

**The European Union's FEMIP Support Fund  
for the Syrian Arab Republic**

**Feasibility Study to develop new  
options for private sector investment  
financing in the Syrian Arab Republic  
Phase I**

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for the Syrian Arab Republic

Final Report, March 2006



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# **Feasibility Study to develop new options for private sector investment financing in the Syrian Arab Republic**

**EIB**

## **Final Report**

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**Prepared by:**

Richard Crayne  
Bruce Harrison  
Rauf Khalaf  
Edward Owen

**With contributions from:**

Fatma Dirkes, Senior Project Manager, BAI  
Willemien Libois, Project Manager, BAI  
Raed Karawani, Legal Consultant  
Fahed El-Mohamad, Local Expert

**Bankakademie Damascus Office**

Malki, Abdel Mounem Riad Street  
Kouatly Building No. 5  
Damascus  
Syria

Tel: +693-11-3716332

**Bankakademie International**

Sonnemannstr. 9-11  
60314 Frankfurt am Main  
Germany

Phone: +49-69-154008-619

Fax: +49-69-154008-670

**With further contributions from:****Syrian Government:**

Dr. Abdullah Dardari	Deputy Prime Minister, Economic Affairs	Prime Minister's Office
Nabil Barakat	Deputy Head	Prime Minister Office SPC
Nader Al-Sheikh Ali	Director General of International Cooperation	Prime Minister Office SPC
Marwin Attar	Consultant	Prime Minister Office SPC
Dr. Ghassen Al Habash	Deputy Minister	Ministry of Economy & Trade
Dr. Amir Al Attar	Director, Banking Affairs & Insurance	Ministry of Economy & Trade
Abd Al Razak Abd Al Maged	Director, Interior Commerce	Ministry of Economy & Trade
Ibrahim Ibrahim	Manager, Companies Registration	Ministry of Economy & Trade
Dr. Mohammad Al-Hussein	Minister	Ministry of Finance
Dr. Mohammed Hamandoush	Deputy Minister, Public Expenditure	Ministry of Finance, CMC <sup>1</sup>
Mrs. Basmah Hafez	Manager Banks & Insurance	Ministry of Finance
Farouk Ayash	Senior Banking Advisor	Ministry of Finance
Marouf Al Hafez	Public Debt Fund	Ministry of Finance
Omar Al Elabi	Public Enterprises	Ministry of Finance
Nizar Shurbaje	Department Revenue	Ministry of Finance
Mohee Deen Habeeb	Treasury	Ministry of Finance
Jamal Medelgi	Income Tax	Ministry of Finance
Dr. Mohamed Ghassan Thayara	Minister	Ministry of Industry
Fouad Al-Lahham	Deputy Minister	Ministry of Industry
Dr. Diala Alhaj Aref	Minister	Ministry of Social Affairs & Labour
Dr. Issa Maldaon	Deputy Minister	Ministry of Social Affairs & Labour

**Central Bank of Syria**

Dr. Adib Mayaleh	Governor	Central Bank of Syria
Dr. George Elouzon	Manager Foreign Division	Central Bank of Syria
Dr. Erfan S. Al Azmeh	Economic Advisor, Member CMC	Central Bank of Syria
Dr. Hichan Mutewalli	Member, CMC	Central Bank of Syria

**Public Banks**

Mr. Faysal Kassem	Chairman and GM	Agricultural Bank
Mr. Maan Zeid Mirza	Deputy GM	Agricultural Bank
Mr. Zedan Sa'adat	Credit and Loans Manager	Agricultural Bank
Ms. Seham Mallouh	Planning Manager	Agricultural Bank
Mr. Ahmad Kolaeb	Studies Department	Agricultural Bank
Mr. Saed Shana'a	Accounting Department	Agricultural Bank
Mr. Fayzeh Wanous	Translation	Agricultural Bank

<sup>1</sup> Credit and Monetary Council, Central Bank



Dr. Douraid Dergham	Chairman and GM	Commercial Bank
Ms. Raghdaa Al Yaffee,	Credit Manager	Commercial Bank
Ms. Suher al Halabi	Manager of Planning Department	Commercial Bank
Ahmad Diab	NA	Commercial Bank
Mr Salah Shehab	NA	Commercial Bank
Dr. Ali Kanaan	Chairman and GM	Industrial Bank
Dr. Khaled Al Zamel	Manager of Studies	Industrial Bank
Mr. Adnan Al Okleh	Legal Department Manager	Industrial Bank
Ms. Abeer Sakbani	Technical Manager	Industrial Bank
Mr. Nuhad Haydar	Deputy GM-credit	Industrial Bank
Mr. Shehadeh Othman	Deputy Accounting Manager	Industrial Bank
Ms. Sawsan Barzawi	Deputy Planning Manager	Industrial Bank
Dr. Ibrahim Al Falah	Administration Officer	Industrial Bank
Mr. Motee Shalabi	Administration Officer	Industrial Bank
Ms. Hayfaa Al Assadi	Administration Officer	Industrial Bank
Dr. Abdulrazzak Hasani	Chairman and GM	Popular Credit Bank
Mr. Husain Abdul Wahab	Deputy GM	Popular Credit Bank
Ms. Wafaa Nakhleh	Legal and Administration Manager	Popular Credit Bank
Mr. Adnan Hassan	Accounting Manager	Popular Credit Bank
Mr. Sharif Abbdo	Credit and Loans Deputy Manager	Popular Credit Bank
Dr. Moulham Dibo	Chairman and GM	Real Estate Bank
Mr. Akram Darwish	Credit Manager	Real Estate Bank
Mr. Anas Fayomi	Legal Department Manager	Real Estate Bank
Ms. Nada Nabils	Financial Manager	Real Estate Bank
Ms. Haifaa Younes	Chairman and GM	Savings Bank
Mr. Hussain Al Oudeh	Credit and Loan Manager	Savings Bank
Ms. Layla Attar	Financial Manager	Savings Bank

### Private Banks<sup>2</sup>

Mohamad Haykal	Deputy GM	Arab Bank, Syria
Bassel Hamwi	Deputy Chairman & GM	Bank Audi Syria
Mr. Antoine G. WI-Zyr,	Deputy General Manager	Bank Audi Syria
Mr. Mahmoud Al Kurdy	Chief Financial Officer	Bank Audi Syria
Ms. Zeina El Mohamad	Finance and Accounting Department	Bank Audi Syria
Dr. Rateb Shallah	Chairman	Bank of Syria & Overseas
George Sayegh	GM	Bank of Syria & Overseas
Mr. Jamil Choucair	Credit and Loan Manager	Bank of Syria & Overseas
Ms. Hanadi Ayoubi	NA	Bank of Syria & Overseas
Pierre Ducos	GM	BEMO
Nada Saliba	Head of Credit Department	BEMO
Noureddine Maamar	Branch Manager, Damascus	BEMO
Walid M. Abdel Nour	Deputy General Manager	BYBLOS Bank
Jean V. Bassil	Assistant General Manager	BYBLOS Bank
Didier Drullion	Directeur Général, Issoria	Groupe Caisse d'Epargne
Sultan Alzu'bi	GM	Int. Bank for Trade & Finance
Mr. Aiham Mannaa	Credit Officer	Int. Bank for Trade & Finance
Ms. Rima Malek	Credit Officer	Int. Bank for Trade & Finance

<sup>2</sup> Of the banks the Minister invited to the 25 January 2006 Interim Report Presentation, and surveyed by the Team, only Banque Bemo Saudi Fransi, was not represented.

**Other Finance Institutes**

Dr. Bian Harb	General Director	ACU
Ms. Huda AL Masri	Financial Manager	ACU
Mr. Ahmad Shibib	Assistant Financial Manager	ACU
Maysa Salman	Responsible Internat. Cooperation	ACU
Khalil Hosny Khalil	Community Development Officer	ACU

**Embassies and Donor Officials (including projects)**

Aleem Walji,	Executive Director	Aga Khan Foundation
Nasser B. Al-Kahtani,	Executive Director	AGFUND Riyadh, Saudi Arabia
Jebrin A. Akjebrin,	Director, Projects	AGFUND, Riyadh, Saudi Arabia
Philippe Mongars	Chief de Service	AMF Banque de France
Susan Khan	Capital Market Expert	AMF Consultant
Ulrich Bindseil	Deputy Head of Division	AMF European Central Bank
Mohamed El-Hadi	Chief of Mission, Abu Dhabi, UAE	Arab Monetary Fund (AMF)
Yisr M. Barnieh	Economist, Abu Dhabi, UAE	Arab Monetary Fund (AMF)
Peter Bandilla	Loan Officer, Syria	EIB, Luxembourg, LU
Brain Jenkins	Short-Term Consultant	EIB/SME Project
Bob Leigh	Team Leader	EIB/SME Project
James Mair	SME Finance Expert	EIB/SME Project
Seifeldin Usher	Head, Trade & Investment	Embassy UK
Maysa Mustafa	Officer, Trade & Investment	Embassy UK
Sylvie Sturel	Head, French Economic Mission	Embassy France
Roland Seeger	Economic Attaché	Embassy Germany
Dr. Michael Grewe	Regional Development Policy	Embassy Germany (German Federal Ministry for Economic Cooperation)
Damino Francovich	Economic Attaché, First Secretary	Embassy Italy
Miguel Iriso	Economic Attaché	Embassy Spain
Jose Navarro	Cooperation Attaché	Embassy Spain (Spanish Cooperation Agency)
Ferit Orcun Basaran	Economic Attaché	Embassy Turkey
Todd Holmstrom	Attaché	Embassy United States
Mr. A.M. Fontana	Head Economic Section	EU Delegation, Syria
Fabrice Ferrandes	NA, Economic & Trade	EU Delegation, Syria
Arto Valjas	NA, Private Sector Development & Finance	EU Delegation, Syria
Vassilis Petrides	Project Coordinator	EU Delegation, Syria
Dr. Constantin Zaman	Team Leader	EU Institutional & Sector Modernisation Facility
Heiko Gross	Institutional Development Expert	EU Institutional & Sector Modernisation Facility
Henk Verbrugge	Municipal Finance Expert	EU MAM Project
Ms Joumana Jabbour	Commercial Lawyer, Consultant	EU MAM Project
Jane Tait	Tax Expert, Team Leader	EU Modernisation of the Ministry of Finance
Peter Wagner	Treasury, Expert, Budget & Accounting	EU Modernisation of the Ministry of Finance
Manfred Rientz	Team Leader	EU BSSP II
Ali Sabet	Senior Training Expert	EU BSSP II
Brian Kettell	Central Bank Consultant	EU BSSP II



Mouayed Makhoulouf	Senior Investment Officer	IFC
Murat Sultanov	Leasing Legal Advisor	IFC
Ola Nour	Leasing Specialist	IFC (PEP)
Kamila Makhudova	Leasing Specialist	IFC
Mark Ahern	Public Expenditure Management Advisor	IMF, Middle East Technical Assistance Centre (METAC)
Richard Allen	Deputy Division Chef Public Financial Management II	IMF, Fiscal Affaires Department
Abdelaki Tazi	Senior Economist	IMF, Fiscal Affaires Department
Patrick Mordacq	Cour des Comptes	IMF, Consultant, Public Finance
Daniel Tonnasi	Consultant	IMF, Public Finance
Olivier Benon	Senior Economist	IMF, Fiscal Affaires Department
Kazuhide Nagasawa	Resident Representative	JICA
Shigeru Otake	Deputy Res. Rep.	JICA
Masahiro Yamashita	State Planning Advisor	JICA
Sakher Mrishih	Economic Officer	JICA
Dr. Jürgen Welschhof	Division Chief Middle East	KfW
Dr. Mohamad Kayyal	Local Expert	KfW
John Paton	Director	SEBC
George Catinis	Aleppo Director	SEBC
Noha Chuck	National Team Leader	SEBC
Roberto Rodriguez-Brana	Senior Industrial Policy Advisor	SEBC
Daniele Mazzanti,	Senior Administrator	SEBC
Paul Gadeggard	Business Counsellor	SEBC
Ms Firyal Kherbek	Business Consultant	SEBC
Ms Hala Rizk	Business Consultant	SEBC
Amin El Sharkawi	Head of Programmes	UNDP
Ms Faten Tibi	Business Develop. Team Leader	UNDP
Mr. Ghimar Deeb	Governance Team Leader	UNDP
Dr. Hashim S. Hussein	Head	UNIDO, Kingdom of Bahrain
Radwan Ali Shaban	Lead Economist (MENA Office)	World Bank
John Blomquist	Senior Economist (MENA Office)	World Bank
Ms Anca Mataoanu	Consultant (Financial Sector Policy)	World Bank

**NGO**

Rana Shanawani	General Manager	BIDAYA
Manal Bala'a	Assistant Manager	BIDAYA
Ms Awatef Choura	Field Manager	FIRDOS
Dr. Alfred Kraft	Economist	GTZ, Syria

**Private Sector Entrepreneurs**

Dr. Samir Seifan	Managing Director	ADC Economic & Business Consultants
Mario Matelli	Senior Partner	Agora'2000 (Lead Firm in EU/SEBC Contract)
Abdul Kader Husrieh	Managing Partner	Ernst & Young Syria
Mr. Zouheir Yassar Sahloul	NA	Informal Financial Intermediary
Mr. Maher Safi	Managing Director	IPSOS
Ms. Elisabeth Simon	Market Research	IPSOS
Dr. Nabil Sukkar	Managing Director	Syrian Consulting Bureau
Dr. Rateb Shallah,	President	Syrian Federation, Chambers of Commerce
Mazen Mourtada	Managing Director	Syrian Financial Group
Sulaiman Al Hassan	Chairman, GM	Syrian Insurance Co.
Wafaa Fallouh	Life Insurance Manager	Syrian Insurance Co.
Sofian Haika	Trading Room Supervisor	Syriatel
Muhamad Ali Wahoud	Chairman	Wahoud Group, Ltd.

**Others (Associations, Universities)**

Yannick Marquet	Professeur, Bordeaux	Université de Bordeaux, Programme DESS
Dr. Ayman Midani	Banking & Financial Market Expert	Professor & Government Advisor
Makram Sader	Secrétaire General	Banker's Association of Lebanon

**Pre-Focus Groups Meetings:****Damascus 1**

Walid Al-Sebki, Director	Director	Financial Services Company
Mr. Mohamed Fayez Shamma	Director General	TechnoTex
Ms Hanadi Yassin	Manager	ASAS
Ms Maysaa Raslan	General Manager	Raslan Company
Ms Leila Qallaa	General Manager	Espace Design
Ms Hazar Selo	General Manager	Luxor
Ms Khulud Sirri Halaby	Country Manager	DHL
Mr. Nader Jabali	General Manager	Rabbath Canning Ind.
Mr. Walid Malas	General Manager	ASLAK

**Damascus 2**

Nawaf Ziedan	Manager	
Zuher Sahloul	NA	Construction Company
Ghiath AL Khen	NA	Programming Company
Mahmoud Abdul Baki	NA	Tourism
Naji Kelbukji	NA	Importer
Imad Hedar	NA	Exporter Agricultural Products
Omar Barbour	NA	Printing
Firas Amir,	NA	Katakit
Khaldun Kraim	NA	Town Center-Retailing
Nihad F. Silawi,	NA	Trade Well, Representative,



Wissam Al Mashhour	NA	CGTIM, Trade Well, Representative, CGTIM,
--------------------	----	---

**Aleppo, Arabic**

Wajih Fteimi	NA	Sabbagh-Sharabati
Sammer Tahhan	NA	Al Maamoun
Suhail Khawam	NA	Technopack
Nori Ashram	NA	C.P.A
Rassoul Douba	NA	Hajjar
Amal Awad	NA	H.S.Group
Sabri Nashawi	NA	Soukkar
Nasser Kayali	NA	Issam Kayali & Sons
Jamal Tatari	NA	Tatari Group
George Sarkis Tufenkji	NA	Tufenkji Bros. Co
Hanadi Saati	NA	Arizona
Mayada Adjan El Hadid	NA	Bremer Women's Wear

**Aleppo, English**

Khaled Sammani	NA	The Art of Chocolate
Riad Kurdy	NA	Kurdy Pharma Glass
George Salme	NA	Salme & Co.
Safwan Samsam	NA	Hanin Est.
Rita Arik	NA	Hanin Est.
Safouh Nahas	NA	Nahas Group
Steve Boyadjian	NA	Boyadjian Carpets
Nabil Kaspar	NA	BKC Company
Aladdin Kassab	NA	Classic
Rony Moulla	NA	Moulla Tex

**Aleppo French**

Mazen Jabri	NA	Syritour
Antoine Taoutel	NA	Taoutel Group
Nabil De Sahb	NA	Nabil De Sahb & Co.
Sabine De Sahb	NA	Financial Consultant
Edouard Megarbane	NA	Megarbane Co.
Philippe Amer Chite	NA	Export Consultant

**Pre-Focus Group Meetings****Aleppo, Arabic**

Mohamad Adeeb Badenjki	Chairman, Board	Al Arabia for Paper
Butrus Mrjaneh	General Manager	Bab Al Faraj Co. for Hotels and Tourism
Md. Sabbagh Sharabati	President	Chamber of Industry
Bashar Tatari	Owner	Tatari Co. for Curtains
Fouad Al Jouni	Manager	Tfenkji Broths. Co.
Mohsen Ganem	Owner	Al Shark Glass Co.
Abdul Mounem Kanbari	Manager	Al Shark Glass Co.
Nouri Al Dalati	Manager	Anas LTd. Co.
Mohamad Zuheir Wassouf	General Manager	Wassouf Co.
Abdul Karim Souleiman Debo	General Manager	Abdul Karim Debo Co.
Abdula Seerees	General Manager	Grain Milling Co.
Ohanis Keyomejian	Manager	Kohanis
Narsees Keyomejian	Manager	Kohanis



**Homs, Arabic/English**

Mr. Adel Taiyara	President of Homs Chamber of Commerce	Raslan-Taiyara Co.
Mr. Sulieman Hakemeh	Manager	Industrial Servics Co.
Mr. Gazee Abo Alkheer	President of Homs Chamber of Industry	Ibn Al Waled
Mr. Essam Tizini	Owner	Jawad Veterinary Medicines
Ms. Samar Ebrahim	Marketing manager	Farzat Oil
Mr. Lokman Droubi	General Manager	Farzat Oil
Dr. Zouhir Houssami	General Manager	Houssami Trading Co.
Mr. Ahmad Al Hafez	Manager	AL Hafez Group – Refrigerators Manufacturing
Mr. Adeeb Dayoub	Financial Manager	Daoud Trading
Mr. Bassem Oyoun Alsoud	General Manager	Motanabi Trading Co.
Mr. Zewar Solieman	Manager	Medical Labs
Mr. Nabil Kourdi	Manager	Textiles

**Lattakia, Arabic/English**

Sonia Razouk	Manager	Hotel Institute
Sausan Dahiyah	General Manager	Syrian Cane Furniture Production
Rihab Garib	Owner	Kanary woman dress
Salma Younes	Owner	Dita
Sawsan Rafoul	Expert	Customs Clearance
Insaf Soued	Manager	Soued Hospital
Taleb Soued	Assistant Manager	Soued Hospital
Lea Hakim	Manager	Chocolates shop: Ghraoui & Mohanna
Hussen Khaddour	Manager	Khaddour Trading Co.
Ha'la Khaddour	Owner	Al Wasset Language Center
Zeina Tabbaa	General Manager	Tabbaa Travel and Tourism
Tbarak Morheg	Owner	Tourism

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Per agreement with the Ministry of Finance, the following Annexes will only be provided upon written request.

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## Abbreviations

ACB	Agricultural Cooperative Bank
ACU	Agency for Combating Unemployment
ALCO	Asset-Liability Committee
AMC	Asset Management Company
AMF	Arab Monetary Fund
ATM	Automatic Teller Machine
AWP	Annual Work Plan
BAI	Bankakademie International
BIS	Bank for International Settlements
BSSP II	Banking Sector Support Project II
CBoS	Commercial Bank of Syria
CBS	Central Bank of Syria
CDs	Certificates of Deposits
CEO	Chief Executive Officer
CMC	Credit and Monetary Council
CR	Credit Registry
DBK	Development Bank of Kazakhstan
DDI	Difficult Debt Institution
EBRD	European Bank for Reconstruction and Development
ECA	Export Credit Agency
EIB	European Investment Bank
EU	European Union
EUR	Euro
FEMIP	Facility for Euro-Mediterranean Investment and Partnership
FX	Foreign Exchange
GDP	Gross Domestic Product
GoS	Government of Syria
IAS	International Accounting Standards
IB	Industrial Bank
IBTF	International Bank for Trade and Finance
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards



IPO	Initial Public Offering
JLGC	Jordan Loan Guarantee Corporation
KFED	Kuwaiti Fund for Economic Development
LC	Letter of Credit
MIS	Management Information System
MoF	Ministry of Finance
NPL	Non-Performing Loans
OECD	Organisation for Economic Co-operation and Development
PCB	Popular Credit Bank
PE	Public Enterprise
PMU	Project Management Unit
REB	Real Estate Bank
ROA	Return on Assets
ROE	Return on Equity
SB	Savings Bank
SME	Small and Medium Enterprise
SOE	State-Owned Enterprises
SSEC	Syrian Securities and Exchange Commission
SWOT	Strengths, Weaknesses, Opportunities and Threats
SYP	Syrian Pound
T-Bill	Treasury Bill
TSKB	Turkish Development Bank (Turkiye Sinai Kalkinma Bankasi A.S)
ToR	Terms of Reference
UCA	Unified Chart of Accounts
USD	US Dollar
VAT	Value Added Tax





## 1 Executive Summary

### 1.1 Introduction

The Ministry of Finance (MoF) of the Syrian Arab Republic has requested advisory services from the European Investment Bank (EIB) with a view to expanding medium and long-term financing of private sector investment projects in Syria through domestic lending institutions. The purpose of the Technical Assistance designed hereafter was to contribute in the preparation of such advisory services. The overall objective of the FEMIP Technical Assistance mission for this project was hence to identify and compare strategic options that would contribute to expanding medium and long-term financing of private sector investment projects in Syria through domestic lending institutions. This overall objective of the TA mission is in line with the overall goal of the FEMIP Technical Assistance Fund to accelerate and enhance sustainable private sector financing in the Mediterranean Partner Countries. In a first phase, the Consultant adopted an open approach whereby all existing and possible and available options were identified, evaluated and compared. If such a market and needs study is conclusive, and the preferred options are endorsed by the Syrian authorities and the European Investment Bank, the second phase of the mission will be dedicated to elaborating in more detail a business plan for the retained options. The study was conducted by Bankakademie International from October 2005 to March 2006.

This report will provide the results, findings, conclusions and recommended options as required by the Terms of Reference (ToR) for the *“Feasibility Study to develop new options for private sector investment financing through the domestic banking sector”*.

The *Feasibility Study* contributed the following content:

- A **“Brief Economic Reform and Macroeconomic Overview”** about Syria, provided in Chapter 2.
- A **“Demand Side Analysis (Syrian Enterprises)”** presenting the Market analysis for private sector financing in Syria, described in Chapter 3.
- A review of existing institutions in Syria extending private sector financing is given in Chapter 4: **“Supply Side Analysis (Syrian Domestic Banks – Public and Private)”**
- The pros and cons of setting up a new financing vehicle versus upgrading an existing intermediary, as well as a review of models for a new financing vehicle made in countries with a socio-economic background comparable to Syria and evaluation of different options for a new vehicle in the case of Syria can be found in Chapter 5 **“Public Bank Mergers and Restructuring”**, Chapter 6



## **“Options for new Financial Institutions / Products” and Chapter 7 “Methodology and Implementation – Phase 2”.**

In this Executive Summary, the Team will only present the key issues relating to each chapter in this Report. All of the Team’s recommendations are fully supported by the data contained in each chapter, which is itself based on the data set out in the annexes.

Finally, the Team wishes to acknowledge the Ministry of Finance’s full and qualified support, from the first day they met with the MoF’s Manager for Banks and Insurance until the last day the Phase 1 Team remained in Syria. Without the MoF’s unwavering support, as well as the professional efforts of the Project’s two Syrian Experts, the Team could not have completed this challenging mission within the 6-month timeframe allocated for it.

As described in the ToR, there are several other programmes funded by donors, or the beneficiaries themselves, which are of relevance to the project. In this context, the expert team compiled a list of meetings held to benefit from the opportunity to discuss the “lessons learned” from those initiatives with the relevant institutions and stakeholders in order to integrate their experiences and recommendations into this study and to ensure a synchronisation between the different projects.

### **Preferred Options**

The ToR state the following: *“In broad terms, two strategic directions should be investigated during the first phase: (i) transform or expand an existing financial intermediary to cover the new tasks required to achieve the overall objective of promoting sustainable private sector investments through increased access to adequate bank credit and (ii) develop a new “financing vehicle”, which provides the required financial services not available today through the existing domestic banking sector.”*

During Phase 1, the Team focused on developing the most coherent options, following “Best Practice”, which it now recommends as its preferred choices. Towards this end, the Team has interpreted the above paragraph, not as an either / or scenario, but rather as an opportunity to examine a number of different alternatives with regard to the Public Banks, and at the same time a variety of possible institutional structures and products to enhance the Syrian financial sector. It has made a determination, based on the results of the Demand Analysis that was conducted throughout the six months period (Cf. Chapter 3), as to which of these are most relevant to the needs of Syrian enterprises, both public and private sector.



## The Team's Preferred Options are the following:

### **For the existing Public Banks**

The Team recommends “**Different potential scenarios for restructuring the banking sector**”. The reasons for this recommendation are set out in detail in Chapter 5. The first step includes the assessment of the loan portfolios of the Public Banks. The BAI Team will describe four potential scenarios how to restructure the Public Banks. The choice of the best scenario can only be made when the results of the loan assessment are known.

### **As new Financing Vehicles / Products**

The BAI Team recommends three new Financing Institutions and/or products that it believes would be of particular benefit to the Syrian economy. These are:

- The establishment of a “**Difficult Debt Institution**”:
- The establishment of a **Syria SME Bank**; and
- The establishment of an **Export Credit Insurance facility**.

The BAI Team is fully aware of the complexity of these options. The remainder of this chapter, as well as the chapters that follow, will make the case as to why these are the best possible choices at this moment in Syria's economic and financial reform process, which the GoS has been implementing since 1986.

## **1.2 Brief Economic Reform and Economic Overview**

This chapter establishes the framework within which the economic and financial reform process has taken place to date. For bank sector restructuring to succeed, as well as to be able to establish or to introduce new financial institutions or products, certain actions must precede them. This chapter suggests additional enabling environmental reforms required for the BAI Team's, and for that matter for any financial restructuring options, to be successfully implemented.

### **Economic Reform Issues**

The BAI Team dealt with most of these issues during its presentation to the Minister of Finance (on 25 January 2006). The major points addressed are:

- Lack of a Government Securities Market
- Monetary Framework & Policy
- Lack of a Capital Market
- Legal and Accounting Reforms



These four subjects form the core of the Enabling Environment. If the issues relating to the establishment of each are not addressed, with the necessary legal and regulatory framework put in place, Public Bank Restructuring will be more difficult to achieve. The BAI Team has little or no control over these issues. They remain within the purview of the GoS and/or other donors. More specifically, the Banking Sector Support Programme II (BSSP II) will also have an important role to play as it begins its work with the Central Bank of Syria (CBS).

### 1.3 Demand Side Study

Chapter 3 (Demand Side Study) as well as Chapter 4 (Supply Side Study) are the foundations upon which the BAI Team's recommendations are built. Data and figures in the annexes relating to these two chapters support the outcome of the studies.

The study was conducted by BAI in January and March 2006. It comprised a detailed survey of 650 enterprises in seven pre-selected cities, using a semi-structured questionnaire. The focus was on large enterprises (more than 100 employees), medium enterprises (51 to 100 employees), small enterprises (11 to 50 employees) and micro-enterprises (3 to 10 employees). The survey was further segmented by industrial, trade and services enterprises.

In terms of the Region & Enterprise Size, the study distribution is as follows:

Size	Break-down	Damascus	Aleppo	Homs	Lattakia	Der-ezzor	Tartous	Sweidah
Micro	30%	60	45	30	18	18	12	12
Small	35%	70	53	35	21	21	14	14
Medium	25%	50	38	25	15	15	10	10
Large	10%	20	15	10	6	6	4	4
<b>Totals</b>	<b>100%</b>	<b>200</b>	<b>150</b>	<b>100</b>	<b>60</b>	<b>60</b>	<b>40</b>	<b>40</b>

The Demand Study aimed to:

1. Provide an overview of the socio-economic characteristics of Syrian enterprises.
2. Analyse these enterprises:
  - Current patterns and sources of finance and
  - Their access to banking products as well as their interest in capital market products.
3. Assess the enterprises':
  - Current financing needs,
  - Current indebtedness and ability to take on further debts,
  - Potential demand for existing investment products,
  - Potential demand for new investment products including; equity, debt, export credit insurance, leasing, venture capital.
4. Derive implications and draw conclusions on:
  - Future supply of investment products and services from existing financial institutions, in terms of demand for these products and their volumes.

