village development committees, but will, over time, attempt to develop an institutional infrastructure for servicing individual small farmers directly. It will also provide technical assistance to farmers on farm production matters.

The BNDA program as conceived would appear to be complementary to, rather than duplicative of, any program that might be established to serve the broad-based and multisectoral need for SSE credit that exists in Lebanon. As described elsewhere in this report, a national SSE credit program would likely focus on small commercial and industrial enterprises, essentially excluding farm production activities. By contrast, BNDA will direct its attention principally to farm production and related activities in rural areas. In concentrating on agricultural development, BNDA will have limited application in the areas of commerce and industry, providing credit in those sectors primarily in rural areas and only insofar as activities in those sectors are directly supportive of or can be linked directly to farm production and marketing efforts.

BNDA would also complement the restricted administrative reach of a national SSE credit program run through the commercial banking system, as recommended in this report (see Chapter V). By assisting isolated and remote farm communities, BNDA will be able to reach elements of the identified target SSE group which the banking system, located only in small towns and provincial cities, can never serve.

BNDA will not, however, likely become operational for at least two years. It must first obtain international support and complete the process of government approval and legalization. It will thereafter face the lengthy process of internal institutional development. An SSE credit program operated through the existing commercial banking system could become functional almost immediately.

E. Societe Financiere

The Societe Financiere (Finance Corporation) has recently been established with the initial primary purpose of establishing a secondary market in government T-bills, of which there are LL13 billion outstanding with the commercial banks. For this purpose, it will have discount and rediscount facilities. The Societe Financiere is also expected to develop other, possibly innovative, lines of business.[1] It will operate as a private sector institution under the aegis of the Central Bank with the Governor of the Central Bank serving *ex officio* as the Chairman of its Board of Directors. Ownership of the institution will reside in the hands of private banks; the government will hold no shares of its stock. Ownership will, however, be restricted to one-half million shares per bank to prevent domination by a single bank. The Societe Financiere is thus institutionally *sui generis* in form and akin in that sense to such other quasi-private/quasi-public institutions as the National Deposit Guaranty Institute.

The Societe Financiere is not a bank *per se*. It cannot accept deposits. It may, however, act as agent or fiduciary for grants and loans from private or government sources; the institution has a bank account at the Central Bank and

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1. Discussion with Michel Khoury, Governor of the Central Bank, April 12, 1983.

can draw checks on that account. Like banks, however, its activities will be scrutinized and monitored by the Bank Control Commission.

The Societe Financiere is only in its gestation period. A director has been appointed, but as yet no staff. The new director expressed interest in having the institution serve as agent for the proposed SSE credit program. The Governor of the Central Bank indicated his judgment that the Societe Financiere would be the appropriate institutional base for such a program. Were the institution to develop the required administrative capability, it would appear a logical choice to serve as a financial agent for a SSE program being operated through the commercial banking system.

F. Conclusions

Within the existing institutional framework, the commercial banking sector represents the only vehicle with the present organizational and administrative capacity to operate a national SSE credit program on a high volume and geographically widespread basis. Operating within the private sector, commercial banks can be counted on to implement such a program on a businesslike basis, something government agencies are not likely to be able to do. Moreover, small private entrepreneurs are likely to relate better to banks as fellow commercial operations and generally to take their loan repayment and other obligations more seriously than if dealing with government agencies. Finally, operating a program through the banking sector will bring SSEs more completely into the formal economy and possibly begin to tap dormant financial resources (through savings accounts and other deposits) for productive purposes.

Although it would be possible to create a new, specialized institution for the sole purpose of operating an SSE credit program, it would not appear desirable to do so for several reasons. The cost of establishing such an institution would clearly be greater than the resources that currently appear available for SSE from either the Lebanese government or international donor agencies. Two years' lead-time or more would likely be required to establish such an institution, during which time the reconstruction and other war-related needs of SSEs would be left unsatisfied. Even more time and money would be required to develop the physical (branch bank) and human resources necessary to extend the program geographically to serve a nationwide clientele.

A new institution might have the advantage, if adequately organized and financed, of being able to serve target clientele in remote areas not likely to be reached by the commercial banking system. But the cost of organizing and administering a credit program in those areas might effectively eliminate or substantially reduce the likelihood that a national SSE credit program could be run on the basis of full cost recovery. This issue involves a judgment regarding the trade-off between a social and economic objective that deserves further consideration and perhaps alternative treatment.