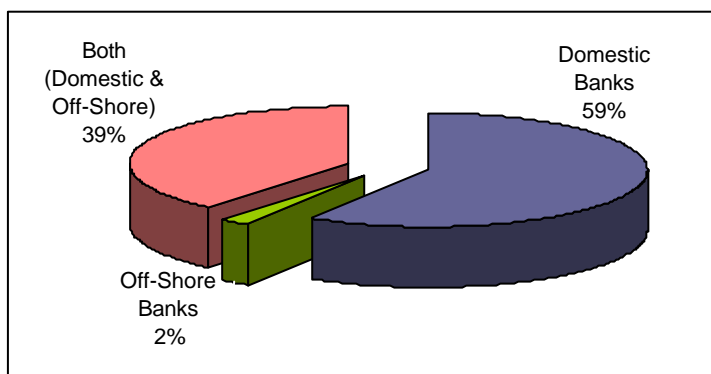


- Future supply of new investment products that could be provided by existing financial or new financial institutions.

## Summary of demand study findings

The study analysed the financing patterns of large, small, medium and micro enterprises, their financing needs and potential demand for bank credit. The main findings of the study are presented in the following.

### 1. Banking Relationships / Market Share



The survey found out, that 80% of enterprises have some kind of relationship with a bank. A key finding is that 41% of enterprises depend on off-shore banks in addition to the domestic ones, especially large enterprises. They need access to this banking source in order to finance exports and imports of goods. Only 19% of the

respondents have changed banks. However, it is difficult to conclude that the Syrians have a high loyalty to their bank. Reasons for this could be the lack of alternatives, especially in rural Governates, and the impression of the potential customers that the banks do not differ in critical issues like knowledge, finance, terms and conditions or service. Concerning bank market share, the CBoS has the highest at 55%. What is interesting is that offshore banks have the next highest at 9%; the private banks together have attained a 15% market share after two years. Their market share of medium and large enterprises loans, at almost 40%, is impressive given short period of time they have been operating.

### 2. Product needs and awareness

The survey has shown, Product awareness is low due to few products offered by the banks. It seems the least known products are: Letters of Credit, Overdrafts, factoring, Export Credit Insurance and Leasing. The survey found out, the interested banks may start to offer the specific products for: *medium and long term lending, Leasing, Factoring and Export Credit Insurance*. These products are principally requested in the future and the enterprises that are willing to take these products. The survey showed that “soft” factors such as service quality, friendliness and helpfulness of bank staff, quickness of service are highly valued by customers and are regarded as major factors in a good bank-customer relationship. The banks may want to consider this feedback in their customer relationship management and their service culture approach. These non-price aspects “Marketing” will be particularly relevant in the competition with other banks, at least from the customers’ point of view.



### 3. Access to loans

All enterprises were asked, if they ever asked for a credit or from a bank or not. The result is perhaps one of the central findings of this study: The majority, namely 92% of public sector suppliers, 84% of private sector suppliers and 86% of the international suppliers have not asked for credit. The survey found out, that 54% of private sector transactions are conducted in cash. Another interesting finding, suppliers request up to 100% collateral for the credit.

### 4. Enterprise Financing Information (formal and informal)

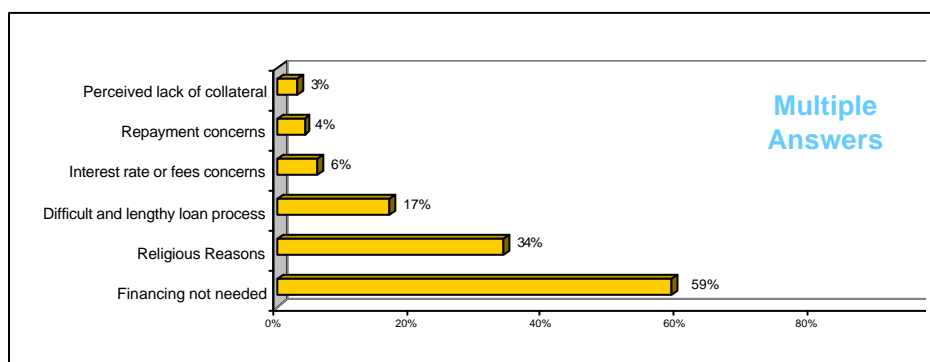
The enterprises were asked to rank the short-term finance products (both formal and informal) and the long-term finance products according to their importance for their company. Among all available financing products/institutions, personal cash and domestic banks are ranked as the most important (both more than three on a scale of 1 to 5) for more or less the same for each size of enterprise.

Asking the enterprises to rate a list of informal capital market products according to the importance for the own company, all financing sources (formal and informal) are more or less equally appreciated (between 2 and 3), with money brokers at the last position (with a score of 1.25).

### 5. Current loan demand

The enterprises were asked whether they ever have applied for a bank loan, and why they have / why they have not applied for a loan. Overall, a total of 68% of all enterprises had never applied for a loan, while their have been wide difference by region.

The two most important reasons cited for not requesting a bank loan are no need at 59% and religious reasons at 34%. This is a positive indicator for Islamic banking and



products. 17% of those who have never applied for a loan gave as reason that the loan procedure is difficult and lengthy.

Respondents, who were stated that they haven't applied for a bank loan because they do not need financing, were asked "Why don't you need financing?" The results indicate that the enterprises only grow as fast as their cash flow allows, as 71% indicated. However, 19% stated that they did not want any looking at their businesses with the remaining 10% not even having had thought of asking. The later assessment of external constraints supports the conclusions that Syrian enterprises



are very risk averse. They want to control what little they can, regardless their own desire to grow or not.

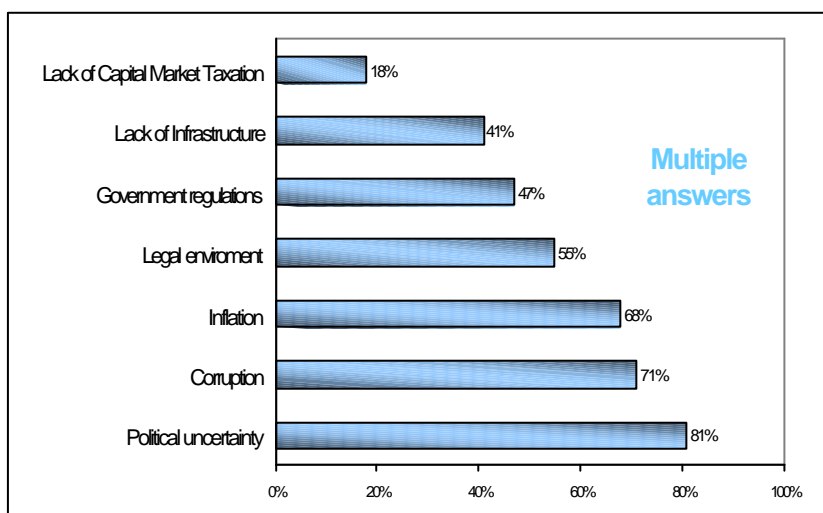
## 6. Future loan demand

There is a clear financing need among the enterprises interviewed. However, the crucial question is to what extend these financing needs would translate into effective demand for future loan.

The issue was approached by an assessment of the current loan demand of the interviewed enterprises. Consequently, a very rough estimate was produced for the current loan demand, the preferred interest rates and loan tenor.

Overall, can be stated, the aggregate loan demand for the 367 enterprises, wanting future loans, amounts to EUR 127 million; the average interest rate they are prepared to pay is 6.94%; average loan maturity required was 8 years.

## 7. General Constrains and Future Growth



All enterprises were asked, with a multiple response possibility, to select external challenges currently facing the business and constraining future growth. From a total sample of 650 enterprises, 81% said the political uncertainty is the major external challenge for the business and its future

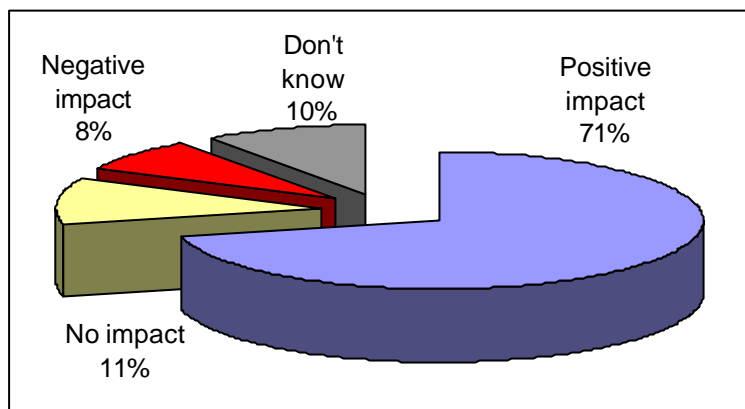
growth. Problems related to corruption were second (with 71%) in the ranking of essential restraint experienced by the enterprises. Further significant challenges for the enterprises interviewed are the inflation, being mentioned by 68% and the legal environment, being mentioned by 55%.

Despite the external challenges experienced, most enterprises are as well optimistic about the future, with 61% of them stating that they believe the economy of Syria will experience accelerated growth and 15% believe there will be little change.



## 8. Relationship with European Union

Another remarkable finding is that 71% of the Syrian enterprises expecting positive impact from the relationship to the European Union. The EU received very high marks concerning its potential impact on the Syrian economy over the next two years, whether by enterprise size or by region. The results are almost the same as the marks given for the impact as a result of collaboration between the EU and Syrian Government over the same period. Concerning the economic impact, the average score was 72% positive.



### 1.4 Supply Side Study

The Supply Side Study examined the Syrian banking sector, tracing some of the reform developments that have been taking place over the past few years. In spite of these, mobilisation of savings remains poor, and investment in the private productive sector is weak. Furthermore, the lack of private sector access to adequate financial services, specifically medium and long-term financing products, constitutes an impediment to the further development of the banking sector.

One of the most significant developments noted by the Study over the past two years is the establishment of an increasing number of private banks. As they continue to grow, and more are attracted to the relatively under-banked Syrian market, the competitive pressure on the Public Banks will only rise. Their inherent inefficiencies and lack of skills can only accelerate the pace of their decline unless serious remedial action is taken.

The Study conducted as detailed an analysis as possible, within the limited time-scale, of all of the six Public Banks and the private banks, and reached a number of conclusions with regard to each of them. The main strength and weaknesses will be described below and all other details are set out in individual bank reports, which are included in the Annexes.





### Strengths and Weaknesses

The strengths and weaknesses from the supply study:

Public Banks		
Bank	Strengths	Weaknesses
<b>Agricultural Cooperative Bank (ACB)</b>	<ul style="list-style-type: none"> <li>• Experience in servicing the rural sector since 1888</li> <li>• A network of 106 branches</li> <li>• Able to collect money owed through the Public Money Collection Law (not reliant on customers visiting the branches)</li> </ul>	<ul style="list-style-type: none"> <li>• Borrowers are sometimes detrimentally affected by adverse climatic conditions which in turn affects the ability to repay</li> <li>• The Bank is unable to attract good professional expertise to the branches</li> <li>• Low wages which make it difficult to retain and attract staff</li> <li>• A loan portfolio of uncertain quality, characterised by forgiveness of interest, non-payment of principal, and rescheduling.</li> </ul>
<b>Commercial Bank of Syria (CBoS)</b>	<ul style="list-style-type: none"> <li>• Largest Syrian bank by total assets,</li> <li>• Only public bank licensed for FX-transactions</li> <li>• Fairly large branch and correspondent network</li> <li>• Strong backing by the Government</li> <li>• Reform oriented top management</li> <li>• (High liquidity but substantial idle capital)</li> </ul>	<ul style="list-style-type: none"> <li>• Weak governance and institution building</li> <li>• Limited diversification of income sources</li> <li>• Low profitability and unclear capital adequacy</li> <li>• Collateral based lending; weak risk management</li> <li>• Overstaffing and insufficient qualification</li> <li>• Poor MIS/IT, but new system under preparation</li> <li>• Loan portfolio of uncertain quality, apparently with many poorly/non performing public sector loans and a significant volume of private sector NPLs</li> </ul>
<b>Industrial Bank</b>	<ul style="list-style-type: none"> <li>• Bank's management considers staff to have good experience</li> </ul>	<ul style="list-style-type: none"> <li>• The inability to recruit graduates or retain their best young staff members</li> <li>• Lack of a computer-based MIS/IT system linked to the branch network</li> <li>• There seems to have been reluctance in the past to provision adequately for difficult debts and an inability to recover funds from collateral.</li> <li>• Failure in procedures; either in assessing collateral, securing title or pursuing collection</li> <li>• A very significant volume of NPLs sufficient to endanger the solvency of the Bank.</li> </ul>
<b>Popular Credit Bank</b>	<ul style="list-style-type: none"> <li>• Widely spread network of branches</li> <li>• Services orientated to the less advantaged</li> </ul>	<ul style="list-style-type: none"> <li>• Low wages which make it difficult to retain and attract staff</li> <li>• Out-of-date technology used</li> <li>• Need to increase the skilled staff numbers in some branches</li> <li>• Inadequate risk management procedures and loan portfolio of uncertain quality.</li> </ul>



<b>Real Estate Bank (REB)</b>	<ul style="list-style-type: none"> <li>• Good reputation</li> <li>• Good administration</li> <li>• Good technology</li> <li>• Well collateralised loans</li> <li>• Centralised on-line accounting</li> </ul>	<ul style="list-style-type: none"> <li>• Prohibited from dealing in foreign currencies</li> <li>• Limited branch network</li> <li>• Need better trained and more qualified staff</li> <li>• Inability to remunerate staff competitively</li> <li>• Funding/Interest rate mismatch problem</li> <li>• Inadequate risk management procedures. Quality of loan portfolio needs to be reviewed.</li> </ul>
<b>Savings Bank (SB)</b>	<ul style="list-style-type: none"> <li>• Positive market reputation</li> <li>• Large domestic branch network and outreach</li> <li>• Particular strength on retail deposit mobilisation</li> <li>• (High liquidity but substantial idle capital)</li> </ul>	<ul style="list-style-type: none"> <li>• Weak governance and institution building</li> <li>• Poor diversification of income sources</li> <li>• Low profit and capital adequacy ratios</li> <li>• No systematic risk management</li> <li>• Insufficient qualification of staff</li> <li>• Poor MIS/IT, but partial modernisation planned</li> </ul>

<b>Private Banks</b>		
<b>Bank of Syria and Overseas</b>	<ul style="list-style-type: none"> <li>• Strategic Partner's (IFC) high reputation in the marketplace</li> <li>• Management's good relations with high net worth individuals in Syria</li> <li>• Training on a rotational basis provided to all employees</li> </ul>	<ul style="list-style-type: none"> <li>• The organisation structure is still evolving and is dependant upon permissions from the regulatory authorities</li> <li>• Unable to determine a precise development strategy because the regulatory environment is constantly changing</li> <li>• Lack of qualified and experienced persons to hire</li> </ul>
<b>Banque Bemo Saudi Fransi (BEMO)</b>	<ul style="list-style-type: none"> <li>• Good reputation</li> <li>• Part of International Group (Credit Agricole, France)</li> <li>• Good knowledge of the country</li> <li>• Fast development / aggressive branch opening programme</li> </ul>	<ul style="list-style-type: none"> <li>• Difficult to recruit trained banking staff</li> <li>• Fast growth has strained internal organisation</li> <li>• IT System needs improvement</li> </ul>
<b>International Bank for Trade and Finance (IBTF)</b>	<ul style="list-style-type: none"> <li>• One of the first private banks in Syria</li> <li>• Clear and effective corporate governance</li> <li>• Diversified product range</li> <li>• Professional management and institutional support provided by main shareholder</li> </ul>	<ul style="list-style-type: none"> <li>• Young corporate history</li> <li>• Limited but growing branch network</li> <li>• Small but increasing market share</li> <li>• Volatile and weakly regulated operating environment</li> </ul>

All public banks are characterised by weak governance resulting in a reduced efficiency level. The powers of the Boards of Directors of the banks are limited and neither qualify for supervision nor for a strategic management. Except for a narrowly defined ordinary course of business all material decisions require state approval, which depending on its respective nature must be sought from the Ministry of Finance, the Office of the Prime Minister, the State Planning Authority, the Central Authority for Financial Control and others. The constant state interference in the



strategy and day-to-day management of public banks represents a significant impediment to their efficiency and constitutes an increasing competitive disadvantage compared to private banks now operating in the country.

The salient feature with regard to all of the Public Banks is the uncertain quality of their loan portfolios, due in large part to serious deficiencies in their risk management systems and procedures, particularly in the monitoring and control of outstanding loans. There appears to be far too much rescheduling when repayments are not made in a timely fashion. In some cases, specifically the CBoS and the Industry Bank, the volume of NPLs is significant to the point where serious remedial action is required, not least because totally inadequate provisions are held against them.

As a result of this, a key recommendation of this Report is that a detailed assessment be made of the loan portfolios of each of the Public Banks. The primary reasons for this recommendation are:

- To obtain detailed and accurate information on the true nature and quality of the lending in each of the Public Banks;
- There has been performed no audit of the Banks since 2003;
- In some cases, it appears that little or no centralised information is held about the loan portfolios at the Banks' Head Offices;
- Monitoring and control procedures in most, if not all of the banks are wholly inadequate;
- Many non-performing loans appear consistently to be rolled-over and/or rescheduled;
- It is uncertain how accurate is the value of security held against individual loans;
- None of the banks appear to hold accurate information on the ageing of their loan portfolios or to practice a provisioning policy consistent with generally accepted banking procedures.

Regardless which, if any, of the proposed scenarios (see below) for a way forward is accepted by the GoS and the EIB, it is recommended that this assessment of the loan portfolios of the Public Banks be started as soon as possible since it will necessarily be required prior to any of the scenarios being implemented.

Additionally, a further recommendation of this Report is that a Difficult Debt Institution (DDI) be established into which a selection of NPLs from all of the banks will be transferred. Both the basis of this selection and the decision to establish a DDI will depend on a prior assessment of the loan portfolios of the Public Banks.

In conclusion, the Supply Side Study found that there are deep-rooted deficiencies of a regulatory and an institutional nature in the banking system, a combination of which results in an inefficient conduct of banking business in Syria. This helps to explain the



poor financial intermediation role that the public dominated banking sector has been exercising hitherto. The amendment of relevant laws and regulations, and the implementation of a banking sector liberalisation policy, are essential to stimulate economic activity by channelling a greater share of domestic savings towards more productive investment in Syria.

**Recommendations**

A number of recommendations are made including:

1. The institutional deficiencies of the Public Banks need to be addressed and at the same time regulatory impediments removed. Recommendations are made with regard to the banking regulatory framework, improvements in monetary policy, liberalisation of Foreign Exchange, the introduction of Treasury Bills, improving clearing and settlement procedures, and the introduction of International Accounting Standards.
2. Comprehensive institutional, operational and financial measures are recommended for a systemic restructuring and rehabilitation of the Public Banks.
3. This includes, specifically, a detailed assessment of the loan portfolios of all of the Public Banks, as a matter of priority.
4. Further recommendations relate to the introduction of non-bank financial institutions for the purpose of broadening the financial sector and enriching the range of and efficient supply of demand oriented bank and non-bank financial services.

**1.5 Financial Sector Restructuring Scenarios**

In the following overview, a number of different possible scenarios are described together with perceived advantages and disadvantages in each case. It should be noted that all of the scenarios assume that the Commercial Bank of Syria (CBoS) and the Agricultural Bank remain as independent institutions, regardless what other specific recommendations are made in their regard.

Base case		
Bank	Target	Pre-Requisites
Commercial Bank	Transform to Universal Bank	<ul style="list-style-type: none"> <li>• Upgrade institution building</li> </ul>
Agricultural Bank	No change	<ul style="list-style-type: none"> <li>• Upgrade institution building</li> </ul>
4 other Public banks	To be subjected to a loan portfolio assessment	<ul style="list-style-type: none"> <li>• Establish TOR</li> <li>• Define "bad loans"</li> </ul>
Establish Difficult Debt Institution (DDI)	<ul style="list-style-type: none"> <li>• Define Non-performing Loans (NLP) criteria</li> <li>• Select, then transfer NPLs, from all the public banks, to the DDI</li> </ul>	<ul style="list-style-type: none"> <li>• Prepare articles of Association / Statutes</li> <li>• Prepare institution building (governance, systems, procedures)</li> <li>• Assess need for branches</li> <li>• Select key management</li> </ul>



**Commercial Bank of Syria:** This bank has the potential to be transformed into a universal bank. First, however, a detailed assessment needs to be done of its loan portfolio, and at the same time a programme of institution building is necessary. This will involve a detailed review of key areas, including corporate governance, strategy planning, definition of key objectives, marketing and business development, risk management, and financial accounting and management. It is also essential that the CBoS's relationship and responsibilities with the Central Bank of Syria (CBS) be untangled, in particular the holding of the GoS's foreign currency reserves. Finally, an urgent priority is to re-establish the Bank's international reputation, which currently suffers from certain derogatory and damaging insinuations, including money laundering.

**The Agricultural Bank:** No change is recommended in the status of this bank other than that consideration could be given to transforming it into an Agricultural Development Institution, maybe under the responsibility and ownership of the Ministry of Agriculture. Here, too, a detailed assessment needs to be done of its loan portfolio, and at the same time a programme of institution building (as described above) is necessary.

**Industrial Bank, Popular Credit Bank, Real Estate Bank, Savings Bank:** All of these banks should be subject initially to a detailed assessment of their loan portfolios. However, Terms of Reference, for this exercise, need to be established. Subsequent action is set out in the scenarios described below.

**Difficult Debt Institution (DDI):** A DDI is established into which are transferred a selection of Non-Performing Loans (NPL) from all of the Public Banks, including all public sector loans in arrears. The precise definition of NPL will need to be established as well as the criteria for their selection and transfer to the DDI. Pre-requisites for the establishment of a DDI are the preparation of Articles of Association/Statutes, preparation of criteria for institution building (as described above), and the selection of key management. It is emphasised that for all of the following scenarios, the establishment of a DDI is a sine qua non.

**Scenario 1**

Scenario 1			
Bank	Target	Pre-Requisites	Pros & Cons
Industrial Bank Popular Credit Bank Real Estate Bank Savings Bank	Merge to form "Universal Bank of Syria"	<ul style="list-style-type: none"> <li>Restructure new bank &amp; build institutions</li> <li>Improve efficiency (close down unnecessary support departments, branches)</li> <li>Harmonise IT/MIS</li> <li>License for F/X operations</li> <li>Ensure level playing field</li> </ul>	<ul style="list-style-type: none"> <li>Public banks would be consolidated</li> <li>Restructuring will capitalise on the existing institution building</li> <li>Reallocation of loans is a daunting exercise</li> <li>High capitalisation requirement</li> <li>4 bank Merger is very risky and difficult</li> </ul>



## **“Universal Bank of Syria”**

This first scenario supposes that the Industrial Bank (IB), the Popular Credit Bank (PCB), the Real Estate Bank (REB) and the Savings Bank (SB) are all merged to become the Universal Bank of Syria.

This would include the following actions:

- To the combined loan portfolios of these four banks (less the NPLs transferred to the DDI) would be added the SME and private sector retail loans of the CBoS, which thereafter would concentrate on public sector and other large corporate lending.
- Integral to the merger process would be:
  - The restructuring of the new bank, including institution building (as described above);
  - Improving efficiency e.g. through consolidation and closure of unnecessary support functions and branches;
  - Harmonising and where appropriate upgrading IT and Management Information Systems
  - Licensing the bank to undertake foreign exchange operations;
  - Ensuring that it operated in a fair and competitive environment.
- Close co-ordination and co-operation with the Ministry of Finance throughout this process would be necessary to ensure that the objectives are clear from the outset in order that the best possible results will be achieved.

## **Main Advantages**

- Four of the Public Banks would be consolidated to create a new Universal Bank.
- The new bank would provide strong competition for the CBoS and at the same time would be acceptable to the international banking community.
- The number of banks owned by the GoS would be reduced from six to three.
- Restructuring will capitalise on existing institution building.

## **Main Disadvantages**

- Reallocation of loans is a daunting task;
- A potentially high capitalisation requirement;
- A four-bank merger is a potentially risky and difficult operation.



## Scenario 2

Scenario 2			
Bank	Target	Pre-Requisites	Pros & Cons
Industrial Bank Popular Credit Bank Real Estate Bank Savings Bank	Merge to form a Universal Bank with focus on private sector retail banking	<ul style="list-style-type: none"> <li>Improve efficiency</li> <li>Harmonise IT/MIS</li> <li>Upgrade institution building</li> <li>License for F/X operations</li> <li>Ensure level playing field</li> </ul>	<ul style="list-style-type: none"> <li>Strong new bank to compete with CBoS and other private banks</li> <li>Restructuring will capitalise on the existing institution building</li> <li><i>4 bank Merger is very risky and difficult</i></li> </ul>
Establish new Bank	"SME Bank of Syria"	<ul style="list-style-type: none"> <li>Prepare Articles of Association / Statutes</li> <li>Prepare institution building (governance, systems, procedures)</li> <li>Prepare branch strategy</li> <li>Select key management</li> </ul>	<ul style="list-style-type: none"> <li>Bank to be professionally established from the outset</li> <li>Bank to be tailored to SME needs without restructuring requirement.</li> <li><i>High capitalisation need</i></li> <li><i>Establishing new bank is time consuming and risky</i></li> </ul>

The second scenario supposes a combination of mergers to create a retail market oriented bank, and at the same time the establishment of a new "SME Bank of Syria".

### "Universal Bank of Syria"

Once again, the IB, the PCB, the REB and the SB are all merged to become a universal bank with a particular focus on private retail banking. This would include the following actions:

- Integral to the merger process would be:
  - The restructuring of the new bank, including institution building (as described above);
  - Improving efficiency e.g. through consolidation and closure of unnecessary support functions and branches;
  - Harmonising and where appropriate upgrading IT and Management Information Systems;
  - Licensing the bank to undertake foreign exchange operations;
  - Ensuring that it operated in a fair and competitive environment.
- Close co-ordination and co-operation with the Ministry of Finance throughout this process would be necessary to ensure that the objectives were clear from the outset so that the best possible results were achieved.

### Main Advantages

- Four of the Public Banks would be consolidated to create a new Universal Bank with a focus on the private retail sector;



- The new bank would provide strong competition for the CBoS and at the same time would be acceptable to the international banking community;
- Restructuring will capitalise on existing institution building.

## **Main Disadvantages**

- A four-bank merger is a potentially risky and difficult operation;
- The merger and consolidation process is likely to be complex.

## **“SME Bank of Syria”**

At the same time as the four banks are merged to form the “Universal Bank of Syria”, a new “SME Bank of Syria” is established to focus specifically on the smaller and medium enterprise market in Syria. This would require the following actions:

- Promulgation of an Enabling Law;
- Preparation of a Business Plan (including a Feasibility study, Definition of strategic objectives and pro-forma financial statements and forecasts);
- Preparation of Articles of Association / Statutes;
- Institution building (as described above);
- Appointment of Board of Directors and key management;
- Recruitment of staff.

## **Main Advantages**

- A professionally managed and focused institution from the outset;
- No restructuring requirements and tailored specifically to SME needs.

## **Main Disadvantages**

1. Time-consuming and risky exercise to establish a new bank;
2. Difficult to establish a market niche for itself, with new depositors and new loan customers, in the face of strong competition from other public and private sector banks;
3. High capitalisation requirement;
4. Difficult to find suitably qualified personnel.





## Scenario 3

Scenario 3			
Bank	Target	Pre-Requisites	Pros & Cons
Industrial Bank Real Estate Bank Savings Bank	Merge to form a Universal Bank	<ul style="list-style-type: none"> <li>Improve efficiency</li> <li>Harmonise IT/MIS</li> <li>Upgrade institution building</li> <li>License for F/X operations</li> <li>Ensure level playing field</li> </ul>	<ul style="list-style-type: none"> <li>Acceptably strong new bank to compete with CBoS and other private banks</li> <li>Restructuring will capitalise on the existing institution building</li> <li><i>3 bank merger risky but less than 4</i></li> </ul>
Popular Credit Bank	Transform to "SME Bank of Syria"	<ul style="list-style-type: none"> <li>Improve efficiency</li> <li>Reform institution building and downgrade to focus on SMEs</li> <li>Modernise IT/MIS</li> </ul>	<ul style="list-style-type: none"> <li>Restructuring will capitalise on the existing institution building</li> <li><i>Capitalisation requirement to compensate NPL transfer to DDI</i></li> </ul>

This scenario supposes a combination of mergers to create a second universal bank (alongside CBoS), and at the same time the transformation of the PCB into the "SME Bank of Syria".

### "Universal Bank of Syria"

Here the IB, the REB and the SB are all merged to become a Universal Bank. This would include the following actions:

- Integral to the merger process would be:
  - The restructuring of the new bank, including institution building (as described above);
  - Improving efficiency e.g. through consolidation and closure of unnecessary support functions and branches;
  - Harmonising and where appropriate upgrading IT and Management Information Systems;
  - Licensing the bank to undertake foreign exchange operations;
  - Ensuring that it operated in a fair and competitive environment.

### Main Advantages

- Creation of an acceptably strong new bank to compete with CBoS and other private banks;
- Creation of a bank which is acceptable to the international banking community;
- Reduction from six to four Public Banks;
- Restructuring will capitalise on the existing institution building.



## **Main Disadvantages**

- A three bank merger carries risks, but less so than a four bank merger;
- The merger and consolidation process is likely to be complex and time consuming.

## **“SME Bank of Syria”**

At the same time as the three banks are merged into a new universal bank, the Popular Credit Bank is transformed into a new “SME Bank of Syria” to focus specifically on the SME market in Syria. This would be in addition to the existing relationships and activities of the other banks with the SME sector rather than in substitution of such relationships and activities.

- Integral to the transformation process would be:
  - The reformation and re-alignment of the new bank to focus on SMEs;
  - Institution building (as described above);
  - Improving administrative efficiency;
  - Where appropriate upgrading IT and Management Information Systems;
  - Licensing the bank to undertake foreign exchange operations;
  - Ensuring that it operated in a fair and competitive environment.

## **Main Advantages**

- An institution dedicated to SME interests;
- Restructuring will capitalise on existing institution building.

## **Main Disadvantages**

- A Potentially high capitalisation requirement may be needed to compensate for NPL transfer to DDI.

**Scenario 4**

Scenario 4			
Bank	Target	Pre-Requisites	Pros & Cons
Industrial Bank Popular Credit Bank	Merge form "SME Bank of Syria"	<ul style="list-style-type: none"> <li>• Improve efficiency</li> <li>• Reform institution</li> <li>• Downgrade to SME</li> <li>• Modernise IT/MIS</li> </ul>	<ul style="list-style-type: none"> <li>• Restructuring will capitalise on the existing institution building</li> <li>• Fairly large bank for SME promotion</li> <li>• <i>Capitalisation requirement to compensate NPL transfer but less than Scenario 2 (S. 2.) above.</i></li> </ul>
Real Estate Bank Savings Bank	Merge to from a Universal Bank	<ul style="list-style-type: none"> <li>• Improve efficiency</li> <li>• Harmonise IT/MIS</li> <li>• Enhance institutional capacity</li> <li>• License for F/X operations</li> <li>• Ensure level playing field</li> </ul>	<ul style="list-style-type: none"> <li>• New bank to diversify the bank sector</li> <li>• Liquidity shortage of REB offset by liquidity surplus of SB</li> <li>• Comparatively low restructuring requirement of REB</li> <li>• <i>Rather small asset base</i></li> </ul>

This scenario supposes a combination of mergers to create a second smaller universal bank and at the same time the transformation of the IB and the PCB into an "SME Bank of Syria".

**"Universal Bank of Syria"**

Here the REB and the SB are merged to become a Universal Bank. This would include the following actions:

- Integral to the merger process would be:
  - The restructuring of the new bank, including institution building (as described above);
  - Improving efficiency e.g. through consolidation and closure of unnecessary support functions and branches;
  - Harmonising and where appropriate upgrading IT and Management Information Systems
  - Licensing the bank to undertake foreign exchange operations;
  - Ensuring that it operated in a fair and competitive environment.



## **Main Advantages**

- Diversification of banking sector to create a second universal bank to compete with CBoS and other private banks;
- Creation of a bank which is acceptable to the international banking community;
- Reduction from six to four Public Banks;
- REB's mismatch positions offset by SB's large and stable deposit base;
- Restructuring will capitalise on the existing institution building.

## **Main Disadvantages**

- The bank would have a relatively modest asset base.

## **“SME Bank of Syria”**

At the same time as the REB and SB are merged, the IB and PB are merged to form a new “SME Bank of Syria” to focus specifically on the SME market in Syria. Here again, this would be in addition to the existing relationships and activities of the other banks with the SME sector rather than in substitution of such relationships and activities.

- Integral to the transformation process would be:
  - The reform and re-alignment of the new bank to focus on SMEs;
  - Institution building (as described above);
  - Improving administrative efficiency;
  - Where appropriate upgrading of IT and Management Information Systems;
  - Licensing the bank to undertake foreign exchange operations;
  - Ensuring that it operated in a fair and competitive environment.

## **Main Advantages**

- An institution dedicated to SME interests;
- Good sized bank for SME promotion;
- Restructuring will capitalise on existing institution building.

## **Main Disadvantages**

- Possible re-capitalisation requirement to compensate for NPL transfer to DDI.



## 1.6 New Financial Institutions / Products

In Chapter 6, the BAI Team examines a number of new financial institutions and products with a view to their possible establishment or introduction in Syria. Each one is described in detail under individual chapter headings, at the end of which the BAI Team provides its conclusions and recommendations.

As noted above, three of these institutions or products are preferred recommendations for immediate consideration by the GoS. This is because they are deemed to be of potentially significant benefit to the Syrian economy in general, and to private enterprises in particular. In addition, the BAI Team believes that the implementation process for all of them could be initiated during the anticipated timeframe of Phase 2. These institutions or products are:

- The establishment of a Syria SME Bank;
- The establishment of DDI;
- The establishment of an Export Credit Insurance facility.

The methodology for the implementation of each of these preferred options is outlined in section 1.7 below and described in detail in Chapter 7.

This, however, is not to say that the remaining options discussed in Chapter 6 are not favoured. All of them have merit, even though their introduction or establishment may need to be undertaken over a longer timeframe, or once the relevant legislative and / or regulatory framework is in place.

The further options that were considered by the BAI Team are the following:

- ***Long term Lending***

The Public Banks in Syria that engage in long-term lending are generally using short-term deposits to fund their long-term, fixed-rate loans. This involves potentially significant risks for the banks that can lead to severe illiquidity, losses and ultimately insolvency.

The BAI Team recommends that the Credit and Monetary Council (CMC) and CBS work together to establish a clear distinction between interest rates payable on local currency deposits for differing terms, with specific emphasis on the encouragement of medium and longer-term investment and the discouragement of short-term savings.

It further recommends that, in the absence of a capital market, the CMC permits banks, both public and private, to trade or broker Certificates of Deposit (CDs) between ready buyers and sellers, if available.



- ***Leasing***

This is a financial service, when focused on the leasing of industrial assets that can facilitate the successful growth of the country's formal economy. It is also acceptable under Islamic laws and culture. To create a leasing sector, this process need not be a long one. Legislation that operates successfully in other countries can be adapted for use in Syria. The technical know how required to develop such specialised leasing companies (within critical areas such as: risk assessment, funding, sales and marketing, and collections) can be brought to Syria to work with the GoS and also potential lessors. Finally, the GoS can develop incentives to bring key international financial institutions and vendors to Syria.

- ***Factoring***

Factoring can be an important source of external financing for SMEs. A key benefit is that the SMEs own credit rating is not necessarily a barrier to receiving funding via the product. However, Factoring is not a product that the BAI Team recommends for Phase 2, although its introduction could facilitate the development and growth of Syrian SMEs in the medium term.

- ***Export Credit Insurance***

Given the benefits, that the availability of export credit insurance is expected to bring, both to exporters, in terms of their ability to offer credit terms to their foreign buyers, and to the overall economy, in terms of increased exports, the BAI Team recommends that an export credit facility be established in Syria. Different options for achieving this are examined in Chapter 6.3, but the preferred option is that this should be a private sector company.

However, it is also suggested that GoS participation in the equity of this company, for example, through the State Insurance Company, would be particularly beneficial, not least because of the need for the GoS to commit to insuring non-marketable risk for account of the State. If this recommendation is accepted, a methodology for the establishment of an export credit insurance facility is set out in this report.

- ***Equity Finance***

The Focus Groups revealed the considerable interest in equity finance of Syrian enterprises, and in particular in private equity investments for a three to seven year period, with the right to buy back the equity holder's capital stake at the end of this period.

The BAI Team recommends that the GoS undertake a feasibility study, perhaps an output of the new SME Agency, for establishing an equity finance vehicle that would aim to determine the nature and extent of the potential market for such equity investments.



- ***The Establishment of a Credit Registry***

There is currently no Credit Registry in Syria, although both public and private sector banks expressed a wish that one should be established. There are a number of legal and regulatory issues that would need to be addressed by the GoS before this could become a practical proposition. Nevertheless, the BAI Team concluded that such a Registry would be beneficial to the Syrian financial sector.

Accordingly, it recommends that the GoS commissions a feasibility study to examine the practicalities of forming a private sector Credit Registry and the pre-requisites that would need to be fulfilled prior to this taking place.

- ***The introduction of a Deposit Insurance Scheme***

Because Syrian banks were all state owned, for almost half a century, prior to private banks re-opening at the beginning of 2004, a general expectation continues to prevail that the GoS guarantees all current and savings deposits.

Although this expectation applies in particular to the Public Banks, the public may legitimately expect that this “implicit” guarantee extends to the private banks as well. Such expectations constitute a potential and severe risk to the state budget. Accordingly, the BAI Team recommends that the Government give serious consideration to the establishment of a Deposit Insurance Scheme, with the specific objective of extending some degree of cover for all retail deposits held by the public, in both the public and the private banks.

- ***Islamic Banking***

An Islamic banking law is in place in Syria and now awaits regulation. The Demand Study found that the reason why 34% of enterprises had never requested a bank loan was for religious reasons. This clearly indicates that this type of financial institution and its products have a potential market in Syria.

Accordingly, the BAI Team recommends the introduction of Islamic Banking and Islamic product development, although it does not consider that either of these is within the Terms of Reference or scope of the Phase 2 Bankakademie Expert Team.

## **1.7 Implementation Methodology – Phase 2 Preferred Options**

Chapter 7 sets out a proposed methodology, which would be initiated during a Phase 2 inception report period. At its conclusion, a more detailed approach would be presented with regard to methodology and implementation for each of the preferred options.







## 2 Brief Economic Reform and Macroeconomic Overview

### 2.1 Objective

The Feasibility Study Report, within which this chapter is found, will present recommended options addressed to restructuring the Public Bank sector, as well as options dealing with enhanced or new banking products. Both are aimed at improving Syrian Enterprises' access to financial investment and services. In order to ensure that these recommendations may be implemented within the most propitious economic and financial climate, the BAI Team will lay out key reforms in both areas aimed at facilitating implementing the selected options during Phase 2.

The BAI Team's preferred options have been thoughtfully considered related to how they may enhance the overall economic growth. This is required, as the sluggish growth of the Syrian economy in recent years has resulted in an aggravation of the problem of unemployment. A survey, conducted by the Agency for Combating Unemployment, showed that there are currently 880,000 people out of work, or 16% of the total labour force. Further, it found that 80% of those unemployed were aged between 15 and 24. In order to improve this employment picture, more successfully providing jobs for all, but most specifically the young, the BAI Team's recommendations may require amending existing laws, new legislation and a more forward looking regulatory environment. More importantly, as these enabling environment changes will affect bank sector reform, they will have then substantial impact on the entire financial sector. Thus, the first part of this chapter will address key economic and financial reforms, which, if implemented, would facilitate the overall economy to expand more rapidly and, thereby, through enterprise start-ups and increased growth from existing enterprises, create jobs<sup>3</sup>.

### 2.2 Economic Reform Issues

#### Monetary Framework & Policy

The Credit and Monetary Council (CMC), was reactivated in May 2003 as a step toward a more active monetary policy. This is in the light, that the level of financial intermediation is very low, and the government has yet to launch a Treasury Bill (T-Bill) market, which is a pre-requisite for the development of financial markets and the proper pricing of financial assets. Additionally, because there are no T-Bills the Central Bank of Syria (CBS) lacks one of the basic tools of monetary policy. Moreover, the Commercial Bank of Syria continues acting *de facto* as a banker and a fiscal agent. This seriously hampers monetary policy implementation and complicates monetary and fiscal policy co-ordination tasks. In order to redress this situation, a

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<sup>3</sup> This section has heavily drawn on the Arab Monetary Fund Mission in October 2005. Reforms of financial markets and monetary policy in Syria, and Foreign Exchange Policy Central Bank of Syria, Ideas for Today and Tomorrow, AMF Mission, October 2005.



revision of the Central Bank Law No. 23/2002, with the aim of strengthening its independence is being planned.

To further rectify this problem, the Government of Syria plans to reorient the activities of the CBoS towards a more classical aspect of commercial banking. In order to facilitate this process, the GoS remains committed to moving the bulk of its in foreign currency denominated assets, from the CBoS to the CBS. The Arab Monetary Fund (AMF) mission fully supported this transfer. As soon as this takes place, the CBS would act as the fiscal agent, improving the co-ordination of liquidity and public debt management. The BAI Team fully supports the separation of institutional roles and responsibilities between the CBS and the CBoS.

## **Money Market**

Additionally, the AMF mission underscored the importance of moving swiftly on the much delayed agenda on the launching of a government securities market through the issuance of T-Bills. This would be critical for financial sector development and moving towards market-determined interest rates. With ability to issue T-Bills, the GoS could more directly manage its short-term treasury needs, creating a money market. CBS would then use T-Bills as its principal tool of monetary policy. To effectively use this tool, the CBS would begin regular T-Bill auctions. Additionally, the AMF mission also suggested that to improve liquidity management, the CBS could consider introducing new instruments; short-term Certificates of Deposits or deposit facilities, and to enforce more strictly and to use more actively the Reserve Requirement.

Interbank lending for short periods of up to one year had been approved by the CMC, but very little movement of funds has taken place so far. The obstacle appears to be a clear and equitable reference interest rate determined by the market, as well as to the fact that the Public Banks are not used to the management of risk and money market operations of this kind.

This is unfortunate, because the private banks, which started operations in 2004, have been highly successful in attracting deposits. They have limited real opportunities to invest these funds in spite of the apparent need of the economy. If there was an active Interbank market, these deposits could be placed. They are not, with the result of a build-up of excess liquidity. However, these cash balances, under current rules, must be maintained as unremunerated cash reserves, on deposit with the CBS.

Finally, to create a more fluid money market, the CMC has allowed short-term deposit interest rates to be increased in a range from between 7.5% and 8.5%. Furthermore, banks are allowed the flexibility to move their current interest rates on deposits within a margin of plus or minus 0,5%. Current accounts will now pay 1% rather than 2%. However, savings accounts, not exceeding SYP 1 million, remain at 5%, but the rates on non-negotiable investment certificates have gone up by 1 percentage point to 7.5%.



## Capital Market

As to the creation of a debt capital market, the AMF recommended that the GoS foreign assets, held at the CBoS, as well as the “non-performing” old “treasuries”, currently held by the CBS, offered an excellent opportunity to introduce tradable longer dated government securities through the securitisation of these two assets. This step could be followed by regular auctions of new longer dated securities.

In that regard, some flexibility in long-term interest rates is being seen, again because of CMC decisions. These adjustments aim to support long-term lending by providing incentives for savers to invest in long-term deposits. Rates on one-year deposits have risen from 6% to 9% in successive adjustments. In addition, banks (public and private) were permitted, for the first time, to issue their own negotiable Certificates of Deposit (CDs) for one, two and / or three year terms. Concerning medium-term securities, they may issue CDs at deposit rates ranging from between 9 and 10%. The second steps towards a more effective capital market.

Thus, the BAI Team fully supports the AMF, when it proposed the following Monetary Policy changes.

### **Monetary Policy: Prioritise in particular the following six reforms:**

- a. Securitise main part of domestic public GoS debt within 6 to 12 months.
- b. Start planning for a market infrastructure for Treasury securities. But securitisation should not wait for infrastructure.
- c. Transfer GoS foreign assets of CBoS to CBS.
- d. Eliminate any remaining restriction for an Interbank market for deposits.
- e. Pursue phasing out of multiple cross-subsidisations within the public sector.
- f. Automation of the payment system should be further pursued - concrete time-table for milestones, resources and responsibility. Real Time Settlements recommendable, for both national and international funds' movements.

### **Central Bank Supervision Department**

- a. Capacity building: Equip and Train staff adequately.
- b. Calculation and publication of reference money market rates, discount, reserve requirement as well as short-term maturity deposits.
- c. Data availability. The CBS needs to know on day plus one day the banks' deposits with the CBS and their use of standing facilities. Real time prudential reporting framework should to be put in .

**Capital Market**

With the nomination of the Syrian Securities and Exchange Commission (SSEC, February 2006), this key piece of financial infrastructure is moving forward. It has as its mandate to launch a Syrian Capital Market during 2006. This is important as a number of private firms (new private banks, Syriatel and other corporations) have raised capital from the public by announcing offerings.

The sale of shares was undertaken by receiving bids directly, a system that is opaque and vulnerable to fraud. In addition, because there is no secondary market, this has discouraged investment and kept liquidity in those shares that have been issued very low. Thus, the SSEC will have to move rapidly to forestall other securities issues without proper due diligence.

In the future, until the SSEC is fully functional, an Initial Public Offering (IPO), should be authorised by CBS. Then they should be sold only through authorised banks, unless it is a private placement. In the latter case, it should exercise regulatory supervision. The introducing banks would be obliged in either case to act as market makers until a secondary market is in place.

**Government Securities (Lack of secondary market)**

Further to the issuance of a government paper, in order to securitise existing government debt, the CBS and the Ministry of Finance should work together for a better co-ordination of liquidity and public debt management. The monetisation of government debt raises risks to the medium-term inflation outlook, as the CBS has no monetary instruments to control inflation at this point in time. However, the launching of a government securities market is critical for providing an efficient yield curve and a risk-free rate of return, which are essential for the proper pricing of financial assets. This would provide all the banks with alternative investment vehicles as well. Additionally, without T-Bills, banks have no reference pricing with which they can arrive at their own cost of funds. It is from this key instrument that Monetary Policy begins.

**Legal and Accounting Reforms**

A key issue, about which all banks complained, is the lack of enforceable loan contracts, related to a generally ineffectual juridical process. Thus, a marked improvement in the weak judicial environment is necessary. It can only come about with time, through legal training for judges and improvement in their pay and working conditions. New Commercial Code, Corporate Code and Customs Code are now about to be considered by Parliament, but changes in Banking Laws may be required as well. At this juncture, the BAI Team cannot provide recommendations. It would address certain of these issues, as they relate to its mandate, during Phase 2. Concerning the absence of International Accounting Standards (IAS), the BAI Team has worked with the authors revising the existing statutes. New Tariff Schedule Legislation is being prepared and will be enacted soon. It will reduce the maximum rates from 230 to 50% and the number of bands reduced from 10 to 5 or 6, while a new FX Dealers' Law is ready for enactment.



If the Auditing Law were passed by Parliament, it would force an improvement in accounting standards. In addition, Public Bank accounting systems need to be modernised and revised drastically to enable them to handle transactions on an International Financial Reporting Standards (IFRS) and IAS basis. This then would begin the process towards financial transparency of the public and corporate sector of Syria. From this change, the banking sector could gradually start requiring that all of its clients (public and private) conform to the new IFRS/IAS accounting standards.

In conclusion, the BAI Team understands that reform is a process. It also believes that certain steps in this process come before others. It fully and completely endorses the need to expedite changes in the way monetary policy is conducted. To achieve this critical objective, tools need to be created, the required analytical skills developed, the operational staff needed trained, but most important is the creation of a T-Bill market.

## **2.3 Brief Macroeconomic Overview**

This next section will present key aspects of the Syrian economy for the period from 1986 to the present<sup>4</sup>.

### **Current Government Lending Policy**

Credit continues to be predominantly centrally allocated and the banking sector is still dominated by public institutions. This remains the case even though six private banks have opened since the beginning of 2004; they are rapidly expanding, by establishing branches throughout the country. The CMC is still setting interest rates on deposits and on loans, because the market instruments are not yet available. However, Public Banks are given limited discretion in determining their own rates; private banks are allowed greater freedom in setting their own rates on loans. This is the case as their loans are different in nature from loans extended by the Public Banks, (e.g., housing, small business, industrial and limited income borrowers), which are partially subsidised.

Furthermore, and in spite of relaxing significantly the Foreign Exchange control system in recent years, some controls remain both of a current and a capital nature. The GoS is on record as intending to further liberalise the current account transactions. As a first step, it has submitted draft legislation to license Foreign Exchange Dealers for the first time in nearly 40 years.

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<sup>4</sup> The Team has used extensively the three documents mentioned below in order to prepare the latter sections of this Chapter. Senior Syrian Economists have read the text and made comments, which have improved it. However, the Team assumes full responsibility for what is presented. Country Profile Syria Financial Chapter by Samir AITA & Samir SEIFAN Draft, July 2005, supported by The Euro-Méditerranéen des Institutes Economiques (EMISE). The project is financed by the European Commission and the Arab Fund for Economic and Social Development.

Syrian Arab Republic: 2005 Article IV Consultation—Staff Report, prepared by the Staff Representatives for the 2005 Consultation with the Syrian Arab Republic, approved by Amor Tahari and Anthony Boote, July 26, 2005.

Country Report, Syria, The Economist Intelligence Unit, London, United Kingdom, August 2005.



The GoS is also working on draft legislation to modernise and liberalise the entire Foreign Exchange system. The full achievement of these goals, and the realisation of the full benefits to the economy, may come only slowly. This is because the authorities will seek to build capacity and guard stability, as well as protect the public sector entities, which would be heavily exposed by a too rapid move towards a fully market orientated system.

Generally, and in response to the slack in the economy, consistent with the policy to support private sector growth, credit policy was eased in 2003, with this policy continuing in 2004 and 2005. Public Banks were encouraged to expand their credit facilities by raising the ceiling on single loans and relaxing the collateral requirements somewhat. At the same time, interest rates were cut by a cumulative 2 percentage points. As a result, credit to the private sector increased by 70% during the 2003 to 2004 period from a very low base. However, at end 2004, the stock of credit to the private sector was equivalent to only 12% of the Gross Domestic Product (GDP) while it contributed an estimated 65% of GDP with a share of the total deposits, which exceeded 70%. The large expansion of credit was facilitated, in part, by the monetisation of GoS debt held by Public Banks, contributing to a surge in money supply.

The current stance of monetary policy will be maintained for the time being with the Public Banks being encouraged to expand further their loans to the private sector. Additionally, given the low level of private sector credit, the continuation of the current pace of credit expansion may not carry significant inflationary risks, if the loans are directed to productive purposes. Nevertheless, there are signs that the greater part of the expanding credit is going for consumption purposes.

This is true for both Public and Private Banks. The result is a marked expansion of the demand for imports of cars as well as other consumer durables and non-durables. As a result, the trade balance and the Balance of Payments are both beginning to show deficits, which, if they persist, will create pressure on the Syrian Pound exchange rate. Thus, care must be taken to strengthen risk management capacity at Public Banks. A too rapid expansion of credit may lead to an accumulation of bad debts, with unprofitable projects being financed.

## **Economic Historical Setting<sup>5</sup>**

Economic reforms in Syria were provoked by a severe financial crisis in 1986 because of a shortage of foreign currency, resulting in acute production shortages and almost default on foreign debt. Over the following five years, the GoS allowed the private sector to take a greater role in economic activities by gradual liberalisation of foreign trade and of industrial investment as exemplified by Investment Law No. 10 (1991). Controls on prices and trade were eased and an effort made to promote non-oil exports. These reforms, combined with new oil fields in production, led, during the first half of the 1990's, to growth rates of about 7% per year.

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<sup>5</sup> This section has profited from Dr. Nabil Sukkar's Opportunities in Syria's Economic Reforms, Arab Banker, Summer 2001.



This did not last long and by the end of the 7<sup>th</sup> five-year plan (1991-1996) growth rates had decreased to 2.6% per year. Additionally, investment fell from 27% of GDP in 1995 to 17.6% in 2000. The growth dynamic deteriorated to the point that the country experienced a recession in 1999. This low growth situation continues until today, except the high growth years in 2001-2002 based on special trade agreements with Iraq before the invasion.

The economic reform process was re-started in 2000. Its impact was felt in the financial sector with the decision that private banks could be established in Syria that same year. It has continued during the last 5 years. In 2001, a law<sup>6</sup> defined the conditions under which private banks could enter into the market. In the same year, Syria formally submitted its application to join World Trade Organisation. In 2002, a new Central Bank Law No. 23 of 2002 was promulgated recreating the CMC confirming the existing limited independence of the CBS. The CBS started its evaluation of the private bank applications received resulting in the first formal authorisations being issued by the Council of Ministers for four bank projects in 2003. Three licenses were granted by the CBS in 2003; the first two private banks opened their doors in January 2004. In 2005, a law<sup>7</sup> authorised the establishment of Islamic banks with “the Shari’a Control Board”, to monitor and advise on the adherence to “Shari’a” in these banks’ operations and transactions. The first of the Islamic banks should open in 2006.

Other key decisions, dealing with the economic reform process, include: an Association Agreement with the Europe Union initialled in 2004, an Arab Free Trade Zone Agreement, which became operational in 2005, and the finalisation of a free trade agreement with Turkey, which is foreseen soon. In summation, there is clear willingness to reform both the economy, and its engine for growth, the financial sector.

## **Policy Back Drop**

The policy debate is focused on two inter-related medium-term challenges posed by the prospective depletion of oil reserves:

The first is to maintain fiscal sustainability and financial stability. Maintaining financial stability would require strengthening the role of the CBS in formulating and implementing monetary and Foreign Exchange policies, with a primary focus on price stability, and re-orienting the activities of the CBoS toward traditional commercial banking. The second is to boost growth. This is necessary in order to expand as well as to diversify the production and export base of the economy before oil resources are exhausted. Acceleration in economic growth will help the GoS in facing the pressures that high demographic growth places on the labour market. This calls for hastening structural reforms by enhancing incentives for the private sector (both domestic and foreign) to invest. Reforms, that concern this study, relate to the

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<sup>6</sup> Legislative decree no 28 of 2001, see [http://www.mybiznas.com/abdlaw/new\\_page\\_402.htm](http://www.mybiznas.com/abdlaw/new_page_402.htm) and the executive decree [http://www.mybiznas.com/abdlaw/new\\_page\\_405.htm](http://www.mybiznas.com/abdlaw/new_page_405.htm).

<sup>7</sup> Law no 35 of 2005.



capability of the financial sector to intermediate as well as those aimed at strengthening good governance, the rule of law, property rights and competition.

### **Recent developments and medium-term prospects**

A significant growth slowdown occurred in 2003, owing to the regional conflict. However, a mild recovery began in 2004, driven by a surge in investment, and an upturn in exports. In spite of the troubled international environment, the recovery continued in 2005, supported by further strengthening of private investment and exports. Inflation remained subdued, even though the external position weakened, reflecting a decline in oil exports and unidentified inflows and a surge in imports. Nonetheless, public and external debt remains manageable, and official foreign assets cover more than 2.5 years of imports.

Over the medium-term, Syria faces fiscal and balance of payment issue as oil production declines and oil reserves dwindle. Without new discoveries, Syria is likely to become a net oil importer within a few years and will exhaust its oil reserves in the late 2020s. This would halve government oil revenues to about 7.5% of GDP by 2010, while net Foreign Exchange receipts from oil would decline from 14% of GDP (USD 3 billion) in 2003 to nearly zero by 2010.

#### **2.3.1 Key Economic Reform Trends and Results<sup>8</sup>**

##### **Debt**

Syria's public and external debt remain relatively manageable. Following the restructuring of the old Soviet-era government debt in late 2004 and early 2005, Syria's external debt stands at USD 6.5 billion, or about 25% of GDP, while total public debt stands at 39% of GDP.

##### **Exchange Rate**

Reflecting the generally strong external position, the Syrian Pound has remained stable in relation to the US Dollar in the parallel market since the early 1990s. The number of official exchange rates has been reduced to two and their levels adjusted. One is called the State and Public Sector Rate, which was depreciated as of January 1, 2005 from SYP 48.5 to the USD 1 to SYP 50. The other is called the Free Rate, which was quoted by the CBoS until May 2005 at which point the CBS started issuing a daily bulletin.

A variable range is set for the rate within which banks determine their own buying and selling Foreign Exchange (FX) rates. The free rate stands now at around SYP 53 to SYP 53.5, which is only slightly lower than the parallel market rate at about SYP 54 to USD 1. This market is an important source of FX for a substantial part of the imports of the private sector. Furthermore, an old official exchange rate of SYP 11.20

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<sup>8</sup> Significant data weaknesses in terms of coverage, consistency, periodicity, and timeliness remain. Preliminary balance of payments and monetary statistics are available up to 2004, while national income and fiscal accounts are available only up to 2003.





to the dollar is still being maintained. It is used only for settling debt service obligations on certain bilateral payment agreements. It is possible, once all the old debts have been renegotiated, that this exchange rate may be abolished.