If a government-sponsored SSE credit program were to be operated through the commercial banking system, an intermediary financial agent or agents would be required to administer such a program on behalf of the government. Collectively or individually, the specialized or development banks represent the best available institutional mechanism to serve as financial agents. Although lacking the capacity of the commercial banks to provide credit directly to SSE, they have resources to function as intermediaries between a government-sponsored SSE credit program and the commercial banks. The private specialized banks may in this regard be more appropriate agents for a small borrower program than the mixed specialized banks which are more oriented toward large government funded projects. The newly formed Societe Financiere would also be able to play the role of financial agent.

It remains to be determined whether more than one financial agent should be engaged in the administration of an SSE credit program through the commercial banks. With multiple agencies, overall administrative capability would be increased and efficiency enhanced through inter-institutional competition. A single financial agent would have the advantage, assuming it possessed adequate administrative capacity, of centralizing the implementation of a program likely to be complicated by the involvement of numerous commercial banks.

Were a single financial agent to be selected, more than one of the specialized banks could probably gear up administratively to manage the program. However, the Societe Financiere would appear to be the most appropriate institution to administer such a program. It has the support and involvement both of the Central Bank and a substantial portion of the commercial banking sector. It has the flexibility of mandate to assume the agency role and, unlike the specialized banks, neither its operational potential nor its future is constrained by restrictive regulatory policy. In the short term, however, the Societe Financiere would likely require considerable technical assistance to prepare itself to assume the full burden of administering a national SSE credit program.

The Bank Control Commission likely represents the best institutional mechanism for monitoring on behalf of the government the performance of both financial agents and commercial banks involved in a SSE credit program.

A number of government agencies might serve as the appropriate, albeit nominal, responsible government "home" for a SSE credit program, including the Central Bank, the Ministry of Finance, and the CDR. Each has a broad national mandate and would serve to project the image of a program that served a wide spectrum of enterprises rather than a set of special interests. Of these the Central Bank is probably the most appropriate base for a program that is clearly focused on credit and banking functions, and already serves as the government "watchdog" of the banking industry.

IV. REGULATORY AND POLICY REVIEW

A. Policy and Attitude Toward the Formation and Operation of Institutions to Provide Credit and Other Assistance to SSEs

As indicated previously, the government has until the present time had no articulated policy toward the SSE sector as such. Its policy formulation on even broader planes has been equally undeveloped. In recent years, however, the government has demonstrated increased interest in assisting the organization and operation of credit programs aimed at the SSE sector.

In 1977, the government became involved in the provision of credit to small-scale farmers through a USAID-supported program called the Agricultural Rehabilitation Program (ARP). The ARP program engaged the Directorate General of Cooperatives in the Ministry of Housing and Cooperatives and the NUCC in a collective effort with SCF. The ARP program was so successful that it led to a further USAID grant in 1981 and an expansion of the effort to include small urban entrepreneurs as well as small farmers. The institutional future of this program appears somewhat up in the air, as neither the SCF nor the Directorate General for Cooperatives appears to have any clear sense of what the next steps toward institutionalization of their program will be, apart from a draft design for a guarantee and revolving fund.

As already noted, the government is currently in the process of establishing a national agricultural development bank. The principal purpose of this bank will be to service the credit needs of small farmers. The creation of this institution will give evidence of a clear interest on the part of government in the fortunes of small cultivators.

B. Policy and Attitude Toward SSEs

The government's increasing interest in and willingness to support institutions that provide credit to SSEs clearly evidence a growing interest in SSEs themselves. This may in large part represent the government's developing sense of responsibility for assisting all segments of society adversely affected by the civil war and more recent Israeli invasion. There still appears to be, however, a strong belief in the primary role of the private sector and the responsibility of the individual to look after himself.

In discussions at the CDR, for example, the President expressed the view that the government should help the SSE sector, but primarily for social reasons. SSE is part of the social texture of the nation and those in need should be helped. This view seems to hold that SSE should be dealt with through PVOs and benevolent organizations because the cost to banks of servicing this sector was commercially prohibitive.[1]

Nonetheless, it can be stated that such government officials as the President of the CDR and the Governor of the

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1. Discussion with Dr. Mohamed Atallah, President, Council for Development and Reconstruction, March 23, 1983. Dr. Atallah's interest appears focused on the smallest of the SSE in the identified target population.

Central Bank expressed concern for the SSE sector and a willingness to support and participate in programs aimed at assisting the sector. Still, the government has yet to enunciate an official view in the matter.

C. Policy and Attitude Toward Banking Laws, Lending Laws, Mortgage Laws, and Practices Affecting Loan Terms and Collateral Requirements

There are a number of specific subject areas in which government policy and attitude bear on the question of providing credit to the SSE sector. These will be addressed *ad seriatim*.

1. Taxation Policies

Government taxation policies do not appear to impinge very directly on the issue of loan terms and collateral requirements, particularly as they may apply to credit offered to SSE. For example, tax law permits a borrower to write off interest payments on a commercial loan as a business expense. This policy, however, is probably of little significance to that large segment of the sector which keeps few financial records and apparently negotiates taxes owed directly with the tax collector.

At the banking level, interest earned on savings accounts is tax-free. Interest earned on current accounts (checking accounts) is taxed at 12 percent. Only individuals may hold savings accounts; thus only individuals may qualify for tax-free interest. Corporations and commercial establishments, being limited to checking accounts, pay tax on all interest earned in bank accounts.

Although such policies may affect to some degree the deposit structure of the commercial banks, they would not appear to have any impact on the terms and conditions of loan programs.

As noted earlier, the government has taken measures to assist commerce and industry in the wake of wartime destruction. Among these are Legislative Decree No. 81 of June 27, 1977 and Law No. 2/79 of March 22, 1979, which allow industrial and commercial establishments to carry forward for tax purposes losses suffered in 1975-77 for an additional five years beyond the 3-year limit under current tax law. This policy has no evident impact on loan terms or collateral requirements.

In at least one respect, the taxation system works to encourage the development of small- as opposed to large-scale enterprise. Under existing law, corporations are subject to a progressive income tax, which mitigates against the use of the corporate business form. Since the corporate form tends to be the most conducive to large-scale operations, this law discourages economies of scale and probably hampers to some degree the industrial development of the country.[1]

It should be noted that specialized banks are exempted from income tax for seven years and up to the equivalent of 4 percent of their paid-in capital thereafter. These exemptions, however, have no bearing on terms and conditions of loans offered.

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1. Salim Hoss, "The Development of Lebanon's Financial Markets," November 1974, p. 39.

2. Collateral

As for commercial banks, no collateral requirements are imposed by law. Banks set their own terms for collateral, which have ranged as high as 3-4 times the value of the loan in recent times. Although collateral is usually required for large commercial loans, banks also pursue a "popular loan" policy for regular customers in which small consumer loans and loans for personal needs are offered to regular customers on their signature alone. Such accommodation loans are also extended to other than regular customers upon obtaining co-guarantors, usually a regular bank customer or an individual known and respected in the community.

Specialized banks are enjoined by law to lend only against real collateral or bank guarantees. In the case of the former, the loan may not exceed 60 percent of the value of the mortgaged assets, as evaluated by the bank's experts, and on their own personal responsibility. As for the latter, the guarantees must be issued by sources accepted *a priori* by the Bank Control Commission with each case considered separately. The 60 percent requirement clearly puts the specialized banks at a disadvantage vis-a-vis the commercial banks, which are hindered by no such restriction.

3. Loan Tenor

Commercial banks may only offer loans whose maturities match those of bank deposits. Since 85-90 percent of current deposits are held for less than six months, banks can, as previously indicated, only offer very short-term loans officially. Commercial banks overcome this restriction by providing one-year roll-over facilities for preferred customers.

Specialized banks (i.e., development banks) are only permitted to lend at medium- and long-term and with a 2-year grace period. As previously discussed, they have been unable to do so because of their inability to attract long-term accounts and the restrictions under which they operate. Given depositor aversion to long-term blocking of funds, it is doubtful that these banks will ever be able to offer longer term credit in the absence of government support in the form of deposits of public sector resources and/or soft loan facilities.

4. Foreign Exchange Policies

Foreign exchange rates are essentially set by the market, which is to say by supply and demand. Rates are affected by the needs of commerce, expectations of buyers and sellers, inflation rates in Lebanon and elsewhere, and by internal events.