Notwithstanding this progress, Syria has yet to unify its exchange rate market and adopt current account convertibility. As mentioned before, steps are being taken and laws are being prepared in order to realise these objectives, but this will not happen soon. The foreign trade regime, in spite of being significantly liberalised remains classified as restrictive. Private importers are given considerable, but not complete access to the official Foreign Exchange market. Private sector importers of raw materials, intermediate goods, and a large number of finished products are allowed access to the FX from the banks. It is estimated that these imports constitute about 60% of total imports of the private sector.

## **Inflation**

Inflation picked up in 2003 and decelerated somewhat in 2004 as it was running below 4 percent year-on-year in September 2004, allaying somewhat previous concerns about a monetary overhang. A stable exchange rate, in turn, helped maintain low inflation by stabilising the price of imports and anchoring inflation expectations. However, the appreciation of the Euro vis-à-vis the US Dollar during 2005 and the increase in consumer lending together with a rapid expansion in the demand for real estate have contributed to visible signs of a rising inflation rate in comparison with rate of the last 5 years.

## **Banking supervision and prudential regulation**

The CMC (Cf. Chapter 2.2) meets almost every week. Since 2003, it has issued close to 180 decisions dealing with monetary policy aspects, Foreign Exchange matters and banking supervision subjects. Around 25 provided regulations to be followed by all banks public or private. These regulations include: the reporting requirements; credit, interest and operational risk management; concentration of credit; internal audit and control standards; the liquidity ratios and the Reserve Requirement. The core ratio (i.e. sine qua non) is the capital adequacy ratio of Basel I at least.

Concerning the latter, there was an old regulation that confused the liquidity ratio with the deposit reserve requirement. In September 2004, the CMC separated the two requirements, imposing a 20% liquidity ratio in addition to a 5% deposit Reserve Requirement. The same decision explained in detail the composition and the calculation of both. Other decisions dealt with the interest rate level and, in several steps, altered the term structure of deposits. This was to encourage a lengthening of the average maturity of deposits in order to help banks to extend medium to long-term loans.

Finally, other CMC decisions are being prepared, with key decisions made addressing the limits of net open FX positions of banks, and modalities of implementing them. Finally, the CMC will set Capital Adequacy Standards and mandate the creation of a Centre for Credit Risk Information.

**Taxes**

The income tax has been simplified and marginal rates lowered substantially. Additionally, various specific taxes were consolidated into a single “*ad valorem*” consumption tax, and much of the remaining tax legislation has been reviewed and streamlined. Nonetheless, the tax regime is still complex, with widespread exemptions and tax liabilities which are subject to negotiations between tax collectors and taxpayers. Finally, the GoS may introduce a Value Added Tax in 2008.

**Fiscal policy**

It remained expansionary in 2003 and 2004. In 2003, the non-oil budget deficit widened by 2.5% of GDP to 18%, reflecting a combination of lower non-oil revenues, largely due to the economic slowdown, and higher spending on investment and wages. The increase in wage costs came from the 20% wage increase in mid-2002 and additional hiring to support employment.

**Public administration and Public Enterprises (PE)**

Limited progress has been achieved in this area. A plethoric and ill-paid civil service is still a major impediment to effective economic management and reform implementation, while PEs, operating under a soft budget constraint, continue to drain resources and hinder the growth of the private sector. The GoS acknowledges that PE reform is a critical component of the reform programme given the drain PEs exert on public finances.

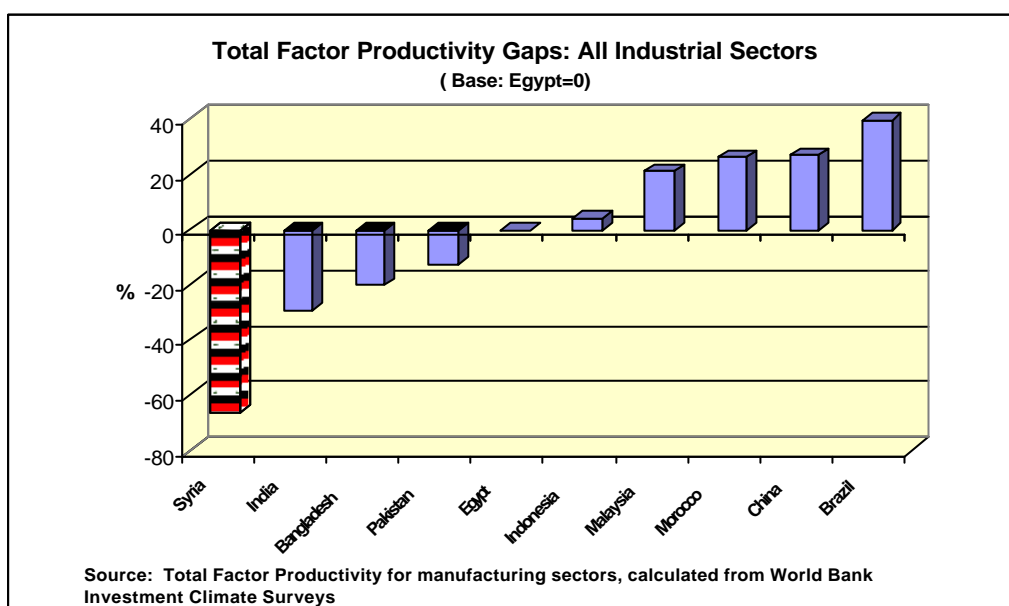


### 3 Demand Side Study

#### 3.1 Background

In spite of talented entrepreneurs, numerous national assets and an expanding agenda of reforms, the Syrian economy is not achieving its growth potential. Some of the reasons include low productivity and slow technology take-up. Furthermore, economic liberalisation is exposing its entrepreneurs to both new markets and new competition. Syrian enterprises have enormous opportunities but challenges that go with new market entrants as well. Thus, unless the entrepreneurs, and the firms they manage, become more productive, they will not profit from the opportunities and may be overwhelmed by their new competitors. In addition, Syrian enterprises lack access to the required financial services and investment products necessary to enhance their competitiveness. This key missing link, if provided, would enable them to exploit these new market possibilities. Without medium- and long-term finance, Syrian enterprises will find it very difficult to close their productivity gap vis-à-vis their most closely associated country competitors as the following chart shows<sup>9</sup>.

**Chart 1: Total factor productivity gaps: All industrial sectors**



Additional factors, which the Syrian Government must take into account as it continues to implement its reform programme, are the rapid growth in working-age population. However, acceleration in job creation can only come from faster economic growth, which then is dependant on investments to improve enterprise efficiency. Work force population growth will produce a swelling of entrants into the

<sup>9</sup> Taken from the World Bank Investment Climate Survey, draft report, June 2005.



labour force over the next five years, projected to increase at 4% a year.<sup>10</sup> If it does, unemployment could exceed 20% by the end of the decade.<sup>11</sup> An average employment growth rate of 4.5% a year would need to be sustained over the next 10 years to reverse this trend, a daunting challenge. Dwindling oil reserves create further pressure for Syria to push forward its reforms, which, if implemented, can stimulate economic diversification over the next decade producing the economic growth necessary to provide the jobs required.

The BAI Team fully concurs with the above overview, summarised from other international donors' work<sup>12</sup>.

## **3.2 Overview of Syrian Enterprises<sup>13</sup>**

### **3.2.1 Public Enterprises**

Public Enterprises are concentrated in the energy, utilities and financial services sectors. Depending on how the contribution is measured, they account for about 30% of GDP. In the energy sector, they control 75% of oil production; enjoy a monopoly in all utilities; held a monopoly position in the financial sector, until private banks opened in 2004.

Since then, Private Banks have started to operate (Cf. Chapter 4), with the insurance market being opened in 2005 and the SSEC named in 2006. The role of the public sector in manufacturing, representing only about 8% of non-oil GDP, is less clear. However, PEs continue to enjoy monopolies in cement, oil, sugar refining and fertilisers. They profit from their monopoly privileges or privileged role in key supply chains such as in cotton and cereals, as well.

In 2002, because of their concentration in capital-intensive sectors, the PEs, only employed 296 thousand people, out of a total estimated employment of 4.8 million people. This is a relatively small share compared to other countries as the table below shows. It is possible to conclude that addressing redundant labour, in the context of a PE reform, would be relatively less challenging in Syria than in other countries.

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<sup>10</sup> This would result from the projected natural growth rate of working age population (3% annual average) and a modest education-driven increase in labour force participation rates.

<sup>11</sup> The rate of job creation has declined from 4.8% in the 1990s to about 2.9% a year since 2000, while unemployment is estimated to have risen from 9½% in 2000 to 14% in 2004.

<sup>12</sup> The description of the background above is a resume of key points taken from International Monetary Fund Article IV Report, October 2005, the World Bank Investment Climate Survey, Draft June 2005 and UNIDO Enterprise Study, Draft Final Report, December 2003.

<sup>13</sup> The following Chapter borrows appreciatively from: IMF: "Syrian Arab Republic: 2005 Article IV Consultation - Staff Report", 2005; S. Atta & S. Seifan: "Country Profile Syria – Financial Chapter", 2005; Bank Audi: "Syria /Economic Report", Oct. 2005; Oxford Business Group: "Emerging Syria", 2005.

**Table 1: Employment in State Owned Enterprises (in percent of population)<sup>14</sup>**

Syria	<b>1.7%</b>
MENA	<b>2.7%</b>
Central and Eastern Europe	<b>8.3%</b>
Low Income Countries	<b>13.1%</b>
Middle Income Countries	<b>3.6%</b>

PEs will continue to have their operational deficits covered by the public budget in 2006 as well as their investment needs. The latter have seldom been repaid and more frequently written-off or converted into government participation in PEs' capital. The positive impact of direct budget support to PEs, is that Public Banks have less exposure to loss making PEs. However, there are two important exceptions, the relatively large stock of loans to the General Organisations for Cereals (Commercial Bank of Syria) and Cotton (Agricultural Cooperative Bank). They administer two of the main government price support policies. Overall, according to the IMF Article IV report, the stock of bank loans to other PEs is less than 2% of GDP. The negative impact of direct GoS budget support of the PEs is the crowding-out of private investment, directly through the budget and indirectly, through monopoly positions, both of which create unfair competition.

The recent law giving PEs greater autonomy is welcomed. Equally important is the GoS' decision concerning how it will produce its 2007 Budget. The direct support to PEs and credit funds for them, which the Public Banks have in the past provided, will not be included. The next step in the PE reform process would include levelling the playing field, so that private enterprises can tender for government contracts, and removing the monopolies. Perhaps the most important reform would be allowing PEs' management to make independent employment and pricing decisions. Finally, PEs should be subjected to the discipline of the market as soon as possible.

### **3.2.2 Private Sector**

#### **Formal Enterprises**

The private sector is dominated by many small firms, and under some international definitions, the great majority would be considered micro enterprises. In 2002, private sector enterprises contributed 61% of GDP (up from 40% in 1980). The most common form of corporate entity is the joint liability company, essentially a formal partnership. Most enterprises in Syria operate as family businesses (sole proprietorships)

<sup>14</sup> Source: IMF Article IV report of October 2005.



As to shareholding enterprises (musahama), which require a high level of capital, the BAI Team only found 169, through October 2005. It obtained this information from the Ministry of Economy and Trade<sup>15</sup>. The first enterprises listed were formed in the 1920's. However, the large majority have been created in the last 15 years. The BAI Team profited from this list, as well as a list containing Syrian enterprises, having contacted the European Investment Bank and the SME loan fund Project, as it invited enterprises from both entities to its post survey Focus Groups' as participants.

As to the sector distribution of the private enterprises, they are found in the primary agriculture sector (about 35% of non-oil GDP) and over 75% of non-government, non-financial services (about 45% of non-oil GDP). The industries are centred in Aleppo and Damascus with the important secondary cities being Homs, Hama, and Lattakia. With this in mind, the BAI Team undertook a survey among enterprises in each of these regions, except Hama. It was not included, as all parties to the data collection concurred, with Tartous added, that the Hama enterprises' information would be obtained from the other enterprises surveyed.

### **Informal Sector**

The BAI Team has no reliable information on the informal sector's size. It did receive interesting data concerning its participation in financial activities. This information led to the conclusion that informal sources are having an impact, by providing important sources of short-term working capital and trade finance. This is based on a Money Broker's yearly turn over of EUR 1.8 billion in addition to information that at least 100 non-registered investment firms operate. Their estimated annual transactions could exceed more than EUR 300 million.

### **3.2.3 Sector Contribution to GDP<sup>16</sup>**

#### **Oil**

The oil sector remains administered and controlled by the GoS. It contributed 22% of GDP. Foreign companies can explore for oil, but must form a joint venture with the state-owned Syrian Petroleum Company to actually produce it. Oil income comprises over two thirds of Syria's export earnings and about half of GoS revenues.

#### **Agriculture**

Agriculture provides up to 25% of GDP, and is second to the oil sector as a source of export earnings, accounting for around half of non-oil exports. It continues to absorb the growing working-age population as it strives to meet government goals for food self-sufficiency. In addition to traditional cotton exports, new exports include wheat, fruits and vegetables.

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<sup>15</sup> This list is found in the December 9, 2005 weekly report as is the SME list.

<sup>16</sup> GDP contribution is taken from the World Bank and is for 2002.



## **Industry**

Industry has been open to private investment since 1958, Legislative Decree No. 103. However, the Investment Law No. 10<sup>17</sup> of 1991 gave more freedom and incentives (through tax incentives or the ability to transfer profits or capital) to new types of businesses, such as transportation. Since this law was enacted, the industrial sector has grown significantly, and now contributes roughly 23% of GDP, employing around 14% of the workforce. However, it has thrived within import substitutions policies of the GoS. Thus, the sector's enterprises will have to become increasingly outward-oriented and competitive in order to survive the export-oriented reforms. To do so will require substantial investments in order that private industry meets the competitive challenge of trade liberalisation.

## **Services sector**

The service sector is still quite undeveloped although transport, telecommunications and tourism contribute 28% of GDP. As to the latter, the World Tourism Organisation rated Syria, from the period 1995-2002, as the leading emerging tourism market in the Middle East. This sector continues to hold great potential despite recent geopolitical events.

### **3.3 Demand Side Survey Overview**

Bankakademie International (BAI) undertook the Study's Demand Side Survey in collaboration with a Survey Team. The Team prepared the initial questionnaire, which it finalised through pilot testing and revision. The Team notes that this was a very difficult survey to implement. Because of this, the Team worked as closely as possible with the Survey Team during all phases. At the same time that the Survey Team was pilot testing the questionnaire, it was also validating the content and Arabic translations via Focus Groups (see below). The Survey Team monitored the fieldwork (external and internal) as follows:

**1<sup>st</sup> level** Team Supervisor, by being present in the Governate:

- Accompanies 10% (face to face)
- Telephones 20% of the fieldwork of his team of interviewers
- Controls 20% (telephone) of the completed questionnaires
- Asks interviewers to repeat the work when the information is not clear
- Cancels improper interviews

**2<sup>nd</sup> level:**

In the office, all questionnaires are reviewed and edited by the supervisors not later than the day following its execution. This is done for the purpose of identifying all incomplete or wrongly completed questionnaires, which are then substituted.

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<sup>17</sup> In order to read Law No.(10) encouraging investment 1991, please refer to the Ministry of Economy and Trade web site [http://www.syrecon.org/main\\_frame.html](http://www.syrecon.org/main_frame.html).

**3<sup>rd</sup> level:**

This is done in the data processing department in order to review and check in detail all the information in the questionnaires before the data entry is done.

The BAI Team wishes to express its sincere appreciation to the Survey Team members who conducted the interviews and compiled the data.

**3.3.1 Methodology**

The data was collected in 650 face-to-face, business-to-business interviews, with the interview time for each questionnaire an average of one hour. The field-work began in late November 2005 and was completed in early January 2006. The proxy variable for enterprise size was employees. Because there are no official enterprises definitions in Syria as well as the BAI Team's understanding of the enterprise distribution, in addition to the work done by the UNIDO survey, conducted in December 2003, the BAI Team developed the following distribution. The sample was weighted as following.

**Table 2: Break down of survey sample according to enterprise size**

Sizes	Employee	Break-down
Micro	>3-<10	30%
Small	10-<50	35%
Medium	50-<100	25%
Large	>100	10%

**Table 3: Break down of survey sample according to enterprise size and location**

Size	Break-out	Damascus	Aleppo	Homs	Lattakia	Der-ezzor	Tartous	Sweidah
Micro	0,3	60	45	30	18	18	12	12
Small	0,35	70	53	35	21	21	14	14
Medium	0,25	50	38	25	15	15	10	10
Large	0,1	20	15	10	6	6	4	4
<b>Totals</b>	<b>100%</b>	<b>200</b>	<b>150</b>	<b>100</b>	<b>60</b>	<b>60</b>	<b>40</b>	<b>40</b>

The survey was further segmented by Industry and Services Enterprises

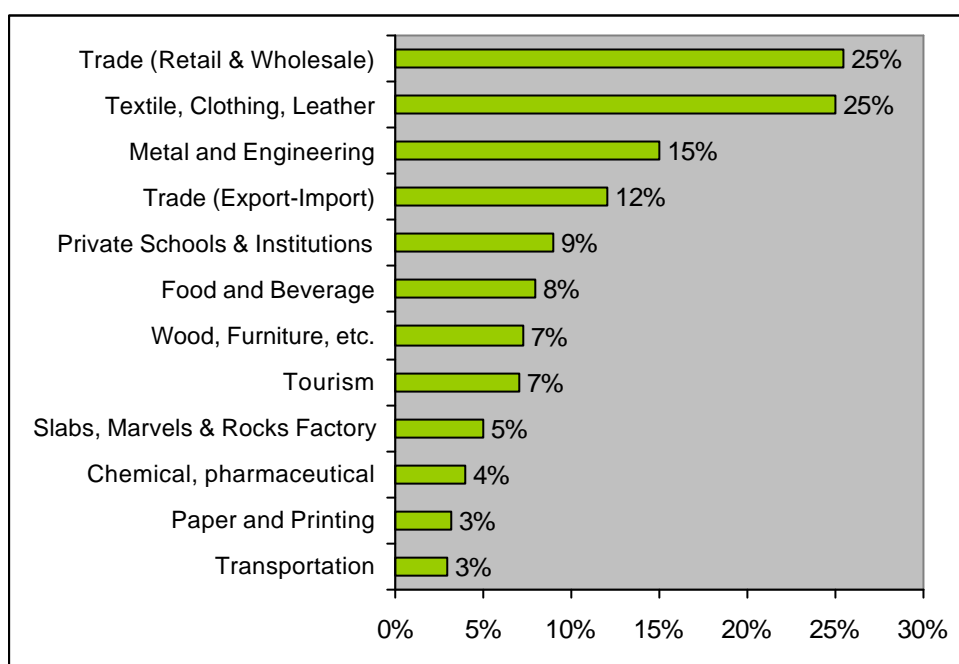
Size	Sector	Damascus	Aleppo	Homs	Lattakia	Der-ezzor	Tartous	Sweidah
Micro	Industry	42	32	21	13	13	8	8
Small		49	37	25	15	15	10	10
Medium		35	26	18	11	11	7	7
Large		14	11	7	4	4	3	3
Micro	Services	18	14	9	5	5	4	4
Small		21	16	11	6	6	4	4
Medium		15	11	8	5	5	3	3
Large		6	5	3	2	2	1	1





The BAI Team used the UNIDO survey as well as the GoS Statistical Abstract as the bases from which the above distribution was created. The sector percentages are as follows:

**Chart 2: Distribution of survey sample according to activity**



It is difficult to obtain a truly stratified random sample in Syria. This was not the survey's objective. However, the BAI Team profited from the sampling technique used by the UNIDO Study, and the experience of IPSOS as the prime Marketing Research Firm in Syria, as well as its local Syrian experts, to arrive at the cell distribution presented above.

**Thus, the survey aimed to:**

1. Provide an overview of the socio-economic characteristics of Syrian enterprises.
2. Analyse these enterprises:
  - Current patterns and sources of finance and
  - Their access to banking products as well as their interest in capital market products.
3. Assess the enterprises':
  - Current financing needs,
  - Current indebtedness and ability to take on further debts,
  - Potential demand for existing investment products,



- Potential demand for new investment products including; equity, debt, export credit insurance, leasing, venture capital.
4. Derive implications and draw conclusions on:
- Future supply of investment products and services from existing financial institutions, in terms of demand for these products and their volumes.
  - Future supply of new investment products that could be provided by existing financial or new financial institutions.

The key results of the survey are presented in the Annex 1 with key comments provided in Section 3.3.2.

### **Focus Groups Methodology**

Prior to the Demand Survey and after its completion, the BAI Team held Focus Group meetings<sup>18</sup>. The pre-questionnaire meetings were conducted in Arabic, English and in French. Pre-questionnaire discussions were aimed at ensuring the relevancy of the questions posed in the questionnaire. In addition, the Focus Group meetings allowed the expatriate BAI Team to rapidly complete its steep learning curve, related to Syrian enterprises' needs for financial services and investment products. There was a tertiary output of the pre-focus groups: they verified the correct Syrian Arabic phrasing of all questions. The final pre-questionnaire focus group presentation for Aleppo can be found in the Annex 1.

Post questionnaire Focus Groups were aimed at validating key data collected. They were conducted in Arabic and English, with the BAI Team's Syrian Expert handling the translation responsibilities. They proved very useful, not only confirming the data, but also reinforcing the BAI Team's recommendations, as presented in the following chapters.

It is noteworthy that it is in Arabic and English. The latter language was used for the financial institutions and products slides, in order to enhance the Arabic understanding of certain financial terms. Securitisation is a prime example. This a product used in Morocco, having a specific law governing its practice.

### **3.3.2 Survey Findings**

The findings will be presented following the questionnaire format:

- General Information about Enterprises
- Relationship with Commercial Banks & Financial Institutions
- Contractual Relationship with Suppliers
- Enterprise Financing Information

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<sup>18</sup> Please see weekly reports for summaries of these workshops, which were held in Damascus, Aleppo, Homs and in Lattakia with Tartous enterprises present at the latter workshop.



- Loans from Formal Financial Institutions
- General Problems and Constraints

### 3.3.2.1 General Information about Enterprises

In the statistician's terms, this information is static data. It does not change and therefore, its presentation will be very succinct. Of the enterprises surveyed, 57% were created in the period from 1990 to the present, and of that grouping, 33% were founded starting in 1999. At the other extreme, only 11% have existed from pre 1950 through 1969. Thus, there seems to be a high level of enterprise creation. This is supported by the fact that 76% of the enterprises had begun as start-ups. The next highest number was inherited enterprises at 17%.

The ownership validates the start-ups data, as 79% are owned by the person interviewed, with 97% of those surveyed being privately held. The Survey Team did conduct interviews with 13 mixed ownership structures and 7 PEs. The percentage by enterprise type is as follows:

• Sole Proprietorship	51%
• Partnership Enterprise (ta'awunyia)	2%
• Privately held, limited liability	2%
• Mixed Enterprise (mushtarika)	23%
• Cooperative (tadamun)	16%
• Tawasyia baseeta	4%
• Shareholding Enterprise (musahama)	2%

There are estimates that the informal sector only contributes 20% to GDP. The fact that only 7% of enterprises are not registered would seem to support this estimation. As to type of registration, 86% have been registered as commercial enterprises. Only 6% have taken advantages, 3% respectively, for Law no. 10 of 1991 and legislative decree No. 103 for Industry of 1958 (Cf. section 3.2.3 'Industry' concerning these legal instruments).

### 3.3.2.2 Relationship with Commercial Banks & Financial Institutions

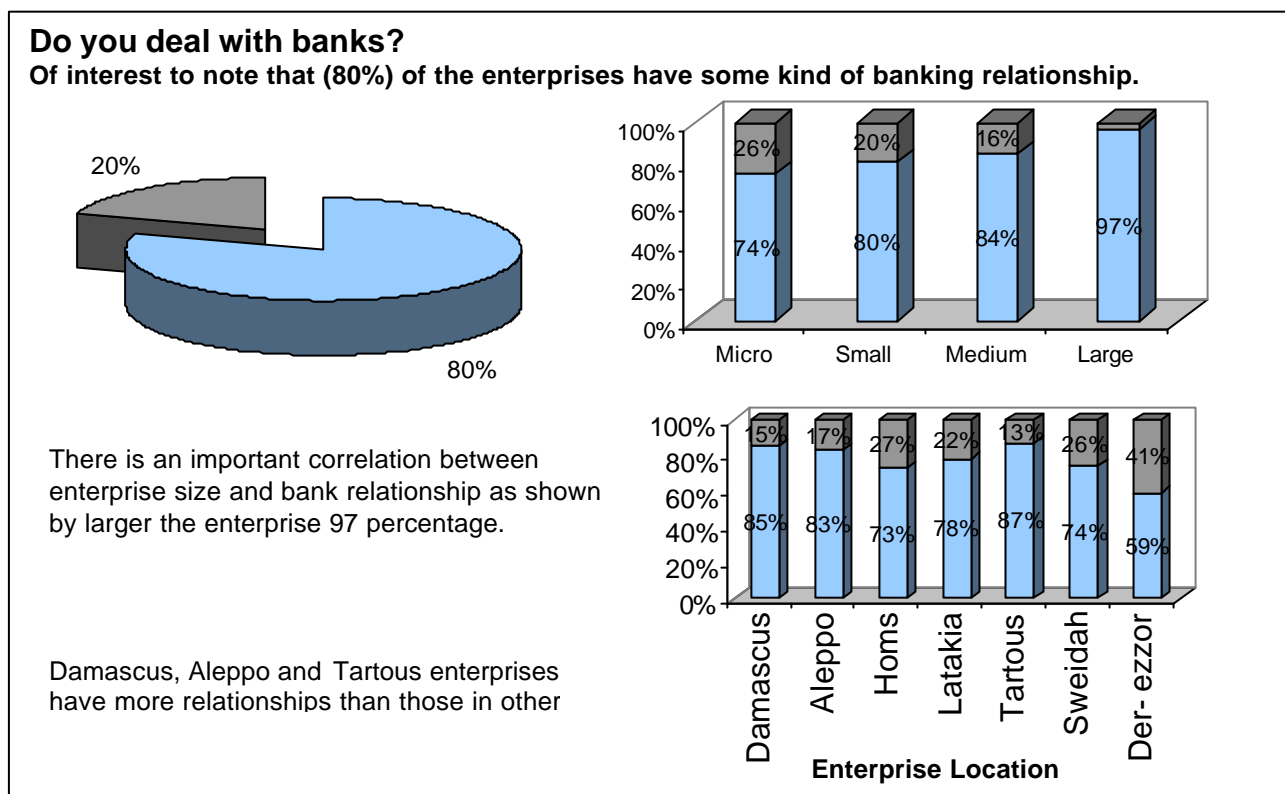
#### Banking Relationships and Market Share

On average 80% of the enterprises interviewed have some kind of banking relationship. Except for Der-ezzor at 59%, all other Governates where the survey was conducted show at least 73% of their enterprises working with banks. There is a very high correlation between enterprise size and banking relationships, with large firms at 97% and micro enterprises only working with banks in 74% of the cases. The three highest bank market shares are in Tartous at 87% and 85% and 83% respectively for Damascus and Aleppo. Given the remote location of Der-ezzor, with very few Public Banks and no Private ones, the opposite case for the other Governates explains well



its banking relationship result. Only 19% of the respondents have changed banks. However, it is difficult to conclude that the Syrians have a high loyalty to their bank. Reasons for this could be the lack of alternatives, especially in rural Governates, and the impression of the potential customers that the banks do not differ in critical issues like knowledge, finance, terms and conditions or service.