The Central Bank does not attempt to set foreign exchange rates. However, the Bank will intervene in volatile markets to promote the parity and stability of the pound and to curb speculation. For example, in order to halt the depreciation of the pound in 1981, the Bank issued the following directives to commercial banks:

- Banks were prohibited from holding net debtor balances in foreign exchange exceeding 50 percent of their authorized capital.

- Banks were prohibited from holding net creditor foreign exchange positions.

- A ceiling of LL500 thousand was placed on forward foreign exchange operations, and banks were prohibited from exceeding this ceiling unless such operations involved the financing of foreign trade transactions.

- Banks were prohibited from giving loans to non-residents in Lebanese pounds.

- Banks were prohibited from giving loans in Lebanese pounds against guarantees from non-resident banks unless such loans were to be used for investment or commercial purposes in Lebanon.

The Central Bank again intervened heavily in the exchange markets in the fall of 1982 to stem the rapid appreciation of the pound as depositors purchased local currency in the expectation of a return to normalcy.

The Central Bank's fiscal policies regarding foreign exchange markets have at most only an indirect impact on lending terms and collateral requirements; without the stabilizing impact of Bank intervention, the short-term nature of the commercial banks' deposit structure would be narrowed even further, possibly raising interest rates and tightening the conditions on which credit is offered.[1]

5. Industrial Credit Policies

As previously noted, the government has provided in the past various kinds of support to encourage industrial development, including tariff protection, export subventions, customs exemptions, etc. It has also recently been active in providing credit to industries facing reconstruction requirements resulting from the war. These include:

- Legislative Decree No. 131 of February 11, 1977 providing extraordinary credit facilities to industrial, tourist, and medical establishments

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1. See generally Nasser Saidi, "Flexible Exchange Rates and Competitive Banking: An Interpretation of Lebanon's Monetary Experience, 1950-1977." Bulletin Trimestrial No. 9, Central Bank, June 1981, p. 27.

damaged in 1975-76. The initial tranche of LL400 million was supplemented by LL100 million pursuant to Decree No. 4722 of January 11, 1982.

- Legislative Decree No. 144 of January 31, 1977 providing for an additional LL200 million in state guaranteed loans from commercial banks.

- Decree No. 9/83 (referred to as the "Interest Subsidy Law") has recently been approved under which LL350 million will be made available to subsidize the provision of commercial bank credit to commerce and industry.

Under Decree No. 131, the government provided lines of credit to the commercial banks through the specialized banks acting as financial agents of the CDR, the agency responsible for the program. These loans were offered on a subsidized basis to the borrower, i.e., at a net cost or effective rate of 5 percent. There was a ceiling on single loans of LL4 million.

Initially, the program worked as follows. The first 75 percent of the loan was provided by the CDR fund at a rate of 3.35 percent and the remaining 25 percent was provided by the commercial banks at the existing market rate of 10 percent, which resulted in a weighted average effective rate of about 5 percent to the borrower.

As market interest rates climbed, this formula was modified to fit existing realities. Thereafter, 90 percent of the loan was provided by the CDR at 3.35 percent and the remaining 10 percent by commercial banks at a market rate of 20 percent, resulting in the same weighted average interest rate of about 5 percent to the borrower.

Under the newly enacted "Interest Subsidy Law," the government will no longer advance a line of credit. Rather, funds will be provided to subsidize the provision of commercial bank credit.

6. Interest Rate Policy

In Lebanon, interest rates are set in relation to market forces -- they are neither controlled nor set by the Central Bank. The Central Bank, however, is an influential actor on the scene both because it intervenes in the foreign exchange markets and because it prescribes the interest rate of Treasury bills sold to the commercial banks. A floor on market interest rates is set by the consensus of about 40 banks represented in the Lebanese Bankers Association (ABL). In general, that floor corresponds to the current T-bill rate plus 3 percent. Bank charges are thereafter applied to that basic figure. The floor rate established periodically by the ABL is called the Beirut Inter-Bank Offering Rate (BIBOR).[1]

7. Large-Scale vs. SSE

It is clear from earlier discussions in this report that the government has only recently begun to evidence some degree of interest for and willingness to provide support to the SSE sector. Existing policies and practices that impinge on the provision of credit to SSE, particularly collateral and loan tenor, generally work against the SSE. Even special government credit programs formulated to help rehabilitate the commercial and industrial sector effectively exclude SSE. Nonetheless, there appear to be no policies or regulations that would impede the provision of commercial bank credit should a means be devised to satisfy existing banking requirements.

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1. See generally Erich Spitaller, "Interest Rate Policy: Optimal Response of Domestic Policy to Fluctuations in Interest Rates Abroad," Bulletin Trimestriel, No. 5, Central Bank, June 1980, p. 25.

V. A PROPOSED GUARANTY AND REDISCOUNT FUND

A. Rationale for the Proposed Fund

There is a large demand by SSE for medium-term rehabilitation and development credit. SSE credit demand is not -- and never has been -- addressed by the formal banking system. Traditional sources of SSE financing have been family loans, savings, and some use of expensive resources from comptoirs and moneylenders.

PVOs have lent some supervised credits at the level of microenterprises. The technical assistance which accompanies those loans, particularly in rural areas, increases the real cost of lending. Supervised credit also requires the attention of such a large staff for the amounts lent that the system cannot easily be extended to national coverage.

A mechanism is lacking which could:

- Compensate for the inability of SSE to qualify as creditworthy for formal bank loans.
- Enable commercial banks to use short-term resources prudently for medium-term lending.
- Reduce the processing and administrative costs of loans much smaller than normally of interest to the formal banking sector.

Operate nationwide

Put SSE credit on a more businesslike basis by severing the link between credit and technical assistance as a necessary condition.

A Guaranty and Rediscount Fund is a mechanism which could achieve these five objectives.

B. The Effect of the Fund on the Obstacles to SSE Credit

1. Creditworthiness

To establish creditworthiness, commercial and investment banks in Lebanon require that a borrower have a good character and reputation, that his firm be capitalized in an amount equal to 3-4 times the amount to be borrowed, that he use the money in a manner which generates a cash flow that can service the loan, and that he offer real property as collateral worth several times the value of the loan. SSE cannot meet these criteria and consequently do not qualify for loans from the formal credit market.

The proposed Fund would compensate for the lack of creditworthiness by offering to substitute a guaranty of repayment for the normal eligibility requirements.

2. Longer Term Commercial Bank Lending

Commercial banks are not in the business of lending at medium- or long-term, nor should they be. Prudent banking practice dictates that loan maturities be matched to deposit maturities, and commercial bank resources are mainly short-term and sight deposits.

The proposed Fund would convert medium-term loans (up to five years) into liquid assets by standing ready to discount the loans. The Fund would make it possible for commercial banks to hold an interest-earning asset rather than idle cash in times of high liquidity (as at present).

3. Administrative Costs

The analysis of loan applications, the establishment of creditworthiness, and the cost of administering loan collections is essentially the same for a small loan as for a large loan. Normally it is not profitable for a bank in Lebanon to lend less than about LL200,000 as an isolated transaction unrelated to a client's use of additional bank services.

The proposed Fund would cut through much of the need for loan analysis and client creditworthiness with its guaranty facility, thereby reducing administrative costs.

4. Delivery Mechanism

Neither PVOs nor ministries at present have a nationwide network which can deliver credit. The proposed Fund could operate throughout Lebanon by using the commercial banking system as financial intermediaries.

5. Technical Assistance

The proposed Fund would be operated on banking principles. The principal objective is to make credit available to SSE, on a businesslike basis. Although it is hoped that PVOs will continue their supervised credit programs while making use of Fund facilities to multiply the effectiveness of their own resources, the Fund would dispense with technical assistance as a necessary condition for granting credit.

C. Administrative Structure of the Fund

The Fund would be operated in the name of the government by one or more financial agents. The financial agents would be prepared to guarantee and discount loans made to SSE by financial intermediaries.

1. The Fund

The resources available to the Fund would be deposited in the name of a government entity. This might be, for example, the Central Bank. Checks drawn on the Fund would bear the name of the government entity. The purpose is to associate the government with the Fund in the eyes of the public.

2. Financial Agent

The financial agent would operate the Fund and be prepared to guarantee and discount eligible loans. Eligibility criteria would be few and easy to verify: amount of the loan is not more than LL200,000; the borrower does not employ more than nine workers, including himself and family members; the loan has been co-signed by a responsible person; and the loan is to be used for a productive purpose.