**Chart 3: Relationship with a bank**

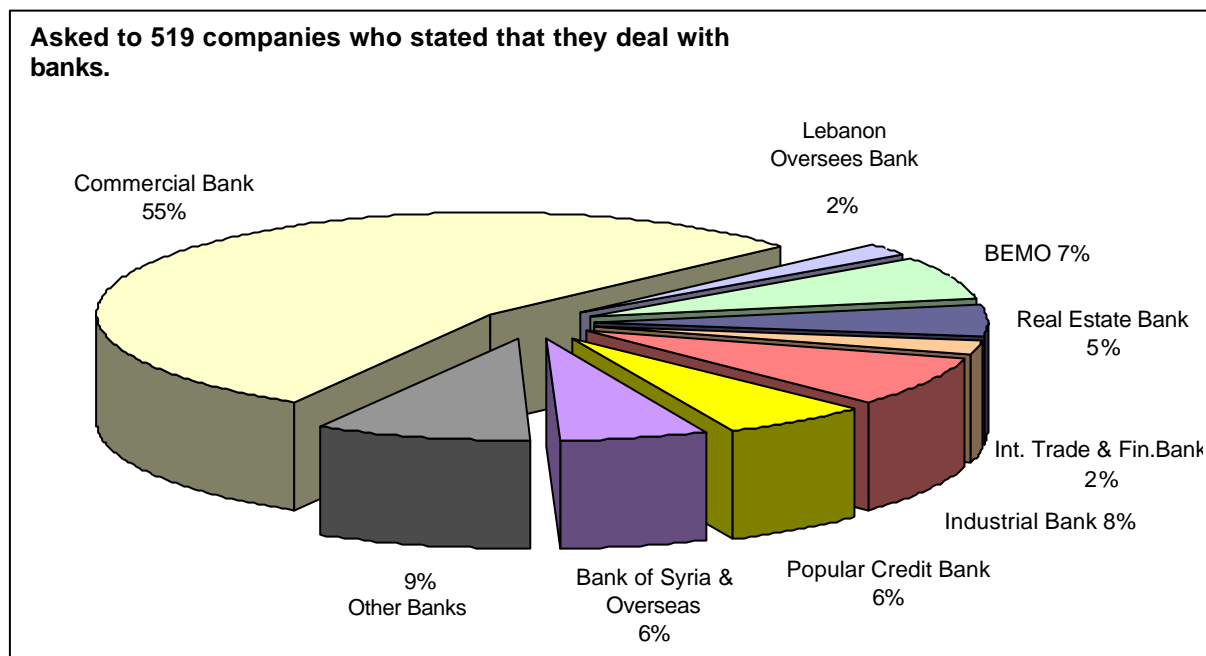


A key finding is that 41% of enterprises depend on off-shore banks in addition to the domestic ones, especially large enterprises. They need access to this banking source in order to finance exports and imports of goods. Der-ezzor is the lowest in dealing with offshore banks at 11%, with Damascus and Aleppo having the highest at 52% and 47%.

Finally, concerning bank market share, it is no surprise that the CBoS has the highest at 55%. What is interesting is that offshore banks have the next highest at 9%; the private banks together have attained a 15% market share after two years. Their market share of medium and large enterprises loans, at almost 40%, is impressive given short period of time they have been operating.



**Chart 4: Enterprises' Main Bank**  
**What is the name of your main bank?**



### Product Awareness

In order to respond to these questions, respondents were shown a card listing specific financial products. They were asked whether they knew the products or not. Following their response, the Awareness Level was divided according to:

Non-assistance Awareness:

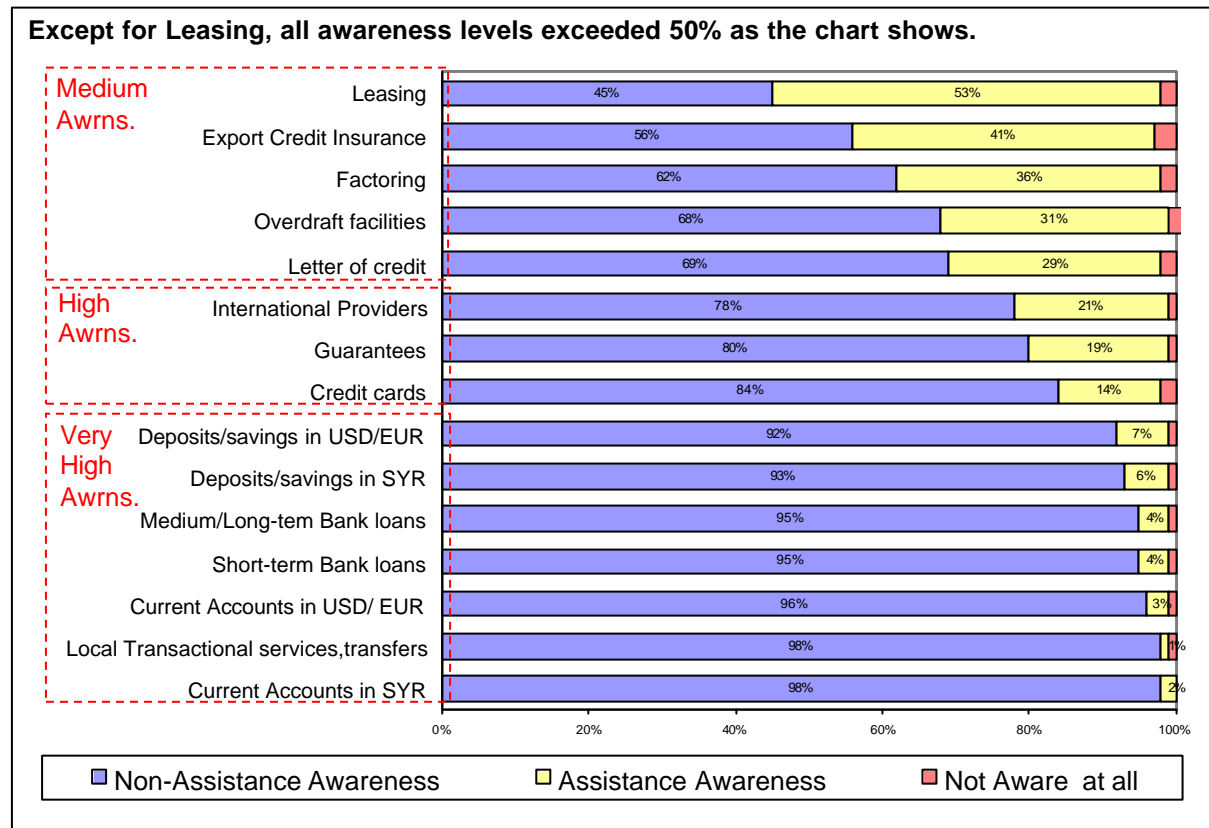
The respondents knew the product without the assistance of the researchers.

Assistance Awareness:

The respondents only provided their opinion about the product after hearing a brief explanation by researchers about the financial service or investment product.

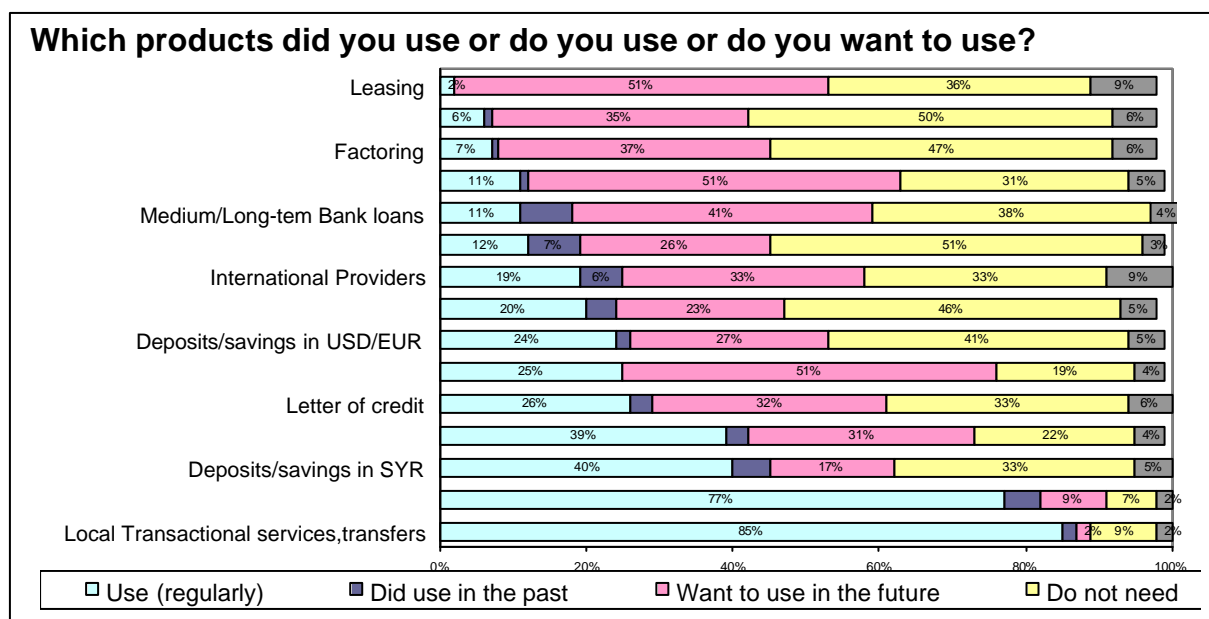


**Chart 5: Awareness levels regarding specific Banking Products**



However, the BAI Team provides a serious caution concerning the production awareness data. Related to future usage for Leasing and Export Credit Insurance, two of the BAI Team’s preferred options, Chart 5 indicates for Leasing a 51% level of future usage and a 35% level for Export Credit Insurance. It is noteworthy that these products were each used by only 3% of enterprises in the past.

**Chart 6: Past and future use of financial products**



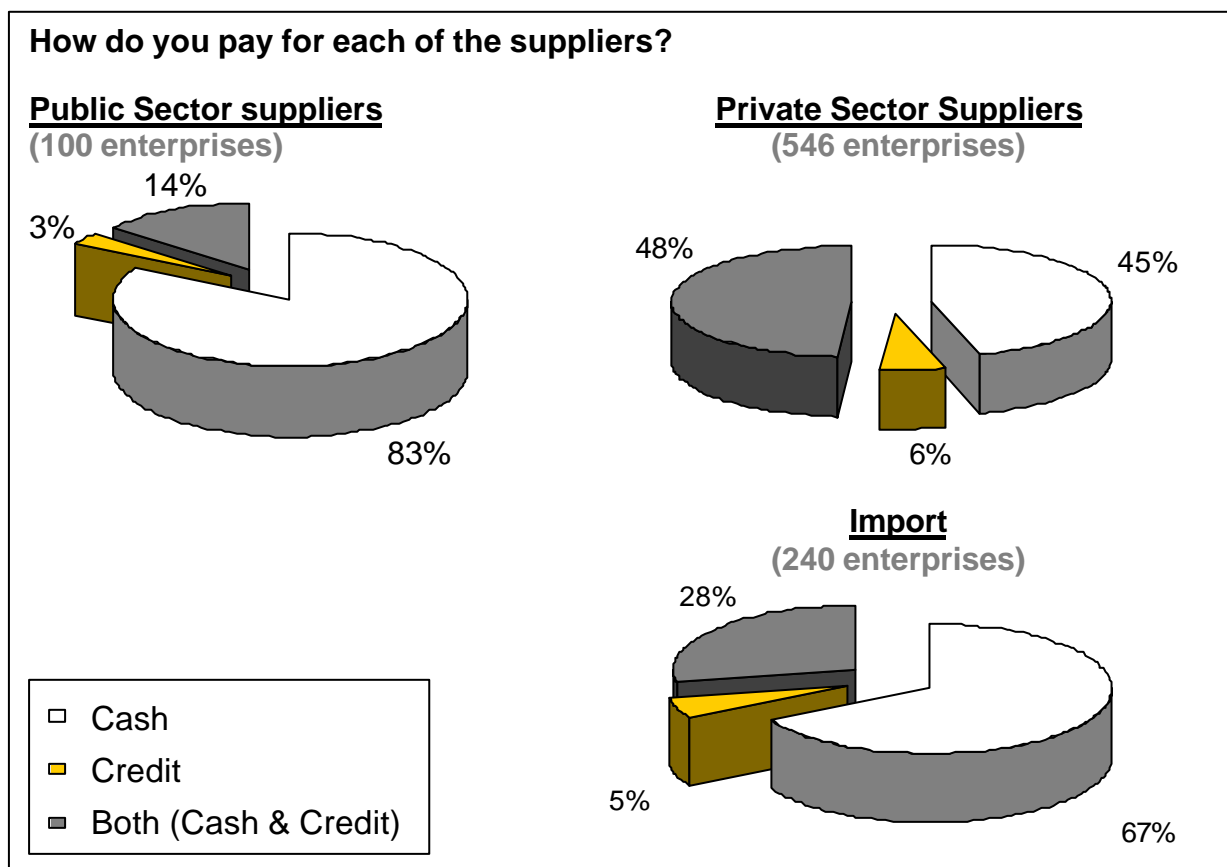


Conversely, Annex 1.1 shows those levels at 16% for Leasing and only 7% for Export Credit Insurance. Finally, this slide demonstrates only a 7% demand for medium and long-term loans while the product awareness slide presents the demand at 41%. The BAI Team explains this difference as cultural. Respondents did not want to show a lack of knowledge. However, once they had acquired product knowledge, a greater level of discernment is shown in the later slide. See the Focus Groups concerning the BAI Team’s further assessment of Syrian entrepreneurs’ product awareness.

### 3.3.2.3 Contractual Relationship with Suppliers

Supplier credit is provided, even by the Government, though with low frequency, only in 17% of its activities, with the remaining 83% of transactions being undertaken on a cash basis only. However, for private sector transactions, 54% are conducted partly by credit and partly in cash, with 6% handled only by credit. As it relates to importers only, the percentages are 28% and 5% respectively. What is even more interesting is that enterprises, which only deal in cash, for all three cases, the best level was that only 16% of private sector clients had ever asked for this type of financing.

Chart 7: Suppliers’ Credit



Export credit finance is supported as importers (81%) can take from 3 months to 1 year to complete repayments.



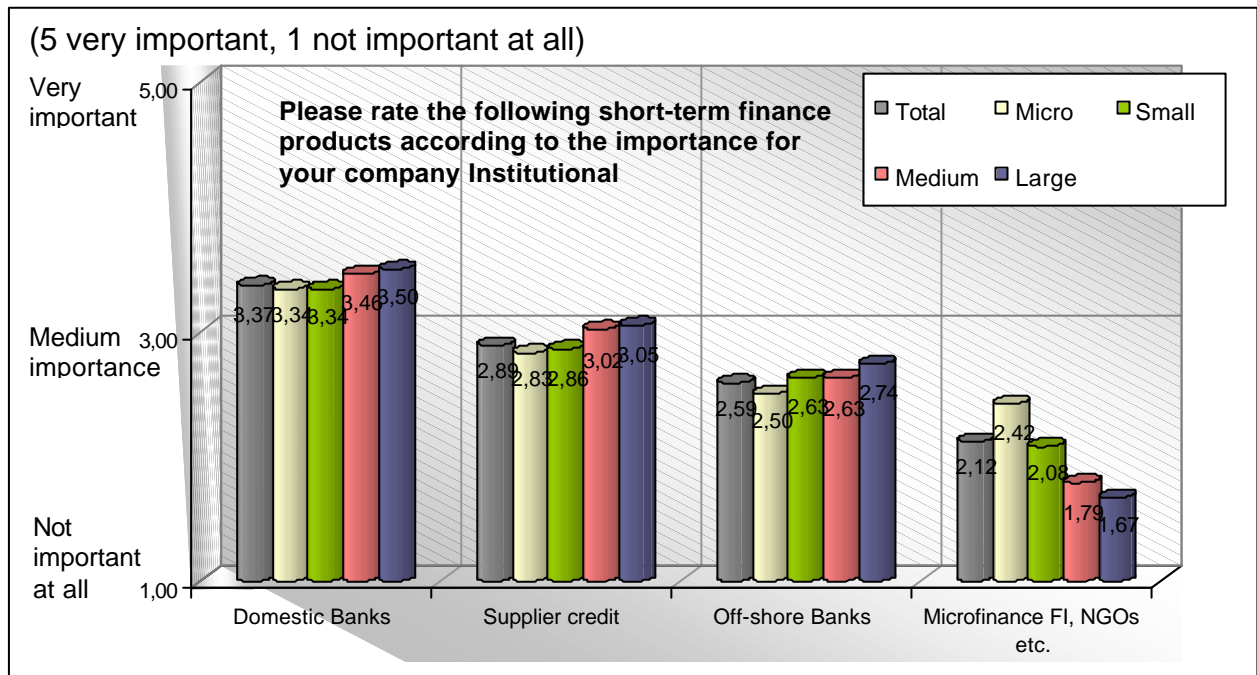
The cost differential of credit versus cash varies from 6% for the Government, to 3% for local private and only 2% for the importers.

Finally, it is important to note that suppliers request up to 100% collateral for the credit. Supplier credit and factoring present very positive aspects based on the survey data and this untapped market for supplier credit could then be monetised via the financing product of factoring.

### 3.3.2.4 Enterprise Financing Information

Syrian enterprises, having little product opportunity, rate domestic banks as their key source of funding. However, this is a misleading conclusion as, on a scale from 1 to 5, with 5 being the most important, the banks received just a 3 rating from the four enterprise groups.

Chart 8: The importance of formal Institutional Products vs. Enterprise Size

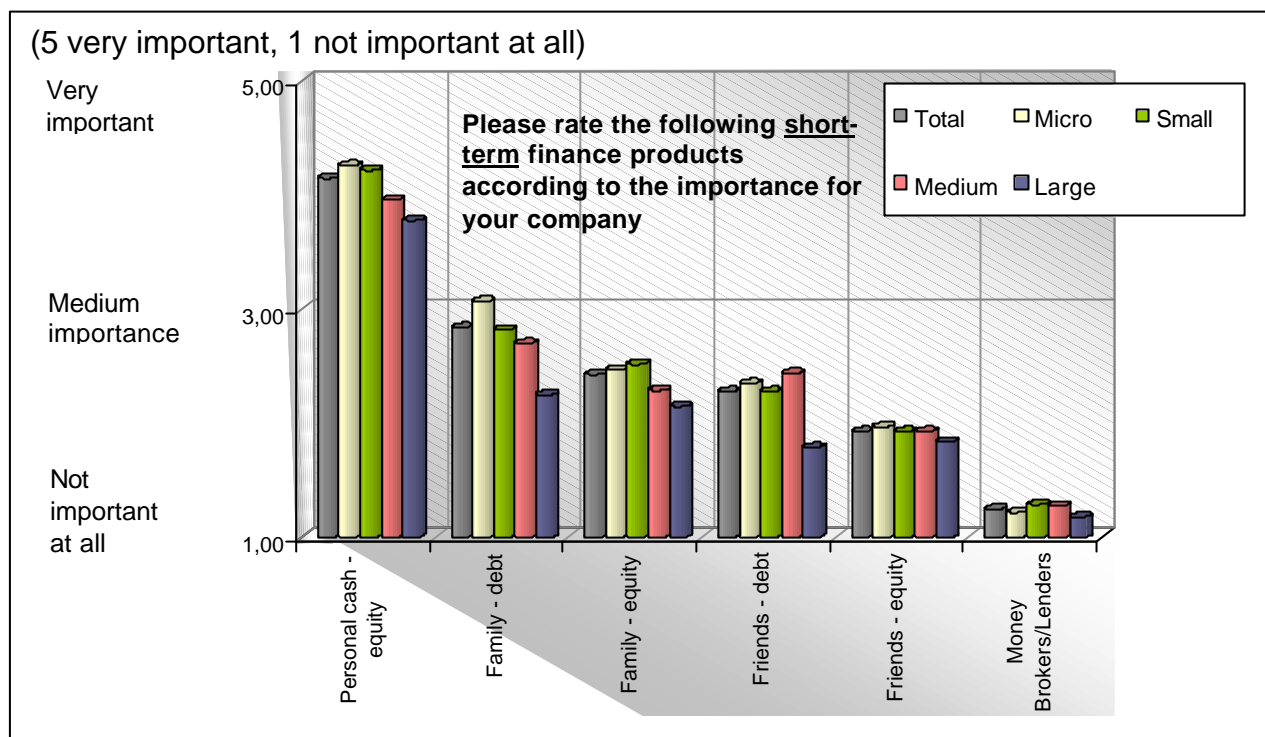


Only supplier credit, for medium and large enterprises, attained a 3 as well. All other financing sources are rated less important. The most important source of funding comes from owner equity, which is rated as 4 by all enterprise sizes, and then comes family equity at a 3 for micro enterprises.





Chart 9: The importance of informal Institutional Products vs. Enterprise Size

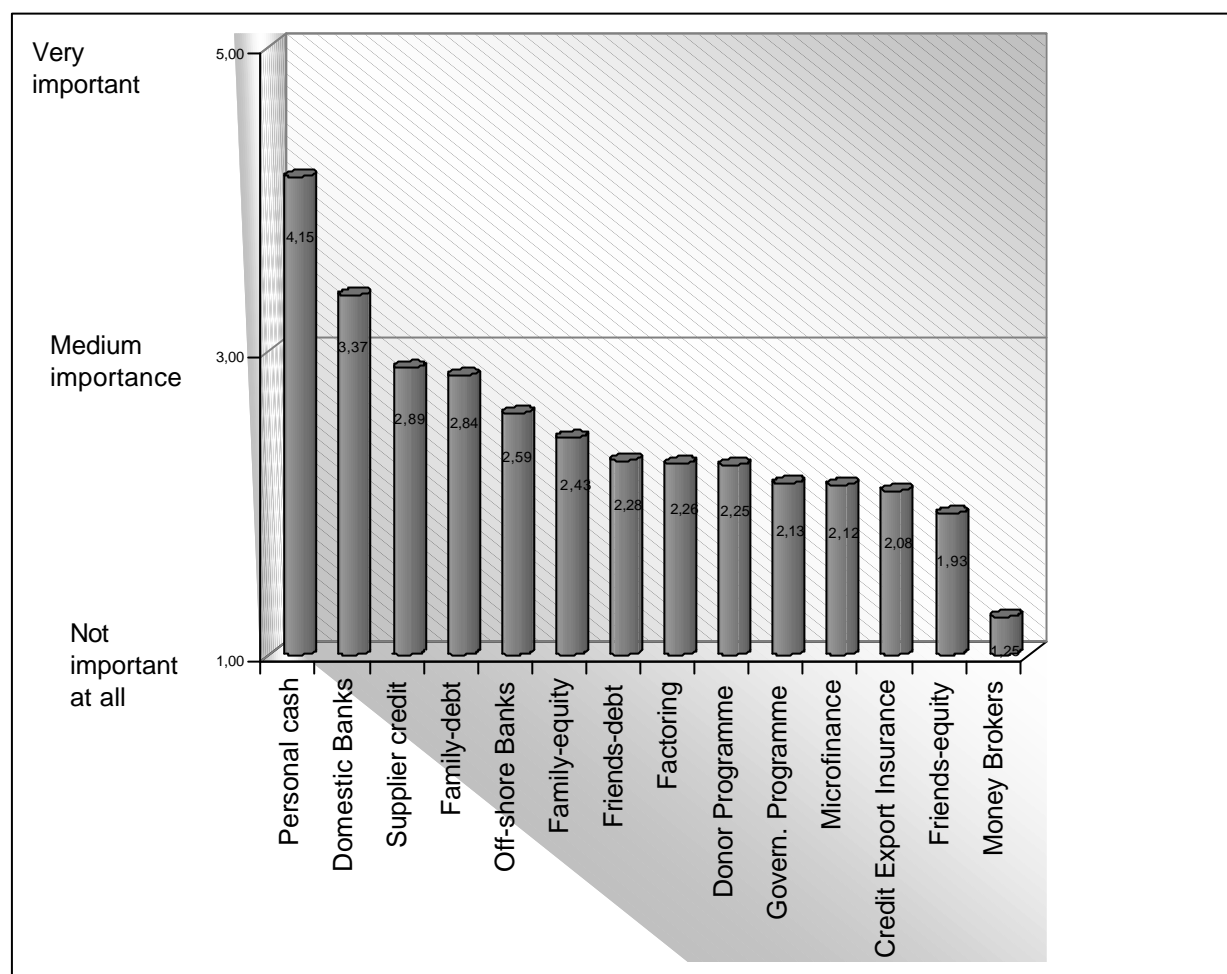


The lowest informal source is the Money Brokers at barely 1 plus. They are important but for only a small, select group of export and import focused businesses.

As to long-term sources, again banks, both domestic and offshore, score above 3 for all enterprise sizes, except for microfinance related to offshore banks. The lack of capital markets and product awareness, caused by absence of markets, is well shown by the fact that only equity placement receives a 3, and then only for large enterprises. Venture capital does the worst at barely 1.5, which translates into little interest in this product. Again a caution, lack of access causes a lack of knowledge which then lowers general awareness.



Chart 10: Ranking of institutions sources & short-term finance products



As to informal capital market sources, family equity or private placements are considered quite important, but only micro enterprises come close to giving family equity and private placements a number 3 of importance. This section reinforces the conclusion that product awareness is closely correlated to product availability. An old economic adage has it that “Supply creates its own Demand”. Only banks supply finance and therefore, only they are known well enough to be cited as important.

### 3.3.2.5 Loans from Formal Financial Institutions

#### Bank loans – general overview

An important finding of the survey is that 68% of the Syrian enterprises surveyed have never requested a bank loan. There is a wide difference by region, which runs from only 16% of Aleppo’s enterprises having requested bank funding to 63% in Sweidah. The only other two regions close are Lattakia at 50% and Tartous at 56%.

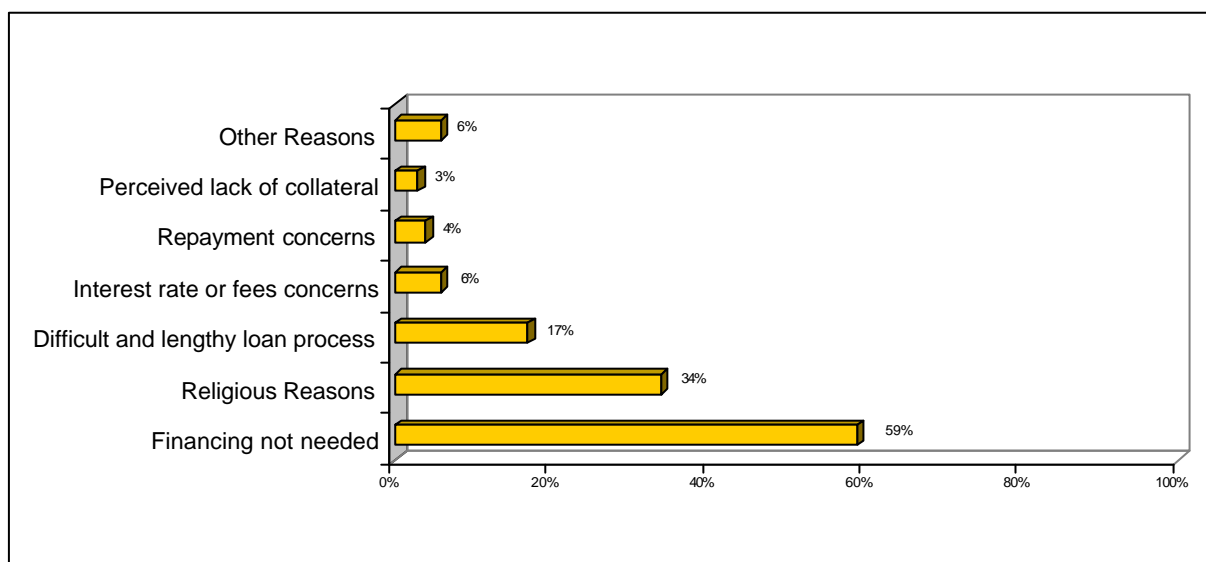
A possible explanation for these differences could be that. Sweidah has a relative high number of people that have asked for a loan as it has an important Druze



community, less influenced by Islamic rules, (e.g., prohibition of interest). However, it puts forward the importance of religious views for Aleppo. For the other 3 Governates, two are ports and Sweidah is close to the Jordanian border. Perhaps proximity, to world-wide markets, makes their entrepreneurs more open to bank funding; another reason for the difference.

The two most important reasons cited for not requesting a bank loan are “no need for financing” at 59% and “religious reasons” at 34%. This is a positive indicator for Islamic banking and products, which we will further explore in the following chapters. As to the question why enterprises do have no need for financing, the Survey BAI Team undertook a follow-up contact. 17% of those who have never applied for a loan gave as the reason that the loan procedure is difficult and lengthy.

**Chart 11: Reasons for not applying for a loan**



The results of the follow-up contact indicate that 71% of the enterprises grow only as fast at their cash flow. However, 19% stated that they did not want to have somebody looking into their businesses and the remaining 10% had not even thought of asking.

Later, the presentation of the external constraints will support the conclusions that Syrian enterprises are very risk averse. In addition to this point, investment is low, due to the lack of financing instruments. The BAI Team concludes in this section that the entrepreneurs want to control what little they can, regardless of their own desire to grow or not. This business decision, to grow or not, to invest or not, is very understandable. It is a reasoned, smart management decision for each individual entrepreneur. These individual business decisions not to invest, and thus to grow, is a disaster for the overall economic growth required to create jobs.

The key uses for loans tend toward medium and long-term needs, with expansion at 56%, in a multiple choice question, cited the most. The World Bank Investment Climate Survey, Syria, Draft Report, June 2005, produced the following results, which support the BAI Team conclusions.