An issue identified in Chapter VI as one yet to be determined is whether there should be more than one financial agent. In some ways it would be simpler administratively if the government used only one financial agent, for example, the recently established Societe Financiere. At the same time, one can argue that opening up the role of financial agent to more than one institution -- for example, INFI, BNDIT, and the Banque du Financement as well as the Societe

Financiere -- would promote more efficient processing because of competition among the financial agents.

3. Financial Intermediaries

Any institution which makes an eligible loan to SSE can present the paper to the Fund for a guaranty or for discounting. The financial intermediaries would be primarily the commercial banks, but would also include such PVOs as the Save the Children Federation.

D. Monitoring Fund Operations

Whether the Fund uses one or several financial agents, Fund operations would be monitored by the Bank Control Commission associated with the Central Bank. The Commission would verify that Fund operations deal with eligible loans and regulations governing the conduct of financial institutions.

E. Illustrative Funding Operations

1. Guarantees

A financial intermediary could receive a guaranty by paying a guaranty fee to the financial agent. The fee should be priced to cover the cost of any defaults or delinquencies. The guaranty operation should not decapitalize the Fund.

The guaranty should be for less than the full amount of the loan. The financial intermediary should remain partially at risk as an incentive to screen loan applications with more than cursory attention.

Loans would have one or two responsible co-signers. They would substitute for the community peer pressure to make timely repayments which is provided by local committees and cooperatives in the SCF programs. Commercial bank loans in Sidon have been made for 40 years with co-signers substituting for real property collateral. Loss rates have been minimal.

2. Discounts

A financial intermediary could discount an eligible loan with the Fund. The discount would be for less than the full amount of the loan. As with guarantees, the financial intermediary should remain partially at risk. The financial intermediary would continue to collect loan payments during the life of the loan.

Several possible types of discount operations could be offered by the Fund. For example, the Fund in essence could buy the longer term maturities of a loan; or it could mix Fund resources with the resources of the financial intermediary, perhaps yielding a slight additional spread to the financial intermediary.

F. Fund Principles

1. Decapitalization

The Fund should be a revolving fund which does not become decapitalized. This implies that market rates of interest should be charged. If the government's sector financial policy makes it impossible to charge full market rates at this time, an agreement should be sought that the government will maintain the financial integrity of the Fund by compensating it for any subsidy costs.[1]

2. Risk of Loss

The guarantees and discounts also should be priced so as not to decapitalize the Fund. If there are losses above those expected, however, it is the Fund rather than the financial agent which should bear the loss. The right guaranty fee should be subject to modification in the light of actual experience.

3. Leverage

The Fund credit program should be designed and operated with a view toward obtaining the greatest leverage in the use of its available resources. It should, for example, encourage financial intermediaries to increase their exposure by holding guaranteed loans rather than simply discounting all small borrower loans processed under the program.

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1. Larger firms have had LL400 million of loans through the CDR and its financial agents (specialized banks) at 5 percent interest. The government has subsidized the difference between 5 percent and the market rate for commercial banks. An additional LL350 million (Decree Law 9/83) is now being made available on similarly subsidized terms. This represents a subsidy of some LL75 million per year to larger firms during the operation of these programs.

VI. ISSUES

This feasibility and project identification study conceptualizes a mechanism which can induce the formal credit market to lend to SSE at medium term. The project paper team should address several issues during an intensive review of the proposal.

A. Operating Details of the Fund

Operating details will have to be agreed to by USAID, the government of Lebanon, the financial agents, and the financial intermediaries. The commercial banks probably should be represented by their trade association, the Association des Banques Libanaise. The details to be agreed upon include:

- How much recourse should the financial intermediaries be at risk for on guarantees?
- How should the guaranty fee be priced?
- How much should the financial intermediary remain at risk for on discounts?
- What type(s) of discounts should be offered?
- What spreads are necessary to cover the administrative costs of the participating financial agents and financial intermediaries?

- Do commercial banks require any incentives (e.g., tax exemptions, lower reserve requirements) beyond normal commercial incentives to enlist their participation?

- What should be the interest rate to the borrower, and how should it be set? If there are any costs not fully recovered, how will they be financed? (Will the government make up any Fund losses? Can some initial costs, for example, for publicity, be financed by resources in addition to Fund resources)?

- Agreement between USAID and the government is necessary on loan eligibility criteria. These should include requirements that the borrower be a SSE as defined in this study, that he have responsible co-signers, that the amount of the credit be less than LL200,000 and that the use of the loan be for a productive purpose (in contrast with consumer loans or paying overdue rent, for example).

- Loan tenor.

Once the operating details are agreed upon, an illustrative cash-flow analysis of the Fund can be carried out to ensure that the Fund not be decapitalized.

B. Location of the Fund Accounts

As a preliminary judgment, the team recommends that the Fund accounts be located in the Central Bank. The name of the Central Bank would appear on checks. The intensive review should confirm that there are no legal obstacles to locating the Fund accounts in the Central Bank, that the Bank is the most appropriate government entity to sponsor the Fund and that it is prepared to assume responsibility and accountability for the establishment and continued functioning of the Fund's program.[1]

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1. The Governor of the Central Bank thinks that there are no legal problems and he is prepared to confirm this with his legal staff.

C. Financial Agents

The Societe Financiere, BNDIT, INFI, and the Banque du Financement have all expressed an interest in participating in the Fund as a financial agent. This willingness should be confirmed during the course of agreeing on the operating details of the Fund. The key issue, however, is whether there should be one or several financial agents.

D. Financial Intermediaries

Many commercial banks expressed interest and a willingness to participate in the Fund concept proposed herein. All, however, noted the many disincentives to providing commercial credit to the SSE sector. An extensive survey of the commercial banking sector will be required at the project paper stage to confirm the sector's continuing and widespread support for the proposed credit program, to identify those banks most likely to actively promote and participate in the effort, and to ensure that the final design of the program compares with the realities of engaging active commercial bank involvement.

E. Technical Assistance to the Fund

It is recommended that a full-time technical assistance position be funded for 6-12 months to ensure promotion and coordination of the project. There are three reasons for this recommendation:

- The Fund would be a new kind of operation in Lebanon.
- Many entities would be involved.

- The Fund would not be the full-time responsibility of any one of the participating entities.

The intensive review should evaluate the necessity for this technical assistance.

F. Definition of SSE

This study recommends that the target group include firms with 1-9 employees. This definition implicitly involves some value judgment concerning trade-offs between social and economic objectives. The larger firms within the SSE definition used here may be favored by the commercial banks because they likely would borrow larger amounts than the smaller firms. This would reduce average administrative costs per "credit dollar" but may involve investments with higher productivity. Default rates may be lower and any tendency to decapitalize the fund mitigated. Technical assistance requirements would be minimal.

The intensive review should evaluate the implicit judgment that the economic benefits of including firms with 6-9 employees outweigh the possible loss of "social justice" by not restricting the target group to firms with no more than four or five workers.

G. Scope of Credit Program

The identified demand in the SSE sector is so great that it may not easily be satisfied by the resources likely to be made available initially to the Fund. By raising expectations that cannot be fulfilled, Fund sponsors may create serious pressures on the government. This potential problem might be resolved by narrowing the focus of the program to selected needy industries, such as textiles and leather, or to particular productive activities the government wishes to promote. This issue needs further examination by the project paper team. A related question for review is whether the program should initially be established on a pilot basis. This approach may have administrative merit, but it would involve the serious drawback of possibly delaying urgently needed rehabilitation efforts.

Finally, the project paper team needs to consider establishing criteria for the allocation of Fund resources to ensure that the credit program is given wide geographical and sectoral effect.

H. Technical Assistance to the Societe Financiere

The Societe Financiere is just beginning operations. If it is to be considered the (only) financial agent, the intensive review should explore whether technical assistance to the Societe Financiere is merited. Technical assistance might greatly enchance the speed and efficiency with which the Societe Financiere could manage the Fund.

I. Project Risks

Four project risks have been identified:

- Inadequate promotion may result in few loan applications being presented.
- Without proper coordination, project implementation may be delayed.
- The borrower may be tempted to view the loans as a gift from the government which need not be repaid.
- Renewed, large-scale violence and consequent lack of security may drastically reduce SSE demand for credit.

The intensive review team should assess whether the proposed project adequately deals with the first three project risks.