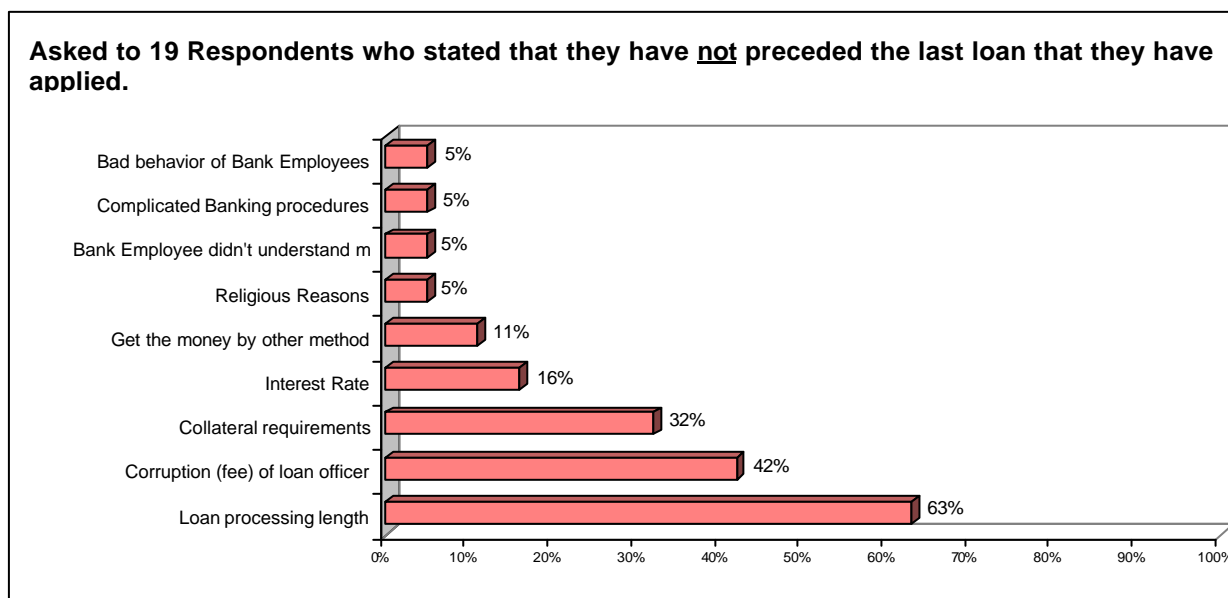


“In the survey, only 12% of the formal enterprises in the sample report having bank financing for working capital, and only 12% report having bank investment finance. Banks provide only 2% of working capital overall and 4% of total investment finance among surveyed firms. There are few financial services offered beyond traditional lending. For Syria, the source of future growth and diversification must be a growing private sector. This requires more private sector investment, and it requires that investment to be more productive.”

### Loan application data

Almost a majority (49%) of all loan applications have been made since 2000. Of this number, the most are from large enterprises (78%) and the least from micro enterprises (39%). Regionally, the highest was 60% for Damascus and the lowest in Tartous at 32%. It had the highest level of old loan applications (9%) dating prior to 1980. Loan approval rates are very high at 87%. The conclusion is that if an enterprise makes the effort, it goes all the way and therefore succeeds. The reason why loan applications were successful is collateral availability at 35%. This means that the project is less important than the assets that a borrower can present. If cash flow lending methodologies were used, collateral would constitute a second support for making the loan, and not the key indicator, as is the case currently. Innovation and growth are impeded by such banking practices.

Chart 12: Reasons for not preceding the loan application



Additionally, it is worth mentioning that 33% of the enterprises that had applied for a loan in the past, have not done so during the last 2 years.

This percentage is highest among Micro and Small Enterprises. This is a high drop out rate from enterprises that already know the banking system.



This is not a positive indicator of bank sector performance. The reasons why loan applications were not made support this assessment. The three most important reasons were loan processing time at 63%, loan officer corruption at 42%, and collateral requirements at 32%. These findings speak for themselves. Conversely, the entrepreneurs know what constitutes good banking principles, all of which receive more than 4.75 rating on the scale of 1 to 5. They are:

- Loan Application Speed
- Professionalism of Financial Institution Staff
- Financial Know-how of FI Staff
- Loan Officer understands my Needs

**Banking practice Issues**

Collateral requirements remain important in Syria as shown by the survey where 17% of those looking to apply for a loan would put up between 200% and 300% coverage. The largest coverage is from 100 to 150% as expressed by 45% of the respondents. The preferred asset is a building at 81% with the next choice at 38% for machinery.

Poor accounting practices and limited transparency of borrowers aggravate a correct appraisal of a borrower's ongoing business. The banks cannot determine the enterprise's ability to service the loan. Thus, the credit decisions are based on a simple assessment of the borrower's collateral. In support of this assertion, fewer Syrian enterprises keep audited accounts than in a number of other countries in the region as the following table shows:

**Table 4: Percentage of enterprises with audited accounts per country in the region**

Egypt	81.5%
Oman	77.3%
Algeria	59.6%
<b>Syria</b>	<b>34.5%</b>

Furthermore, as noted below largely for tax purposes, many firms keep more than one set of books in order to conceal part of their income and/or payroll from authorities. It is reasonable to assume that investors, like banks, would be reluctant to invest without reliable information.

**Future Loan Demand**

The past is not necessarily a prologue to the future, which is the case related to bank loan demand. Thus, 56% of enterprises surveyed expect to request a loan as opposed to 32% of those who had requested one in the past. This is an increase of



24%, which is statistically significant. It is interesting to note that Aleppo has gone from 16% in the past to 68% in future. This is an important indicator for future, overall economic growth, as it seems that confidence in investing is returning. The key needs are for medium and long-term investment. Expansion, thought by the BAI Team to be for investment purposes, is cited by 71% of the respondents, within a multiple response framework, and modernisation next at 32%. These are important precursors of future growth, if the loan demand is satisfied, and provided to enterprises capable of repaying.

The amounts demanded went from less than SYP 1 million to more than SYP 50 million. It follows that large enterprises are most interested in the latter amount with 57% of its respondents opting for that amount. However, even 11% of microenterprises would request SYP 50 million. As to the interest rate, 10% of the enterprises surveyed wanted Islamic loans, and thereby, did not want to pay interest. Most, 45% were willing to pay from 5 to 10%, with 4% even willing to pay as much as 15%. With a positive awareness programme, bank loans could be increased rapidly. The banks have the liquidity; they would have to choose their clients well. Finally, the long maturities requested bode well for a development bank.

**Forecasted Loan Amounts**

Based on this information, the BAI Team has prepared its financial calculation of potential loan demand for the 367 enterprises stating that they would seek future loan funding. A cautionary note, the estimations are based on survey information, but using averages in order to complete them. As an example, the mid-point of SYP 35 million is used for loans forecasted at between SYP 20 and 50 million. Likewise, averaging is used in order to complete the interest rates and loan maturates forecasts.

However, the BAI Team strongly believes that this is crucial information. It clearly demonstrates the potential impact on the Syrian economy and thereby, on job creation, if bank lending is increased to solid enterprises. Likewise, it is a proxy indicator of the effect that new financial institutions and investment products could have on economic growth as well.

**Table 5: Overall loan demand**

Loan Demand in Euro			
Enterprise Type	Number of Enterprises	Total Loan Demand by Enterprise	Average loan size
Micro	110	21,043,306	191,129
Small	128	43,605,667	339,476
Medium	92	41,561,270	452,984
Large	37	21,191,290	577,419
Totals	367	127,401,534	
<b>Weighted Average</b>			<b>347,143</b>

It is noteworthy that the EIB/SME Loan Fund begins its loans at EUR 100,000 and stops at EUR 1,000,000. The above shows that the Fund has the right target for loan amounts, as its loans are made in hard currency on a 50/50 share basis. Additionally,



this estimation shows that there is real pent up demand, which restructured Public Banks could satisfy. However, in order to meet this demand, both the banks and enterprises have a lot to accomplish.

The next chart presents an estimation of what enterprises are willing to pay for financing. The Islamic requests, as well as those unknown, have been withdrawn. This lowers the pool of enterprises from 367 to 315 included in the forecast.

**Table 6: Average Interest Rates requested**

Loan ranges	Average loan amount	Excluding answers like “not interested because of Islam” and “unknown”	Weighted interest rate
50 M and more	50,000,000	80	6.51%
10 M to less than 50 M	20,000,000	96	6.93%
5 M to less than 10 M	5,750,000	81	7.02%
1 M to less than 5 M	2,000,000	45	7.47%
Less than 1 M	500,000	13	7.37%
Total of Enterprises		315	
<b>Weighted Interest Rate Average</b>			<b>6.94%</b>

The BAI Team thinks the average interest rate is low but not totally out of line with existing market conditions. This is a positive indicator showing that Syrian enterprises have realistic expectations when it comes to financing costs. Larger loans could have a lower interest rate. This is because of the lower overall average of administrative costs. However, given the risks, this is highly unlikely at present. If the enterprises were ready to accept rates of between 9% and 11%, the banks should be more ready to make loans to good clients at those rates.

**Table 7: Average maturities requested**

Loan Ranges	Average loan Amount	Excluding answers like “unknown”	Maturity of loan Amount
50 M and more	50,000,000	86	9 years
10 M to less than 50 M	20,000,000	122	8 years
5 M to less than 10 M	5,750,000	87	8 years
1 M to less than 5 M	2,000,000	50	6 years
Less than 1 M	500,000	16	5 years
Total of Enterprises		358	
<b>Weighted Maturity Average</b>			<b>8 years</b>

This chart clearly shows the demand for long-term financing. This type of loan, in a developing country, is most often provided by specialised financial institutions, which include SMEs or Development Banks.

These forecasts are based on only 367 enterprises. The BAI Team is not in favour of trend-line forecasting, which is drawing a straight line, based on incidental data. However, even if this estimation were spread over the 100,000 registered enterprises, the impact would be more than significant. This point is made for policy makers' consideration.



### 3.3.2.6 General Constraints and Future Growth

#### Constraints

Internal and external constraints were provided by the respondents. In the first case, they were separated into financial and other. Given the fact that this was a multiple answer question, the total of financial constraints cited (including lack of financing, costly financing, insufficient collateral and lack of funds), totalled 96% of those questioned. The next highest number related to the lack of skilled labour at 69% with the third being domestic competition 56%. The BAI Team believes that this is a proxy response to unfair economic rules and conditions, which favour the PEs, at the expense of the private entrepreneurs interviewed for the survey. No other response exceeded 50%.

External constraints merit being listed in the text because of their importance. They are:

1. Political Uncertainty	81%
2. Corruption	71%
3. Inflation	68%
4. Legal Environment	55%
5. Government Regulations	47%
6. Lack of Infrastructure	41%
7. Lack of Capital Market	18%

It is noteworthy that only the last two points relate directly to economic issues. The rest come from what are Enabling Environment Issues. These are areas, which are most positively affected by economic, financial and legal reforms. With a level playing field, as it would relate to government regulations, which include all fiscal issues (e.g., income taxes and customs) as well as legal matters (e.g., respect of contract, rapid redress for non-payment). Three most cited constraints remain issues that only time and a continued strong reform push can modify. Thus, for the enterprises, and their owners/managers, they focus on what they can control. They grow at the rate of their cash flow or other family financial resources.

#### Future Growth

Even with the constraints stated, the entrepreneurs remain very confident in their future, with 61% believing that Syria will experience accelerated growth. The next highest number was little changed at 15%. Because the entrepreneurs believe that things will improve, this bodes well for future economic growth and thereby, a potential increased demand for financial services and investment products. Again, in a multiple answer format, in order to achieve their growth, the respondents cited at 54% and 51% respectively, that they would seek out either new geographical markets or new types of customers. The next two most important visions for growth, were open new branches/premises at 32%, or invest in new equipment and machinery at 29%. A positive indicator for export credit insurance is the fact that 22% of enterprises will aim to start exporting or increase what they are exporting already.



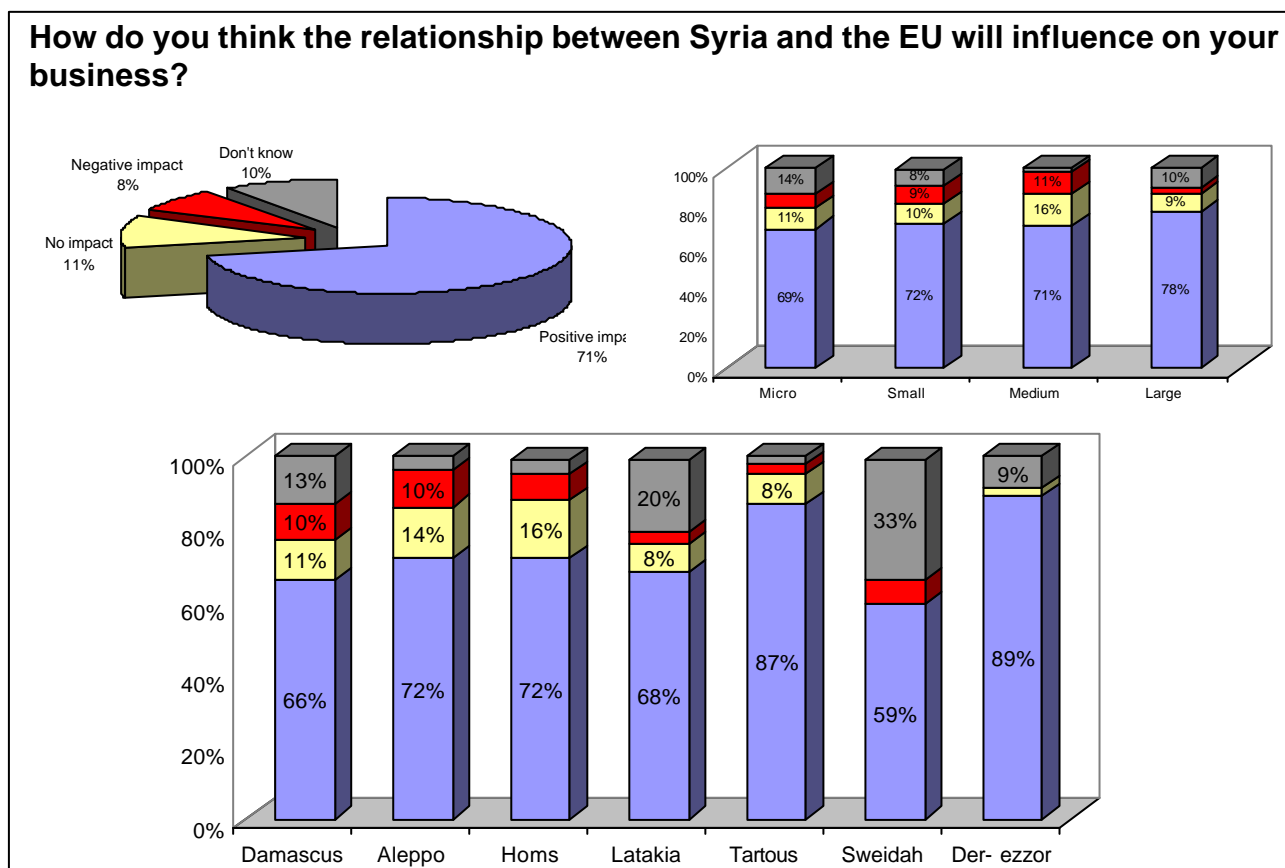


To close this section, the BAI Team notes that the Syrian entrepreneurs had a very positive vision of their own firm's future. This is clearly shown, as 56% expect to grow rapidly over the next two years, with 32% believing that they will grow at a moderate rate. Perhaps, the reform programmes are becoming convincing, and if hastened, maybe the optimism expressed by the entrepreneurs will be fulfilled. If yes, jobs will be created and from this growth can yet again accelerate. Syria does have a possibility to enter into a virtuous circle of economic growth. With an increasing job force, put to work, incomes increase, which then support growth and on the circle grows. Possible, but this will only happen if policies are right and reforms related to them pushed forward.

### Entrepreneurs' Assessment of European Union (EU)

The EU received very high marks concerning its potential impact on the Syrian economy over the next two years, whether by enterprise size or by region. The results are almost the same as the marks given for the impact as a result of collaboration between the EU and Syrian Government over the same period. Concerning the economic impact, the average score was 72% positive. The lowest enterprise size score was 69% for micro enterprises and the highest 83% for large, which is normal, as the largest enterprises have more opportunity for contact. The lowest regional markets come from Sweidah at 56%, with Tartous and Der-ezzor reporting positive scores of 95% and 91% respectively.

**Chart 13: Influence of relationship Syria – EU on business**





Returning to EU/Syrian Government relations, the average score was again 72% positive. The lowest enterprise size score was 69% for micro enterprises and the highest 78% for large and thus, the enterprises were more in agreement on EU/GoS relations. The lowest regional markets come from Sweidah at 59%, with Tartous and Der-ezion reporting positive scores of 87% and 89% respectively. In conclusion, the entrepreneurs believe that the EU is a positive force for economic change, but slightly less positive as it relates to EU/GoS collaboration.

## **Disclaimer**

The BAI Team did exercise oversight related to the manner with which the Survey Team undertook its survey. The BAI Team participated in the training of its especially recruited interview staff. Its local Syrian expert had direct contact with the senior field staff. The BAI Team believes that the Survey Team executed its work with professionalism; it cannot guarantee the correctness of the underlying data. Therefore, the above findings should be read with caution.

## **3.4 Key Focus Group Results**

Without these workshops, the above disclaimer would have been even stronger. Syria remains an oral culture; paper work is feared. Having direct contact with enterprise owners, or their senior management, allowed the BAI Team to follow-up points made during the sessions or push questions left unanswered. Additionally, dealing only with financial institutional sources of funding, and then financial services and investment products, the core of the survey and the Study permitted the BAI Team to clearly centre its discussions.

It did so by presenting information, which allowed participants to respond with as much freedom as possible. From the discussions, all parties made their points, as the BAI Team intervened only in order to clarify points or to request further information. This then led to the following conclusions, which are based on the Focus Group Meetings.

### **3.4.1 Financing Sources**

Following a brief introduction about the mission, the presentation turned to formal and informal sources of finance. These are found in the Annex.1.1 of the eight possible sources, only three are currently relevant to Syrian enterprises: Domestic Banks, Offshore Banks and Supplier Credit, which the survey results reinforce. Other sources of funding were presented, in order to discern how much the participant understood about commonly used financial sector funding sources. The BAI Team spent time explaining that insurance companies and pension funds could and did invest their funds in enterprises directly, either through private placement or the capital markets. All participants agreed that these were not even in the near future sources for them. The introduction completed, the discussion turned to the banks.

The most telling remarks about the banks came from the Focus Groups. In the first case, an entrepreneur stated that the "Private Banks were cleaner, the staff better



dressed, sometimes served free coffee, but provided no better services and their costs were higher". The second, "the Public Banks are not banks, they are places that hold money". Both types of banks have a serious selling job ahead of them. Syrian enterprises have offshore sources. Some stated that they have foreign banks, which call on them, but domestic banks do not.

As to informal sources, personal equity; family: equity and debt; friends: equity or debt all agreed that these were the sources upon which they counted the most. They admitted that they grew at the rate of their cash flow generation and no faster. Money brokers were only useful, even at a cost, when dealing with exports and imports. This supported the survey results.

### **3.4.2 Other Key Issues**

The Focus Groups revealed other important issues, not covered by the survey, as follows:

#### **Asset Base**

The Syrian collateral base is completely distorted. Imported machinery is declared at from a tenth to a fourth of its real value in order to minimise customs duties. Land is valued at a hundredth or even a thousandth of its real value. Thus, collateral, the most important basis upon which Public Banks make their lending decisions, is undervalued.

#### **Financial Statements**

They recognise that their financial statements are poor. They respond, even if they had audited statements, that they believe that they could not obtain loans. There is too much paper work; they do not have enough collateral; they do not have well placed contacts in the banks.

Finally, corruption is an issue that concerns all of them.

### **3.4.3 Product awareness**

Once the discussion finished with traditional institutional sources of funding, it then turned to specific products beginning with short-term instruments. It continued on to formal and informal medium and long-term products and their sources, capital markets in the first case and family, friends and money brokers in the second.

#### **3.4.3.1 Short-term Products**

The discussion focused on three products; factoring, insurance related products and leasing. The reasons why related to the fact that the other products were well known and used, or of no interest to the participants. For the former these included loans, letters of credit, guarantees of all types, and for the latter renting plants, or financial services like treasury management and funds transfers.



Factoring and Leasing stimulated the discussions in all focus groups. They both can be viewed from the perspective of Asset based (secured) loans.

## **Factoring**

Even though the survey's awareness of this product was high at 62% and the future use projected at 47%, very few focus group participants really understood the principle behind factoring. Additionally, certain focus groups participants went so far as to ask whether they could turn oral contracts into promissory notes and then discount them.

Following a sometimes long, as well as difficult discussion, related to how the product does function, the BAI Team estimates that 90% of all focus group participants wanted this type of financing more than any other to meet their short-term needs. They understood well, that they could liquefy key balance sheet assets; their accounts receivables and in some cases, their product contracts with foreign enterprises. (Cf. Chapter 6.5 for more information concerning factoring).

## **Leasing**

It had the lowest initial awareness of any product presented in the survey at 45% but the highest interest in future use at 51% tied with overdrafts. It is both a short-term and medium-term product, short-term in its costing (monthly payments) and medium-term as to its impact (building and equipment). Consequently, it took more time to explain.

Once better understood, the enterprises were interested in the equipment aspects more than sale/lease-back of plant or buildings. However, this kind of leasing may find a market once the shorter-term needs for leasing have been satisfied.

The entrepreneurs liked leasing as they would not have to tie up their capital in assets, but could use the leased assets rapidly to make more profits. They were also interested in having outside investors (Syrian Expatriates) use this product through which the latter would invest in their enterprises. In any case, leasing will require legal changes in existing law, or its own law, in order to make it widely available.

## **Insurance Products**

The discussions centred on Export and Key Man Insurance in the post-survey focus groups and Export Credit Insurance in the pre-survey focus groups. After leasing, this product had the least awareness at 41% with a projected future use interest at 35%. Once again, after the advantages and disadvantages of this product were discussed, exporting entrepreneurs would like to have access to this type of facility.

Concerning Key Man Insurance, this is a risk-mitigating product for both enterprises and banks. The banks' loans are covered by the death or disability clauses of the insurance policy, the enterprise as well because the insurance pays off the loan. If offered at a reasonable price, entrepreneurs would have interest in this product.



### 3.4.3.2 Medium and Long-term products

In the pre-survey focus groups, these products evoked less interest in general. Perhaps the survey result information changed the dialogue and explains why there was more interest in these products by the post-focus groups.

However, returning to the survey, classic products are well known and understood as covered above. For reference, medium and long-term financing products achieved an awareness level of 95% with future use at 41%. However, when asked later about investment funding, this product dropped to 7% from other sources, while equity received, either from Capital Markets or Private Placements, 24% and 28% interest scores respectively.

### Equity Finance

The post-survey Focus Groups supported the latter view. Specifically, following a detailed explanation of equity, capital market or private placement, whatever the funding source for a private placement, the entrepreneurs opted for the private placement. Entrepreneurs were specific in wanting equity investors' entry and exits carefully controlled. Placements should be for 3 to 7 years and contain the right to buy back the investors' equity stake. In general, they would consider sale of stock through the capital markets, but they did not like the financial and reporting requirement.

### Other products

Venture capital evoked no interest what-so-ever with either pre or post survey focus group. This is supported by the survey in which it received an 8% interest survey and an importance score of 1.5 on a 1 to 5 scale. Securitisation has a 4% interest level and the same low importance score. However, once explained, securitisation did interest the Focus Groups.

### 3.4.4 Focus Group Conclusions

The Focus Group Meetings served the BAI Team well, as they provided much qualitative information. The pre-focus groups produced initial information with which the BAI Team could work while waiting for the survey results, as well as improving the questionnaire technically and linguistically. The post-focus groups validated key information. They support recommended options; Equity Finance came uniquely from the focus groups.

## 3.5 Conclusions

The Demand Side findings, whether derived from the survey results or from the Focus Groups, first and foremost, indicate Syrian enterprises' profound lack of awareness related to modern financial services and investment products. Even the most used SME financing product, factoring, is not yet well understood. On the other hand, the aggregated loan demand data, and the interest in new products, demonstrate clearly that there is a large market for new financial services and



investment products. The demand data supports all product options proposed by the BAI Team in Chapter 6.

## The most important Demand Survey Findings are:

- |  |
|--|
| <p>1. Banking Relationships/ Market Share:</p> <ul style="list-style-type: none"><li>• 80% of enterprises interviewed have some kind of relationship with a bank</li><li>• 41% of enterprises depend on offshore banks in addition to domestic banks</li><li>• 19% of enterprises have changed their banks in the past</li><li>• Market share: 55% Commercial Bank of Syria, 9% offshore banks, and all private banks together 15%</li></ul>   |
| <p>2. Product Awareness</p> <ul style="list-style-type: none"><li>• Product awareness is low due to few products offered by the banks</li><li>• The least known products are: Letters of Credit, Overdrafts, factoring, Export Credit Insurance and Leasing</li><li>• However, when understood, enterprises express a high level of interest in future use of these products</li></ul>   |
| <p>3. Contractual Relationship with Suppliers</p> <ul style="list-style-type: none"><li>• Public Sector Suppliers only provide supplier credit in 17% of the cases</li><li>• Private Sector Suppliers provide supplier credit in 54% of the cases</li><li>• International Suppliers provide supplier credit in 33% of the cases</li><li>• However, Suppliers request in most cases 100% collateral for the credit</li></ul>  |
| <p>4. Enterprise Financing Information (formal and informal)</p> <ul style="list-style-type: none"><li>• Among all available financing products/institutions, personal cash and domestic banks are ranked as the most important (both more than three on a scale of 1 to 5)</li><li>• All other financing sources (formal and informal) are more or less equally appreciated (between 2 and 3), with money brokers at the last position (with a score of 1.25)</li></ul>   |
| <p>5. Bank loans</p> <ul style="list-style-type: none"><li>• 68% of all enterprises had never applied for a loan</li><li>• The reason for not applying for a loan was, in 59% of cases, due to no need for financing, in 34% due to religious reasons, and in 17% due to long and complicated loan procedures</li><li>• Of those that do not need financing: 71% of enterprises only grow as fast at their internally generated cash flow permits; 19% stated that they did not want any external involvement; 10% had not even thought of asking.</li></ul> |



## 6. Future Loan Demand

- A very rough estimate was produced for loan demand, preferred interest rates and loan tenor.
- Aggregate loan demand for the 367 enterprises, wanting future loans, amounts to EUR 127 million; the average interest rate they are prepared to pay is 6.94%; average loan maturity required was 8 years.

## 7. General Constrains and Future Growth

With a multiple response possibility, the results were:

- Political uncertainty 81%
- Corruption 71%
- Inflation 68%
- Legal Environment 55%
- However, most enterprises are optimistic about the future, with 61% of them stating that they believe the economy of Syria will experience accelerated growth and 15% believe there will be little change

Finally, there is a deep fear of sharing information by managers specifically with banks. Unfortunately, they hide behind the lack of International Accounting Standards, which gives them an excuse not to provide clear and precise financial statements. Or worse, they can purchase an accounting certification. It is commonly stated in Syria that there are four sets of account books:

- The first is for the Tax Authorities
- The second is for the Banks
- The third is for the Family or Friends
- The fourth for the Brother.

Thus, it is with reason that the banks - public or private - do not trust the financial statements that they receive. This is in addition to the fact that profits are understated to evade taxes. Turning to the banks, the enterprises have an overall negative opinion. Banks are perceived to be too demanding, complicated, expensive and corrupt. Finally, and perhaps the worst problem, the asset base in Syria is totally distorted.

There is much institutional rebuilding to be undertaken on both the Demand and Supply Sides, to bridge the gaps exposed here, and those that will be presented in Chapter 4.



### **3.6 Recommendations**

#### **SME Bank for Medium and Long-term Investment**

The opening of the banking sector, through the licensing of Private Banks, has just started to provide Syrian enterprises with another potential source of short-term working capital finance. Islamic Banks will soon enter the Syrian banking market. They may, eventually, offer an Islamic form of medium-term investment, but this is unlikely in their start-up phase.

It is improbable that either the private banks or the existing Public Banks would provide this type of investment product, notwithstanding Industrial Bank's mandate in this area. Thus, the BAI Team recommends the establishment of an SME Bank in order that Syrian enterprises can have access to the medium and long-term finance necessary for their expansion and modernisation.

#### **Export Credit**

The Demand Side Study supports the recommendation of this option as preferred.

#### **Factoring**

The BAI Team has proposed Factoring as a non-preferred option (Cf. Chapter 6.5). See this same section concerning the new Syrian European Business Centre's (SEBC) possible role in providing awareness training for this product.

#### **Equity Finance**

This product is recommended as a non-preferred option based uniquely on the focus group information. This again shows the importance of having held these workshops.