J. Counterpart Resources

The project paper team should explore possibilities of obtaining counterpart resources for the Fund. The minimum financial obligation assumed by the government should be an agreement to compensate for any decapitalization incurred by the Fund. Additional sources of funding could be government resources matching the amount of a USAID grant, the resources to come either from the central government budget or from an USAID or commercial bank loan to the Fund guaranteed by the government. It is possible that commercial banks would be willing to lend directly to the Fund or to buy up the early maturities of a loan to the Fund.

VII. PROJECT TEAM

The project paper team should include:

- An economist with some banking experience. He would be responsible for the economic evaluation of the project, including calculation of a simulated internal economic rate of return on the Fund.

- A financial analyst with some banking experience. He would be responsible for reaching agreement on the operating details of the Fund. He would assist the economist in the financial analysis of the project and would simulate cash-flow analyses.

- An expert on administrative, legal, and institutional development with some experience in designing SSE credit programs. He would be responsible for determining the administrative feasibility of the project.

- An expert with some experience in Lebanon who can be responsible for the social impact analysis and who can examine specifically the possible role for PVOs in the project.

All team members should have a reading knowledge of French and at least one member should be fluent in French conversation.

It is estimated that four calendar weeks will be required in the field to produce the draft project paper.

APPENDIX

LIST OF INDIVIDUALS CONTACTED

Washington, D.C.

USAID

Steven Freundlich

Gerald Miller

World Bank

Anil Gore

Beirut, Lebanon

Government of Lebanon

Dr. Mohammad Atallah
President
Council for Development and Reconstruction

Mrs. Makdisi
Council for Development and Reconstruction

Michel Khouri
Governor
Central Bank

Dr. Andre Chaib
Director of Economic and Statistical Studies
Central Bank

Antoine Chamoun
Director General
Directorate General of Cooperatives
Ministry of Housing and Cooperatives

Joseph Torbey
Commissioner
Income Tax Department
Ministry of Finance

Samir Abu Jaoudi
Salim Sarraf
Advisors
Ministry of Agriculture

Associations

Dr. Fouad Abi Saleh
President
Industrialists Association

Gabriel Badaro
Vice President
Chamber of Commerce

Dr. Andre Karam and staff
President
Save the Children Federation (SCF)
(Community Development Foundation)

Judy Obermeier
SCF home office representative

Neil Keny
Save the Children Federation
Locally based U.S. Representative

Mrs. Bakhazi
Director
Artisans du Liban

Tawfic Abi Khalil
President
Federation of United Syndicates of Lebanon

Mr. Titizian
Armenian General Benevolent Union

Universities

Dr. Peter Frank
Prof. International Banking
American University of Beirut (AUB)

Dr. Clement Henry
Professor and Director
Abu Ghazali School of Business Administration
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Dr. Nadim Khalaf
Prof. and Chairman of Dept. of Economics
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Dr. Samir Nasr
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Dr. Clark Bloom
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Consultant Firms

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Former Prime Minister
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Dr. Fouad Abi Saleh
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Near East Commercial Bank

Michael Pennyman
Assistant Manager
Bank Al-Mashrek

Sami Shuhaibar
Credit Department
First Phoenicia Bank

F. Matar
Credit Department
Universal Bank

Samir Hamoud
Walid Haddad
Bank of Beirut and Arab Countries

Specialized Banks (Mixed)

Rizkallah Genadri
President
Societe Financiere

Dr. Fuleihan
Assistant General Manager
National Bank for Industry and Tourism

Specialized Banks (Private)

Bechara Issa, Senior Manager
Fernand Sanan, Director of Research and Documentation
INFI Bank

Chafic Baz
Deputy Director General
Banque de Financement

USAID

Malcolm Butler
Mission Director

William McIntyre
Deputy Mission Director

David Mandel
Capital Projects Officer

Ann Dammarell
General Development Officer

Robert Pearson
Asst. Project Development Officer

Ghassan Jamous
Administrative Specialist
Commodity Procurement

U.S. Embassy

Hunt Jannin
Claude Kenisovich

Economics Department

Sidon, Lebanon

Marwan Sadaani
Save the Children Federation

Mrs. Hariri
Sister of Rafic Hariri

Ahmad Khalash
Mayor

General Manager
Bank of Beirut and Arab Countries