## **4 Supply side study**

To date Syria's financial system consists only of a small banking sector with a low level of financial intermediation and a Central Bank with limited monetary and supervising capacities. The insurance sector is slowly evolving. A law has been passed opening the insurance industry to private sector investments. Non-bank finance institutions such as for leasing or factoring do not exist; neither do supporting institutions such as credit bureaux or bank assurances. The country lacks a stock exchange, though it is currently under consideration. Pension funds have so far been paid negligible attention. In general, legislation and regulations for capital market instruments hardly exist.

### **4.1 Brief Overview of Banking Sector<sup>19</sup>**

#### **Reform Activities**

A process of slow liberalisation in monetary policy has been increasingly visible over the past years. Interest rates have started to be altered for the first time in 20 years and foreign currency rules have been somewhat relaxed. In September 2005 the Central Bank of Syria announced an increase in the bank's base rate from 6.5% to 7%, and the introduction of Certificate of Deposit at a rate of 9%, with the specific aim of encouraging people to save in Syrian Pounds. The step followed the easing of Foreign Exchange controls established in the 1960s, with Syrians now able to open bank accounts in foreign currencies and to trade in foreign denominations. At the Foreign Exchange level, banks are allowed to set their exchange rates within a narrow band around the fixed Central Bank rate. In November 2005 the Central Bank issued a regulation to allow Interbank lending for the first time in Syria.

The Syrian banking sector is undergoing a gradual transition from state-operated banks designed to serve primarily the state sector to a combination of smaller private banks and reoriented state banks. The Central Bank of Syria has been exerting laudable efforts to create the appropriate environment for private banks. Over the past few years, a multitude of regulations have been put into effect to facilitate the work of banks in general. Repatriation of Foreign Exchange has been eased, transaction fees and stamp duties have been cut to acceptable levels, and banks have been permitted to open branches throughout the country.

Other legislative decrees were issued allowing greater flexibility in the operations of state banks. Regulations on bank accounting, liquidity management, and internal audits were adopted, and CB's supervision capacity strengthened, although poor accounting standards used by some of the banks continue to impair the effectiveness of proper supervision.

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<sup>19</sup> The following Chapter borrows appreciatively from: Central Bank of Syria: "Quarterly Bulletin 2004", Volume 42; IMF: "Syrian Arab Republic: 2005 Article IV Consultation - Staff Report", 2005; S. Atta & S. Seifan: "Country Profile Syria – Financial Chapter", 2005; Bank Audi: "Syria /Economic Report", Oct. 2005; Oxford Business Group: "Emerging Syria", 2005.



In March 2001, a law defined the conditions for private banks (minimum capital USD 30 million, maximum 49% ownership by foreigners), and in July 2002, the first formal authorisations were issued by the Council of Ministers for five new banks. Since then four private banks have commenced operations and three more are preparing to enter the market. In May 2005, Law 10 authorised the creation of Islamic banks, fixing the minimum capital at USD 100 million, and created a national board “the Shari’a control board” which aims to validate the Islamic compatibility of the operations. No Islamic bank has opened so far, but three have expressed interest.

A more complicated banking sector is in the process of emerging. On one hand, the private banks' outlook is very promising, driven by the significant potential for growth and diversification while, on the other hand, Public Banks need major backing and support to stay in business. Beyond the difference between the banks' development perspectives, the banking system faces serious challenges requiring continued reform efforts. These include the need to upgrade clearing and settlement procedures, the need for improved corporate transparency and disclosure, the need for a system to exchange credit information, the need to encourage and promote small business finance and the need to introduce longer-term certificates of deposit to enable mid- to long-term lending.

## **Current Status of Banking Sector**

The total balance sheet of Syrian Banks has significantly evolved during the 1990's and early 2000's. Between 1990 and 2003, total bank assets have multiplied by 7.3 in USD equivalent terms, totalling approx. USD 27 billion (SYP 1,250 billion). This growth was one of the highest amongst Arab countries. However, this evolution is to be interpreted with caution, since the total balance sheet of Syrian banks started from a ratio of 24% of the country's GDP in 1990, much below any similar ratio for other Arab countries. 14 years later, the growth brought this ratio to 104% of the GDP. In comparison: in the year 2000, the ratio of total bank assets to GDP was 84% for Syria, 273% for Lebanon, 219% for Jordan, 164% for Egypt, 126% for Bahrain, 110% for the UAE, 93% for Morocco, 70% for Saudi Arabia, 69% for Tunisia and only 47% for Algeria.

**Table 8: Consolidated Balance Sheet of the public financial sector**

End of Period (SYR million)	2004	%	2003	%	2002	%
<b>Foreign Assets</b>	<b>619.663</b>	<b>49</b>	<b>591.826</b>	<b>50</b>	<b>581.677</b>	<b>54</b>
<b>Domestic Assets</b>	<b>630.597</b>	<b>51</b>	<b>591.541</b>	<b>50</b>	<b>493.417</b>	<b>46</b>
Credit to Government & non-financial Public Entities	295.200	24	332.028	28	289.067	27
Credit to other Sectors*	147.769	12	109.403	9	83.935	8
Liquid and other Domestic Assets	187.628	15	151.110	13	120.415	11
<b>Assets = Liabilities</b>	<b>1.250.260</b>	<b>100</b>	<b>1.183.367</b>	<b>100</b>	<b>1.075.094</b>	<b>100</b>
<b>Private Deposits, thereof</b>	<b>498.896</b>	<b>40</b>	<b>431.652</b>	<b>36</b>	<b>404.315</b>	<b>38</b>
Demand Deposits**	150.753	12	109.018	9	95.175	9
Time and saving Deposits	321.754	26	307.642	26	268.708	25
Foreign Currency Deposits	26.389	2	14.992	1	40.432	4
<b>Government and other Public Deposits</b>	<b>245.390</b>	<b>20</b>	<b>235.707</b>	<b>20</b>	<b>209.676</b>	<b>19</b>
<b>Credits from Central Bank</b>	<b>145.867</b>	<b>12</b>	<b>181.854</b>	<b>16</b>	<b>163.551</b>	<b>15</b>
<b>Capital accounts (equity funds)</b>	<b>53.848</b>	<b>4</b>	<b>44.860</b>	<b>4</b>	<b>53.924</b>	<b>5</b>
<b>Other Liabilities</b>	<b>306.259</b>	<b>24</b>	<b>289.294</b>	<b>24</b>	<b>243.628</b>	<b>23</b>

\* Private, mixed and cooperative sectors

Source: Central Bank of Syria

\*\* Includes Import Deposits for L/C opening

End of Period (EUR million) *	2004	%	2003	%	2002	%
<b>Foreign Assets</b>	<b>10.082</b>	<b>49</b>	<b>9.629</b>	<b>50</b>	<b>9.464</b>	<b>54</b>
<b>Domestic Assets</b>	<b>10.260</b>	<b>51</b>	<b>9.624</b>	<b>50</b>	<b>8.028</b>	<b>46</b>
Credit to Government & non-financial Public Entities	4.803	24	5.402	28	4.703	27
Credit to other Sectors**	2.404	12	1.780	9	1.366	8
Liquid and other Domestic Assets	3.053	15	2.459	13	1.959	11
<b>Assets = Liabilities</b>	<b>20.342</b>	<b>100</b>	<b>19.253</b>	<b>100</b>	<b>17.492</b>	<b>100</b>
<b>Private Deposits, thereof</b>	<b>8.117</b>	<b>40</b>	<b>7.023</b>	<b>36</b>	<b>6.578</b>	<b>38</b>
Demand Deposits***	2.453	12	1.774	9	1.548	9
Time and saving Deposits	5.235	26	5.005	26	4.372	25
Foreign Currency Deposits	429	2	244	1	658	4
<b>Government and other Public Deposits</b>	<b>3.992</b>	<b>20</b>	<b>3.835</b>	<b>20</b>	<b>3.411</b>	<b>19</b>
<b>Credits from Central Bank</b>	<b>2.373</b>	<b>12</b>	<b>2.959</b>	<b>16</b>	<b>2.661</b>	<b>15</b>
<b>Capital accounts (equity funds)</b>	<b>876</b>	<b>4</b>	<b>730</b>	<b>4</b>	<b>877</b>	<b>5</b>
<b>Other Liabilities</b>	<b>4.983</b>	<b>24</b>	<b>4.707</b>	<b>24</b>	<b>3.964</b>	<b>23</b>

\* 1 SYR = 0,01627 EUR

Source: Central Bank of Syria

\*\* Private, mixed and cooperative sectors

\*\*\* Includes Import Deposits for L/C opening

The dynamic growth of the total bank assets since 1990 was fuelled by two factors: (1) the growth of current and saving deposits due to the share increase of gross savings in the gross national disposable income (2003: 20% compared to 1990: 13%); and (2) increased borrowings from the Central Bank. To date the structure of the liabilities of the Syrian banking sector offers specific characteristics compared to other Arab countries: a high ratio of demand deposits to saving deposits, a high share of the borrowing from the Central Bank, and a low capitalisation level indicating a probable insufficient solvency ratio.



The total balance sheet growth has been mainly invested in foreign asset deposits and in loans to Government and public sector corporations. In turn the foreign assets currently equal about half of the total bank assets, whereas loans to private sector constitute less than 11% of total bank assets, though they are slowly increasing.

## Structure of Aggregated Loan Portfolio

*Ownership:* As of end 2004 total bank loans amounted to SYP 442 billion thereof 25.5% (SYP 113 billion) directed to General Government (of which legal reserve: SYP 44 billion), 41% (SYP 182 billion) to the non-financial public sector<sup>20</sup>, 3% (SYP 12 billion) to the co-operative sector, and 30.5% (SYP 135 billion) to the mixed<sup>21</sup> and private sector.

*Sectoral Distribution:* Excluding loans to the General Government the sectoral distribution of the remaining aggregated loan portfolio of SYP 330 billion was as follows: 40% wholesale and trade; 26% agriculture; 14% construction, 8% mining, manufacturing and utilities; 12% other activities. Strikingly – and contrary to other economies – the sectors of manufacturing and services do not feature more prominently on the sectoral distribution ranking. This observation corresponds with the findings of the demand side analysis confirming the traditional preference of private companies and individuals to finance assets through their own (or informal) resources rather than through bank loans. The limited usage of bank loans constitutes a crucial bottleneck for investment finance and hence for total economic growth.

*Loan Types:* The distribution of the aggregated loan portfolio (excluding loans to General Government) by loan types was as follows: 51% collateralised loans and advances; 37% loans and overdrafts secured by personal guarantees; 9% discounts; and 3% others.

Available statistical data provide no information on the purpose of the loans. However, the bulk of the loan portfolio has a maturity of up to one year indicating either a very insecure way of fixed asset finance on the basis of continued rollover loans or the predominant deployment of loans for working capital and trade finance purposes.

## Low Financial Intermediation

Despite the relative improvement in banking activity over the past years, the Syrian banking sector is currently characterised by a relatively weak mobilisation of domestic and offshore savings and a poor channelling of savings towards private productive investment. The lack of private sector access to sufficient and adequate financial services of the formal finance sector constitutes an increasing impediment to its further development. This in turn negatively impacts overall economic growth and employment creation given the significant private sector contribution to GDP (65% overall and 90% to GDP excluding oil).

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<sup>20</sup> All public sector companies and organisations apart from financial institutions

<sup>21</sup> Public-private joint ventures are categorised as mixed sector companies. Loans to this sector are negligible



For decades, the resources of the Syrian banking sector were mostly employed in loans to State-owned enterprises. These loans have increased dramatically since the 1986 financial crisis, and mostly since the Government started buying the major crops (cotton and wheat) at international prices. In the year 2000, the loans to the public organisations in charge of collecting the industrial crops peaked at 65% of the total public debts and currently are estimated to be around 50%.

At end-2004 the banking industry had total deposits equivalent to 56% of Syria's GDP. It has a network of 332 branches, equivalent to one branch per 54,000 inhabitants, against a regional average of one branch per 25,000 inhabitants and an emerging countries' average of one branch per 15,000 inhabitants. Total bank loans to the private sector accounted for just 12.3% of GDP, against a regional average of 37.5% and an emerging countries' average of 75.7% of GDP. Bank lending suffers additionally from the weakness of institutional disclosure and the lack of a track record (the borrowing and repayment experiences of private enterprises and individuals). Hence, despite their significant size and their recent growth, Syrian banks have been playing a poor role as a financial intermediary for the private sector economy, the main engine for growth and job creation.

## Lending terms

Interest rates are determined by the "Credit and Monetary Council" and adjusted from time to time. Public and private banks are obliged to abide by the deposit rates according to the Council's tariff. Contrary hereto, the debit rates are only binding for the Public Banks, whereas private banks are expected to use the tariff as guidance and periodically report on actual interest rates charged. Currently lending rates of Public Banks range between 7% p.a. for short-term loans, 9% p.a. for mid to long-term loans up to 10 years. Private banks charge up to two percentage points more on average.

Loans to the private sector are perceived to be expensive in view of additional costs associated with taking a loan. Banks apply commissions on private sector loans and further costs are incurred relating to the necessary collaterals (registration of real estate, guarantees, etc.). In cases of low lending volumes – which would typically be required by SMEs – the additional loan costs could add up to a significant burden. The banks are not required to publish the real effective global interest rate. Other loan-related charges and fees are:

- Overdrafts: A charge of 1/1000 times the highest value of the overdraft during the months in addition to the interest rate.
- A project evaluation fee of between the SYP-equivalent of USD 150 – 500.
- Stamp duty on all contracts: between 1.5/1000 and 4/1.000 times the value stated in the contract. Stamp duties are payable for each copy of a contract (usually three).
- Registering collateral: At least 1.7% times the value of the asset to be registered.
- Releasing collateral: At least 1.7% of the value of the registered asset.



In addition private companies and individuals consistently complain about corruption prevailing in the banking sector resulting in bribes of up to 15% payable on required loan amounts. Allegedly in return for such bribes, assets being assessed for collateral were over valued, sometimes by significant amounts.

## 4.2 Bank Analyses

The BAI Team carried out an analysis of the private and Public Banks in order to assess the capability of the Syrian banking sector to satisfy the demand of the private sector for financial services in terms of range and volume of products as well as suitability, reliability and quality of services provided. Based on the comparison of the demand analysis the ultimate objective was to establish conclusions and recommendations for a comprehensive restructuring and upgrading of the existing Public Banks and/or alternatively the broadening of the financial sector by the creation of new and innovative financial institutions.

### *Methodology*

In order to achieve the objective of the assessment a comprehensive investigation was undertaken into the institutional, operational and financial corporate capabilities of the existing actors. In view of the abundance of information required a questionnaire was developed in both English and Arabic language to serve as a basis for each bank analysis. Public and private banks received essentially the same questionnaire though certain distinctions were deemed necessary. The State-owned banks have been in operation for some time and have historical records; the private banks have just entered the market and therefore lack a track record in Syria; but they have clear expectations and rather ambitious corporate strategies.

The approach adopted was to ask open questions in order to allow the respondents as much freedom as possible. However, to each question, points of clarification and requests for further information have been made to avoid simplistic or uninformative answers. The questionnaires were only considered to be a starting point for the investigation into each bank. Upon receipt, each bank was individually visited in order to explore the background and reason for the answers and to complete the data requirement. The investigation centred on the following issues In order to establish as complete as possible a picture of the banks:

- Institutional issues: Background and mission – Governance and organisation – Management and personnel – IT/Management Information System
- Operational issues: Lending policy – loan processing – loan structure and quality – prudential regulations – loan monitoring – risk management.
- Financial issues: Accounting reliability – liquidity (asset/liability) management –profitability and profit potential – capital adequacy and capital requirement.



The responses to the questionnaires and the subsequent additional information provided necessitated substantial efforts by the banks. **The BAI Team wishes to express its sincere appreciation to the banks' staff, without whom the preparation of the analysis would not have been manageable, within the given short period of time.** The individual analysis per bank is annexed to this report. The main findings are summarised in the next Chapter.

*Disclaimer.* Though the BAI Team has endeavoured to carry out the analysis with utmost care and diligence, it should be noted that the analysis did not – and could not - constitute an audit of systems and procedures, accounting or loan files. The BAI Team based its entire efforts on information kindly supplied by the banks both as a written response to the questionnaire and by subsequent verbal communication with bank key managers. Whilst the BAI Team believes that the analysis reports provide a fairly true and complete picture of the financial and operational status of each bank, yet it cannot guarantee the correctness of the underlying data. Therefore the following findings and conclusions should be read with caution.

### 4.3 Findings

The table below summarises the market positions as of June 2005 for all banks currently acting in Syria in terms of number of branches, total assets, customer deposits, loans to customers and capitalisation, all of which confirm the continued dominance of the Public Banks.

**Table 9: Market Positions of Syrian Banks as of 06/2005**

(million SYP)	Bran -ches	Total Assets	Customers Deposits**	Loans to Customers	Equity Funds
<b>Public Sector Banks:</b>					
Commercial Bank of Syria	54	838.480	380.339	128.052	221.488
Real Estate Bank	17	118.131	59.476	55.910	3.336
Agricultural Cooperative Bank	106	98.295	17.527	27.274	10.704
Savings Bank	57	98.421	93.708	3.840	1.500
Popular Credit Bank	63	75.040	59.352	36.269	2.812
Industrial Bank	17	31.319	21.142	24.213	2.664
<b>Sub-Total Public Banks</b>	<b>314</b>	<b>1.259.686</b>	<b>631.544</b>	<b>275.558</b>	<b>242.504</b>
<b>% of Total</b>	<b>94%</b>	<b>96%</b>	<b>93%</b>	<b>96%</b>	<b>98%</b>
<b>Private Sector Banks!:</b>					
Banque Bemo Saudi Fransi	9	30.868	27.737	5.587	1.394
Bank of Syria & Overseas	5	15.016	12.863	3.155	1.562
International Bank for Trade & Finance	6	9.088	4.420	2.425	1.533
<b>Sub-Total Private Banks*</b>	<b>20</b>	<b>54.972</b>	<b>45.020</b>	<b>11.167</b>	<b>4.489</b>
<b>Total</b>	<b>334</b>	<b>1.314.658</b>	<b>676.564</b>	<b>286.725</b>	<b>246.993</b>

\* Bank Audi is not included, since the bank had only started operations in September 2005.

\*\* Import Deposits (SYP 74 billion) are excluded since banks account them differently (customer deposits /short-term liability)



(million EUR)*	Bran -ches	Total Assets	Customers Deposits***	Loans to Customers	Equity Funds
<b>Public Sector Banks:</b>					
Commercial Bank of Syria	54	13.642	6.188	2.083	3.604
Real Estate Bank	17	1.922	968	910	54
Agricultural Cooperative Bank	106	1.599	285	444	174
Savings Bank	57	1.601	1.525	62	24
Popular Credit Bank	63	1.221	966	590	46
Industrial Bank	17	510	344	394	43
<b>Sub-Total Public Banks</b>	<b>314</b>	<b>20.495</b>	<b>10.275</b>	<b>4.483</b>	<b>3.946</b>
<b>% of Total</b>	<b>94%</b>	<b>96%</b>	<b>93%</b>	<b>96%</b>	<b>98%</b>
<b>Private Sector Banks':</b>					
Banque Bemo Saudi Fransi	9	502	451	91	23
Bank of Syria & Overseas	5	244	209	51	25
International Bank for Trade & Finance	6	148	72	39	25
<b>Sub-Total Private Banks**</b>	<b>20</b>	<b>894</b>	<b>732</b>	<b>182</b>	<b>73</b>
<b>Total</b>	<b>334</b>	<b>21.389</b>	<b>11.008</b>	<b>4.665</b>	<b>4.019</b>

\* 1 SYR = 0,01627 EUR

\*\* Bank Audi is not included, since the bank had only started operations in September 2005.

\*\*\* Import Deposits (SYP 74 billion) are excluded since banks account them differently (customer deposits /short-term liability)

## General Comments on Public Banks

**Weak Corporate Governance and Heavy State Interference:** The powers of the Board of Directors of a Public Bank are limited and qualify neither for supervision nor for a strategic management of the bank. Except for a narrowly defined ordinary course of business, all material decisions (examples: nomination of heads of division or department, creation of any additional jobs, staff training, modernisation's, opening of a branch, introduction of a new product) requires state approval, which depending on its respective nature must be sought from the Finance Minister, the office of the Prime Minister, the State Planning Commission, the Central Authority for Financial Control and/or others. Such approvals are cumbersome, time-consuming and often do not work out to the benefit of the bank, since key persons within the relevant authorities rarely have a banking background and seem to be primarily guided by their fiscal interests. The constant state interference in the strategy and day-to-day business of Public Banks represents a significant impediment to their efficiency and constitutes an increasing competitive disadvantage compared to private banks now operating in the country.

**Low Qualification of Staff:** The general qualification of bank staff is insufficient and is way below international banking standards. In addition some Public Banks tend to be overstaffed. The qualification weakness is a result of the very low salary level of the Public Banks (as determined by the Office of the Prime Minister), which leads to a brain drain of qualified male banking staff especially to the Gulf region. The working morale of bank staff tends to be low and results in poor efficiency and productivity. Private Banks in Syria offer up to 10 times higher salaries. Nevertheless staff migrations to private banks may only be expected in exceptional cases due to the predominantly low quality level of Public Bank employees.





Public Banks face a particular problem in securing qualified staff at managerial level, which is the combined effect of the insufficient qualification of job applicants and the bank's poor salary scheme. Banks therefore try to develop staff capabilities in-house, but lack a systematic human resources development policy and training curricula. Furthermore, the bank's technical and financial resources for this purpose are limited.

**Insufficient IT & Management Information Systems (MIS):** All Public Banks<sup>22</sup> maintain either no or only a marginal IT-supported MIS. Branches are either not or are insufficiently connected with head offices online and often operate as independent units with a separate database and accounting system. Communication between branches takes place by letter or fax. Hence internal **transactions** (transfers, withdrawals, etc.) are cumbersome with both transparency and efficiency of operations heavily constrained. Accounting is mainly manual, with calculations in some cases carried out with Excel spreadsheets. Consolidation of data as well as preparation of balance sheets and profit and loss accounts is carried out monthly or even annually but not daily. In conclusion, the current system neither secure a regular and timely management information system, nor do they allow proactive control of business development, nor prudent budgeting for upcoming periods. A number of banks are currently in the process of modernising their IT systems. Subject to a complementary training of staff the upgraded MIS is expected significantly to improve transparency and efficiency of banking operations.

**Limited Cash Flow Orientated Lending:** Though all Public Banks have strengthened their efforts towards increased lending, yet the existing institution building for a cash flow oriented loan analysis is hardly existent. Neither is the staff sufficiently trained nor does the poor MIS offer a database, analysis tools or projection software for a proper conduct of such lending methodology. Furthermore poor accounting practices and limited transparency of borrowers additionally aggravate a correct appraisal of a borrower's ongoing business and the ability to provide an opinion on his corporate ability to service the requested loan. Hence the credit decisions of banks are based on a rather simple assessment of assets and collaterals of the borrower. In some cases, it seems that the valuation of collateral has been overoptimistic, making the recovery of debts difficult. The banks' institution building and staff capacity have become attuned to this type of appraisal. The mitigation of this weakness appears to be of particular importance in view of the general intention of the banks to increase their lending and even introduce mid- to long-term loans to enterprises.

**Weak Risk Management:** According to the regulations of the Credit and Monetary Council on non-performing loans, any loans to the public sector have to be categorised as "performing" regardless of their state of arrears. Hence Public Banks do not account for loan loss provisions of loans to the public sector and do not even monitor the ageing development of defaulting loans. But even the risk management of the loans to the private sector is unsatisfactory. Loans are insufficiently monitored and are often rescheduled. Banks maintain no separate credit risk departments nor do they carry out a risk scoring or risk rating of loans. The Public Banks also lack

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<sup>22</sup> With the notable exception of the Real Estate Bank although even here, effective and informative MIS is seriously under-developed)



committees, which are typically institutionalised to contain the operational banking risks, such as Committees for Asset-Liability management (ALCO), audit, and compliance. The above-mentioned MIS deficiency additionally impedes banks' capabilities to monitor and proactively address evolving risks in a timely manner.

**No International Accounting Standard (IAS):** Only private banks are obliged to account in accordance with IAS. Public Banks are subject to the audit of the Central Authority for Financial Control on the basis of its own accounting principles. No Public Bank has so far been subjected to an audit according to IAS. The above mentioned lack of proper loan loss provisioning raises serious doubts on whether the disclosed financial statements present a true and fair picture on the financial standing of the banks. An application of a strict risk categorisation of loans and accounting of loan loss provisions for all private and public loans as per IAS would probably lead to a substantial depletion of banks' declared profits and a subsequent deterioration of their capital adequacy.

**Regulation:** All public banks are characterised by weak governance resulting in a reduced efficiency level. The powers of the Boards of Directors of the banks are limited and neither qualify for supervision nor for a strategic management. Except for a narrowly defined ordinary course of business all material decisions require state approval, which depending on its respective nature must be sought from the Ministry of Finance, the Office of the Prime Minister, the State Planning Commission, the Central Authority for Financial Control and others. The constant state interference in the strategy and day-to-day management of public banks represents a significant impediment to their efficiency and constitutes an increasing competitive disadvantage compared to private banks now operating in the country.

### **Specific Comments regarding Public Banks:**

The **Commercial Bank of Syria (CBoS)** is the 7<sup>th</sup> largest Arab bank in terms of assets. Its role within the Syrian financial sector is unique. The CBoS is the only Public Bank licensed for foreign operations and hence is the only Public Bank connected to the international capital and financial markets. It also acts as the fiscal agent of the Government and holds a significant amount of the national foreign currency reserves. Current considerations to re-assign the fiscal agency and to re-allocate foreign assets to the Central Bank would result in a drastic downsizing of the CBoS.

60% of the CBoS assets are foreign currency denominated and are held in offshore accounts, thereby reflecting the peculiar structure of Syria's aggregated bank assets (see above). The revaluation of its foreign assets has been CBoS's major source of profitability. In turn, a loss of its public monopoly on foreign currency transactions – for the purpose of establishing a fair competition ground to all banks – would put CBoS' profitability and commercial sustainability to a crucial stress test.

Meanwhile CBoS's contribution to financial intermediation to the private sector is negligible. While it receives 60% of Syrian bank deposits, it only provides 5% of the total bank credits to the private sector, most of which are short-term trade finance facilities. 98% of the CBoS loan portfolio is granted to the public sector. About 61% of



the portfolio (or 577% of paid in capital plus reserves) was granted to one single company, namely to the "General Corporation for Trade & Production of Grains". The loans to the public sector are not subject to quality control or risk management.

The **Real Estate Bank (REB)** is specialised in financing habitation and real estate constructions, an activity which has been devoted to the public and co-operative sector for decades. The public and co-operative sector used to constitute 63% of its loans in 1989. This has now reduced to 19%. The remainder is delivered to the private sector (22%) and to low-income population (58%). REB is the only bank in Syria, which has made its way to reform its operational procedures and has established a meaningful IT system, with the help of international consultants. In 2002, it launched the first Syrian payment cards system and has deployed a network of Automatic Teller Machines (ATMs) in the country. With a limited network of 17 branches, it would like to extend its activities to compete with the CBoS, and has asked the authorities to allow it to undertake foreign trade and Foreign Exchange transactions. This request has so far been ignored. Meanwhile the Bank has not been audited to international standards, and approximately 2% of its loan portfolio is reported to be non-performing.

The **Savings Bank (SB)** had been created in the early 1990's as a post savings fund to collect popular savings through postal outlets. It was restructured as a commercial bank in 2000 and since then has known the most significant growth, becoming at the end of 2003 the 3rd bank in Syria in terms of total assets. About 97% of the deposits are placed in saving accounts, which may be withdrawn any time. Hence the Bank's liquidity is extremely short-term.

SB's income streams are modest and narrow. Its lending levels are negligible (lowest loan to asset ratio of all Syrian banks), even though it offers long-term loans of up to 10 years, markets start-up loans of the Agency for Combating Unemployment (ACU) and has recently also successfully introduced consumer lending. The Bank has so far depended on depositing the bulk of its resources at the Public Debt Fund. The Bank has now been requested to gradually withdraw its deposits, a situation which could lead to its bankruptcy. Alternatively a merger of the Savings Bank with another bank combining the former's deposit mobilisation capability with the latter's lending business potential may be worthwhile considering.

The **Popular Credit Bank (PCB)** was established to support small-scale enterprises. Whilst this role remains, the Bank has become primarily a deposit-taking institution due to the attractive interest rates it can offer depositors based upon the income it earns from its deposits at the Public Debt Fund. However, the Bank has been requested to gradually withdraw its deposits and the management is faced with finding alternative sources of income. It is currently attempting to do this by increasing its lending greatly to entrepreneurs and small businesses. However, interest margins are narrow, because rates are constrained by the Central Bank's Credit and Monetary Council. Consequently, the Bank has limited room to manoeuvre or make mistakes. Moreover, the target customers are ordinary people and those with limited income, the credit risks of whom are inevitably high. A conservative provisioning policy would without doubt have a significant effect on margins. Hence, the Bank's management and staff may have challenges ahead.



Nevertheless, the concept of a popular credit institution (a small and medium scale enterprise (SME) bank) remains valid because most enterprises in Syria are SMEs and they will need for their development the support of an institution skilled in assessing their projects and willing to meet their needs for financial services. It would not be a mistake to consider developing the Popular Credit Bank into providing this financial window

The **Agricultural Cooperative Bank (ACB)** is orientated towards servicing the rural communities and has the largest network of branches throughout the country. It is also acting as a trading company supplying inputs to farmers and, as part of this activity, operates a network of warehouses. The Government has decided to split the institution into a separate bank and separate trading company to improve governance and simplify banking supervision. During the last 6 years, interest due by nearly half of all customers has been forgiven twice and the loans to all farmers have been rescheduled and turned from annual loans to seven-year loans with a two-year grace period. This debt relief was instructed by the Government following a season of poor or failed harvests. Hence it is difficult to assess the management and operations of the banking component.

There are several challenges facing the Bank; it has to be decided the extent to which the Bank becomes a commercial (profit seeking) entity and the extent to which it becomes a rural development institution. Also it has to be decided whether it is strictly an agricultural bank or a rural development bank and finances non-agricultural rural activities. If the latter, it will inevitably come into competition with other banks and there would be difficulties if the bank were not equally as profit seeking as its competitors.

The **Industrial Bank (IB)** is specialised in providing medium and long-term loans to private sector industrialists and handicrafts. It is the smallest State-owned bank. In the 1990's, an important share of its activities consisted of distributing industrial development loans granted by the Kuwaiti Fund for Economic Development (KFED), at advantageous interest rates. Currently the bank is in a delicate position in that the probable extent of doubtful debts exceeds SYP 5 billion (21% of total portfolio), of which only a very small proportion has been adequately provisioned. Taking prudential provisions would wipe out the paid-up equity twice over. If the problems were confined to the past, as indeed some of the doubtful debts are, being some 10 years old, then one could recommend a re-capitalisation. Unfortunately, it seems possible that further and more substantial problems with difficult debts are only now emerging. Hence, the SYP 5 billion may not be the total sum of difficult debts.

Notwithstanding the above, there is a need for a long-term finance bank because alternative means of long-term financing are not really available in Syria, except to the already wealthy and those with contacts in other financial markets. Whichever way forward is finally accepted, the Bank will need new equity capital and substantial training/retraining of staff in project assessment, new procedures manuals, modern IT as well as good monitoring and accounting systems.



#### 4.4 Conclusions

The above findings relating to the Public Banks indicate deep-rooted systemic deficiencies on regulatory as well as on institutional levels, the combination of which results in an inefficient conduct of banking business. Ultimately, the findings constitute an explanation for the poor financial intermediation role that the state dominated banking sector has so far been exercising. Private companies and individuals are the ones to suffer most from the restricted supply of demand oriented financial services, in particular loan facilities for fixed asset and working capital finance. The general opinion on banks is rather negative. Banks are perceived – even by individuals who never dealt with banks – to be too demanding, complicated, expensive and even corrupt. Hence the Government's reform programme should continue and not lose momentum. The market oriented amendment of relevant laws and regulations and the implementation of a banking sector liberalisation policy are essential to ensure the needed stimulus to economic activity through the channelling of a greater share of domestic savings towards more productive private placements and investment within Syria.

**Table 10: The strengths and weaknesses of the banks in Syria**

Public Banks		
Bank	Strengths	Weaknesses
<b>Agricultural Cooperative Bank (ACB)</b>	<ul style="list-style-type: none"> <li>• Experience in servicing the rural sector since 1888</li> <li>• A network of 106 branches</li> <li>• Able to collect money owed through the Public Money Collection Law (not reliant on customers visiting the branches)</li> </ul>	<ul style="list-style-type: none"> <li>• Borrowers are sometimes detrimentally affected by adverse climatic conditions which in turn affects the ability to repay</li> <li>• The Bank is unable to attract good professional expertise to the branches</li> <li>• Low wages which make it difficult to retain and attract staff</li> </ul>
<b>Commercial Bank of Syria (CBoS)</b>	<ul style="list-style-type: none"> <li>• Largest Syrian bank by total assets,</li> <li>• Only public bank licensed for FX-transactions</li> <li>• Fairly large branch and correspondent network</li> <li>• Strong backing by the Government</li> <li>• Reform oriented top management</li> <li>• (High liquidity but substantial idle capital)</li> </ul>	<ul style="list-style-type: none"> <li>• Weak governance and institution building</li> <li>• Limited diversification of income sources</li> <li>• Low profitability and unclear capital adequacy</li> <li>• Collateral based lending; weak risk management</li> <li>• Overstaffing and insufficient qualification</li> <li>• Poor MIS/IT, but new system under preparation</li> </ul>
<b>Industrial Bank</b>	<ul style="list-style-type: none"> <li>• Bank's management considers staff to have good experience</li> </ul>	<ul style="list-style-type: none"> <li>• The inability to recruit graduates or retain their best young staff members</li> <li>• Lack of a computer-based MIS/IT system linked to the branch network</li> <li>• There seems to have been a reluctance in the past to provision adequately for difficult debts and an inability to recover funds from collateral.</li> <li>• Failure in procedures; either in assessing</li> </ul>



		collateral, securing title or pursuing collection
<b>Popular Credit Bank</b>	<ul style="list-style-type: none"> <li>• Widely spread network of branches</li> <li>• Services orientated to the less advantaged</li> </ul>	<ul style="list-style-type: none"> <li>• Low wages which make it difficult to retain and attract staff</li> <li>• Out-of-date technology used</li> <li>• Need to increase the skilled staff numbers in some branches</li> </ul>
<b>Real Estate Bank (REB)</b>	<ul style="list-style-type: none"> <li>• Good reputation</li> <li>• Good administration</li> <li>• Good technology</li> <li>• Well collateralised loans</li> <li>• Centralised on-line accounting</li> </ul>	<ul style="list-style-type: none"> <li>• Prohibited from dealing in foreign currencies</li> <li>• Limited branch network</li> <li>• Need better trained and more qualified staff</li> <li>• Inability to remunerate staff competitively</li> <li>• Funding/Interest rate mismatch problem</li> </ul>
<b>Savings Bank (SB)</b>	<ul style="list-style-type: none"> <li>• Positive market reputation</li> <li>• Large domestic branch network and outreach</li> <li>• Particular strength on retail deposit mobilisation</li> <li>• First bank to introduce consumer lending</li> <li>• (High liquidity but substantial idle capital)</li> </ul>	<ul style="list-style-type: none"> <li>• Weak governance and institution building</li> <li>• Poor diversification of income sources</li> <li>• Low profit and capital adequacy ratios</li> <li>• No systematic risk management</li> <li>• Insufficient qualification of staff</li> <li>• Poor MIS/IT, but partial modernisation planned</li> </ul>
<b>Private Banks</b>		
<b>Bank of Syria and Overseas</b>	<ul style="list-style-type: none"> <li>• Strategic Partner's (IFC) high reputation in the marketplace</li> <li>• Management's good relations with high net worth individuals in Syria</li> <li>• Training on a rotational basis provided to all employees</li> </ul>	<ul style="list-style-type: none"> <li>• The organisation structure is still evolving and is dependant upon permissions from the regulatory authorities</li> <li>• Unable to determine a precise development strategy because the regulatory environment is constantly changing</li> <li>• Lack of qualified and experienced persons to hire</li> </ul>
<b>Banque Bemo Saudi Fransi (BEMO)</b>	<ul style="list-style-type: none"> <li>• Good reputation</li> <li>• Part of International Group (Credit Agricole, France)</li> <li>• Good knowledge of the country</li> <li>• Fast development / aggressive branch opening programme</li> </ul>	<ul style="list-style-type: none"> <li>• Difficult to recruit trained banking staff</li> <li>• Fast growth has strained internal organisation</li> <li>• IT System needs improvement</li> </ul>
<b>International Bank for Trade and Finance (IBTF)</b>	<ul style="list-style-type: none"> <li>• One of the first private banks in Syria</li> <li>• Clear and effective corporate governance</li> <li>• Diversified product range</li> <li>• Professional management and institutional support provided by main shareholder</li> </ul>	<ul style="list-style-type: none"> <li>• Young corporate history</li> <li>• Limited but growing branch network</li> <li>• Small but increasing market share</li> <li>• Volatile and weakly regulated operating environment</li> </ul>



## 4.5 Recommendations

The introduction of private banks has already enriched and revived the Syrian banking sector and is expected to improve further the financial intermediation and reputation of the banking sector significantly. But so far their market share is still small – though steadily increasing – and hence particular focus needs to be put on addressing the institutional deficiencies of the Public Banks and simultaneously remove the regulatory impediments, which keep the whole banking sector from prospering.

### On Regulatory Level:

- **Banking Regulatory Framework:** Continue developing and upgrading the regulatory framework and improve the institutional and personnel supervision capacity of the Central Bank: Promote demand-oriented competition by establishing supportive, transparent and equal competition grounds for all banks. Combat corruption.
- **Improve Monetary Policy:** Develop monetary instruments for an effective monetary policy on price and currency stability and support of economic growth. This relates in particular to the establishment of market driven credit and debit interest mechanisms for both SYP and foreign currency deposits and loans.
- **Liberalise Foreign Exchange:** The Central Bank should free foreign currency trading on current accounts, legalising it in the country, and regulating its operations in banks and in legal trading companies. In particular, the Central Bank should increase its foreign currency reserves, and manage the foreign currency market in the country through proper monetary and regulatory instruments.
- **Improve Clearing and Settlement Procedures:** The re-engineering of these procedures would help boost commercial activity and make a smooth transformation from a cash economy towards a bank intermediation economy, with favourable impact on aggregate spending at large. The applied laws on payment systems should clearly provide for (1) developing and regulating payment systems, especially with regard to ATMs and payment cards; (2) developing and regulating transfer payments, including electronic transfers; and (3) developing and regulating clearing and settlement operations related to payment systems and financial instruments.



## **In addition, as a complementary measure on intermediary level:**

- **Establish Association of Banks:** The creation of a “bankers association”, representing the interests of all private and Public Banks towards the authorities and the Central Bank would facilitate addressing the upcoming and potentially growing gap between public and private banks. Aligning the development of both types of operating banks cannot but positively impact on the system's overall credibility and its ultimate ability to attract offshore resources at large. Such an Association could also provide valuable research, advice and training on significant operational and regulatory issues. The Association would be the interlocutor of clients for claims relating to improving the quality and conditions of services.

## **On Institutional Level:**

Recommendations with regard to the banks comprise a comprehensive set of institutional, operational and financial measures for a systemic restructuring and rehabilitation of the public sector banks. Further recommendations relate to the introduction of non-bank financial institutions for the purpose of broadening the financial sector and enriching the range of and efficient supply of demand oriented bank and non-bank financial services. Both types of recommendations are elaborated in more detail in the following chapters.





## **5 Public Bank Mergers and Restructuring**

### **5.1 Overview**

#### **5.1.1 Evolution**

The options and scenarios presented in this section are based upon documentary evidence, legal changes, market opening and trade agreements, which show that the Syrian Government is committed to economic and financial sector reforms. The logical next step in that reform process is a restructuring of its Public Banking sector. Maintaining the current situation is not an option because the publicly owned banks are all in difficulties of one sort or another and for some of them their bad loan problems are serious. Moreover, the Government is manifestly clear and determined to restructure these entities institutionally, operationally and financially.

The BAI Team met with many relevant senior government officials, responsible for economic and financial sector reform. There is general consensus to support a best practice approach through which all Public Banks could be merged and/or restructured (or both) with the objective of providing competitive delivery of demand oriented banking services in Syria. The following sections on the options for merging and restructuring the Banks are the outcome of a comprehensive series of discussions held with public and private parties relevant to the banking sector. The discussions have set out the framework within which this merger and restructuring process should take place with a full appreciation of the associated difficulties. Thus, the BAI Team proposes the following goal for Phase 2: that the Syrian public banking sector is consolidated and restructured to become an efficient source of funding for Syrian enterprises with a special focus on the evolving private sector.

### **5.2 Financial Sector Restructuring**

#### **Merger Issues: Competition, moral hazard and systemic stability<sup>23</sup>**

Bank consolidation in most emerging economies has not yet been associated with any marked rise in concentration, as most mergers appear to have involved smaller banks. One reason for this pattern could be the reluctance on the part of the authorities to sanction mergers between the largest banks, which can raise both competition and moral hazard concerns. Many industrial countries follow explicit policies that limit the concentration in the banking industry. For example, the Australian government announced in 1997 a “four pillars” policy under which mergers among the four major banks would not be permitted until the authorities were

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<sup>23</sup> BIS (Bank for International Settlements) background paper: John Hawkins and Dubravko Mihajek, page 31, “The banking industry in the emerging market economies: competition, consolidation and systemic stability: an overview”, ‘BIS Papers: No. 4: “The banking industry in the emerging market economies: competition, consolidation and systemic stability”, Monetary and Economic Department, August 2001.



satisfied that competition had increased, especially in the area of lending to small businesses.

## **Merger Risks**

Mergers are inherently risky. Their perils include overcoming differing corporate cultures, incompatible operating procedures, financial and IT systems, and varying staff skill levels. Additionally, the more mergers there might be, the more the risk of failure increases. The BAI Team presents previous experience with mergers in other emerging market in order to underline merger risk. In that regard, Oldrich Dedek, Vice Governor, Czech National Bank lays out similar Public Bank sector problems to those of Syria.

“The Czech domestic banks suffered from a number of weaknesses: under-capitalisation, a shortage of the long-term funds necessary to support their development plans, inexperienced staff, non-existent risk management, and underdeveloped information systems. The risks were heightened by shortcomings in professional skills and by a number of legal loopholes that could be exploited through fraudulent behaviour. Thus, the political pressure to satisfy the enormous financial needs, combined with the credit expansion and high rates of growth in the banking business as a whole, led inevitably to the generation of losses. In addition, the large banks (which are the backbone of the Czech financial sector) were faced with the difficulty of low capital adequacy coupled with an inherited burden of bad loans<sup>24</sup>.”

With the common background in mind, the BAI Team presents other developing countries' experience with Public Bank sector transformations, mergers or otherwise.

## **Different Country Models: market-driven versus government-led consolidation<sup>25</sup>**

Although the evidence suggests some potentially significant cost and revenue benefits from bank consolidation, market-driven consolidation is a relatively new phenomenon in the emerging economies, and has mainly been observed in central Europe. Most mergers have instead resulted from government efforts to restructure inefficient banking systems (many Latin American countries), or from intervention following banking crises (Korea and Southeast Asia).

In addition to economic factors, legal and judicial considerations often play a major role in determining the outcomes of bank consolidation. In some countries (e.g., the Czech Republic), governments have ended up in court in cases where they forced bank mergers. In others, governments have ended up in court in cases where they did not allow mergers to take place (as in South Africa). Finally, there are countries where government efforts to consolidate the banking system cannot be challenged in courts (e.g., Malaysia), but banks can nonetheless undermine these efforts by other means.

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<sup>24</sup> “Bank consolidation in the Czech Republic”, page 64: BIS Papers: No. 4.

<sup>25</sup> Ibid, John Hawkins and Dubravko Mihaljek, page 14, BIS Papers: No. 4.

**Indonesia: Difficult with the final results still uncertain<sup>26</sup>**

It is still questionable whether merging two or more weak banks can create a strong single bank. This question arose when the Indonesian Government arranged a merger between four state banks, each of them having high levels of Non Performing Loans. While there may be synergies or cost reductions from eliminating overlapping branches, the immediate practical difficulties in merging cultures, linking computer systems, dismissing excess staff, consolidating data and reports, and so forth can be formidable.

The second mandatory merger was in June 2000, involving nine small and medium-sized private banks, which were bundled together to form a large private bank. The new bank has kept the brand name of the largest banks and most of their managers. However, it will take a while to assess the effectiveness and benefits of these mergers. The remaining voluntary mergers, involving seven private banks, seem to be benefiting from synergy and improved efficiency. However, the bank is still encountering some problems related to the unification of accounting systems and liquidity.

**South Korea: The first attempt failed<sup>27</sup>**

Most of the initial mergers occurred in response to government prodding. Individual banks were reluctant to merge, and worried about severe staff layoffs in the event of absorption. This was the case even though huge amounts of public money were injected into troubled financial institutions. Merged banks have not pursued the hoped-for synergies. In one case, the management performance, resulting from merging two banks with equal shares, was so poor that Government was forced to recapitalise this bank a second time. Thus, the first round of restructuring cannot be judged a success, which has forced the government to undertake the second stage of financial restructuring.

**Poland: An example for Syria<sup>28</sup>?**

Bank Pekao SA was created from a former specialised bank and three regional banks spun off from the National Bank of Poland. The legal basis for this merger was a special act passed by parliament in 1996 to promote mergers between state-owned banks. In September 1996, the three State owned banks were combined Bank Pekao SA, thereby, increasing its capital and outreach. This led to the creation of the Group of the Bank Pekao SA. After a few years all group members merged into a single entity under the brand name of Pekao SA.

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<sup>26</sup> Burhanuddin Abdullah and Wimboh Santoso (Bank Indonesia), "The Indonesian banking industry: competition, consolidation and systemic stability", page 89", BIS Papers: No. 4.

<sup>27</sup> Hyung-Gon Ro (The Bank of Korea): "Banking industry consolidation in Korea", p. 98, BIS Papers: No. 4.

<sup>28</sup> Ryszard Kokoszczynski, National Bank of Poland, "Structural changes in the Polish banking industry - three dimensions of consolidation processes in an emerging economy", page 122, BIS Papers: No. 4.



All the banks chosen to participate in this merger offered a wide range of services and were recognised as universal banks, though Pekao SA operated nationally while the other three banks were regionally anchored. At the same time they had certain areas of individual specialisation, so that the group’s activity was not totally overlapping.

The final result of this process is Pekao SA becoming the largest bank in Poland in terms of assets (approx. 20%). However, the almost concurrent privatisation of this bank (partially through the domestic capital market) with a large foreign bank joining as a major strategic investor makes it currently impossible to identify the role of this government-driven merger in the further development of Bank Pekao SA.

**Pakistan: A success story**

It is, perhaps, appropriate to end this introductory section by illustrating what a successful Public Bank sector restructuring process entails. Over a period of seven years, through January 2005, Pakistan has totally rehabilitated and then transformed its Public Banks. As of that date, only 20% of the original capital remained in state ownership. This process went forward successfully because the government undertook the following three types of reforms:

Restructuring	Enabling Environment	Enhanced/New Products
Corporate governance	Prudential regulations	SME financing
Capital strengthening	Supervision and regulatory capacity	Agriculture credit
Improved asset quality	Legal reforms	Islamic banking
Improved human resources	Taxation	Micro financing
Credit ratings for all banks	Payment systems	Mortgage financing
	Liberalisation of Foreign Exchange	Consumer financing

Note that in Pakistan, the Public Bank reform was not a single action. It was embedded in a broad reform strategy covering the legal and regulatory environment, the institution building and the demand oriented product design. In January 2005, Mr Ishrat Husain, Governor of the State Bank of Pakistan, summed up the impact of this process as follows: “The bankers these days go out of their cosy offices to market their financial products and build up a customer base. The seller’s market has changed into a buyer’s market. The customer may choose the bank with the best products and services. There was a time - only a few years back - people used to go to the banks and the staff treated them shabbily, was generally uncooperative and unfriendly. Now, they are after the customers<sup>29</sup>.”

**Merger Summation**

In conclusion, if mergers are to be contemplated, it would be better to execute just one or a maximum of two at the same time, rather than a string of mergers over an extended period. If public sector bank restructuring is to succeed, it will have to address the full corporate concern regarding the banks. In the following overview, a

<sup>29</sup> The above section taken from an Article by Mr Ishrat Husain, Governor of the State Bank of Pakistan, reproduced from Blue Chip - The Business People’s Magazine, January 2005



number of different possible merger and restructuring scenarios are described together with perceived advantages and disadvantages in each case.

It should be noted, however, that all of these scenarios assume that the Commercial Bank of Syria (CBoS) and the Agricultural Bank (AG) will remain as independent institutions, regardless what other specific recommendations are made in their regard. Insofar as institution and capacity building are concerned, it is anticipated that this process will apply to all six institutions, as their systemic enhancement and training needs are similar.

**Alternative Scenarios for Bank Mergers and Restructuring**

With the establishment of a number of private banks in the country over the past two years, and the expectation of more to come, the Syrian banking sector is in a process of transformation which is likely to place increasingly severe strains on the capacity of the Public Banks to compete effectively without significant change to their internal structures, procedures, systems, attitudes, skills, financial management, marketing, and business development.

Aware of this need, the GoS has promoted and supported the present Feasibility Study with a view to exploring the most appropriate means of transforming the public banking sector, so as to bring about its consolidation and restructuring. The end result of this process is intended to meet the twofold objective of enhancing banking services to the growing private sector, whilst at the same time modernising and significantly upgrading the capacity and credibility of the restructured Public Banks, such as to create one or more new institutions that are able to offer their products and services on an equal basis with the growing number of private banks.

Towards this end, the Team is proposing a two-step approach consisting of a Base Case followed by one of a number of alternative merger scenarios of four of the Public Banks. Certain aspects of Step 1 could commence immediately and will run concurrently with Step 2, once the GoS has determined which merger Scenario to choose:

**Step 1: Base Case**

Base case		
Bank	Target	Pre-Requisites
Commercial Bank	<ul style="list-style-type: none"> <li>Transform and upgrade to become a Universal Bank</li> </ul>	<ul style="list-style-type: none"> <li>Upgrade institution building</li> <li>Untangle relationship with CBS</li> <li>Address issue of international image</li> </ul>
Agricultural Bank	<ul style="list-style-type: none"> <li>No change</li> </ul>	<ul style="list-style-type: none"> <li>Upgrade institution building</li> </ul>
All Public Banks	<ul style="list-style-type: none"> <li>To be subjected to a loan portfolio assessment</li> </ul>	<ul style="list-style-type: none"> <li>Establish TOR</li> <li>Define "bad loans"</li> </ul>
Establish Difficult Debt Institution (DDI)	<ul style="list-style-type: none"> <li>Define Non-performing Loans (NPL) and selection criteria</li> <li>Transfer all selected NPLs to the DDI</li> </ul>	<ul style="list-style-type: none"> <li>Prepare articles of Association / Statutes</li> <li>Prepare institution building (governance, systems, procedures)</li> <li>Assess need for branches</li> <li>Select key management</li> </ul>



It should be noted that a sine qua non of all of the scenarios proposed is that any recapitalisation that may be required – as a result of the transfer of NPLs to the DDI, and to ensure that capital levels in any/all of the merged and restructured Public Banks are commensurate at least with Basle 1 requirements – be treated a pre-requisite by the GoS. It should be further noted that institution upgrading and capacity building can only follow on from an adequate recapitalisation of the relevant banks.

**Commercial Bank of Syria:** This bank has the potential to be transformed into a universal bank. First, however, a detailed assessment needs to be done of its loan portfolio, and at the same time a programme of institution building is necessary. This will involve a detailed review of key areas, including corporate governance, strategy planning, definition of key objectives, marketing and business development, risk management, financial accounting and management and human resource availability.

It is also essential that the CBoS's relationship and responsibilities with the Central Bank of Syria (CBS) be untangled, in particular the holding of the GoS's foreign currency reserves which wholly distort the bank's balance sheet.

Finally, if the bank is to be able to perform effectively its foreign currency and other international activities on behalf of its customers, as well as for its own account, as a matter of urgent priority it must address the issue of its international reputation, which currently suffers from certain derogatory and damaging insinuations, including money laundering.

**The Agricultural Bank:** No change is recommended in the status of this bank other than that consideration could be given to transforming it into an Agricultural Development Institution, maybe under the responsibility and ownership of the Ministry of Agriculture. Here, too, a detailed assessment needs to be done of its loan portfolio, and at the same time a programme of institution building (as described under CBoS above) is necessary. Clearly, too, it needs to divorce its trading from its banking activities, maybe by ceding the former to the co-operative movement.

**Industrial Bank, Popular Credit Bank, Real Estate Bank, Savings Bank:** All of these banks should be subject initially to a detailed assessment of their loan portfolios and the transfer of selected NPLs to the DDI. However, Terms of Reference for this exercise will need to be established. Subsequent action is set out in the scenarios described below.

**Difficult Debt Institution (DDI):** A DDI is established into which are transferred a selection of Non-Performing Loans (NPL) from all of the Public Banks, including all public sector loans that under best banking practice would qualify for provisioning. The precise definition of NPL will need to be established as well as the criteria for their selection and transfer to the DDI. Pre-requisites for the establishment of a DDI are the preparation of Articles of Association/Statutes, preparation of criteria for institution building (as described under CBoS above), and the selection of key management. It is once again emphasised that for all of the following scenarios, the establishment of a DDI is a sine qua non.



Step 2: Possible Merger Scenarios

Scenario 1

Scenario 1			
Bank	Target	Pre-Requisites	Pros & Cons
Industrial Bank Popular Credit Bank Real Estate Bank Savings Bank	Merge to form "Universal Bank of Syria"	<ul style="list-style-type: none"> <li>Restructure new bank &amp; build institutions</li> <li>Improve efficiency by consolidating support functions, and rationalising branches)</li> <li>Harmonise IT/MIS</li> <li>License for F/X operations</li> <li>Ensure level playing field with private banks</li> </ul>	<ul style="list-style-type: none"> <li>Public banks would be consolidated</li> <li>Restructuring will capitalise on existing institution building</li> <li><i>Reallocation of loans is a daunting exercise</i></li> <li><i>High capitalisation requirement</i></li> <li><i>4 bank Merger is very risky and difficult</i></li> </ul>

“Universal Bank of Syria”

This first scenario supposes that the Industrial Bank (IB), the Popular Credit Bank (PCB), the Real Estate Bank (REB) and the Savings Bank (SB) are all merged to become the Universal Bank of Syria.

This would include the following actions:

- To the combined loan portfolios of these four banks (less the NPLs transferred to the DDI) would be added any SME and private sector retail loans of the CBoS, which thereafter would concentrate more specifically on public sector and other large corporate lending.
- Integral to the merger process would be:
  - The restructuring of the new bank, including institution building (which includes establishing “best practice” corporate governance, strategy planning, definition of key objectives, marketing and business development, risk management, and financial accounting and management);
  - Improving efficiency e.g. through consolidation and closure of unnecessary support functions and branches;
  - Harmonising and where appropriate upgrading IT and Management Information Systems;
  - Licensing the bank to undertake foreign exchange operations;
  - Level playing field with private banks.
- Close co-ordination and co-operation with the Ministry of Finance throughout this process would be necessary to ensure that the objectives are clear from the outset in order that the best possible results will be achieved.



**Main Advantages**

- Four of the Public Banks would be consolidated to create a new Universal Bank;
- The new bank should, in time, provide strong competition for the CBoS;
- Clean background as it seeks to establish its reputation and image with the international banking community;
- The number of banks owned by the GoS would be reduced from six to three;
- Restructuring will capitalise on existing institution building.

**Main Disadvantages**

- Consolidation of loan portfolios of four banks is a daunting task;
- A potentially high capitalisation requirement;
- A four-bank merger is a risky and difficult operation because the consolidation process is likely to be highly complex.

**Scenario 2**

Scenario 2			
Bank	Target	Pre-Requisites	Pros & Cons
Industrial Bank Popular Credit Bank Real Estate Bank Savings Bank	Merge to form a Universal Bank with focus on private sector retail banking	<ul style="list-style-type: none"> <li>• Improve efficiency</li> <li>• Harmonise IT/MIS</li> <li>• Upgrade institution building</li> <li>• License for F/X operations</li> <li>• Ensure level playing field</li> </ul>	<ul style="list-style-type: none"> <li>• Strong new bank to compete with CBoS and other private banks</li> <li>• Restructuring will capitalise on the existing institution building</li> <li>• <i>4 bank Merger is very risky and difficult</i></li> </ul>
Establish new Bank	"SME Bank of Syria"	<ul style="list-style-type: none"> <li>• Prepare Articles of Association / Statutes</li> <li>• Prepare institution building (governance, systems, procedures)</li> <li>• Prepare branch strategy</li> <li>• Select key management</li> </ul>	<ul style="list-style-type: none"> <li>• Bank to be professionally established from the outset</li> <li>• Bank to be tailored to SME needs without restructuring requirement.</li> <li>• <i>High capitalisation need</i></li> <li>• <i>Establishing new bank is time consuming and risky</i></li> </ul>

The second scenario supposes a combination of mergers to create a retail market oriented bank, and at the same time the establishment of a new "SME Bank of Syria".

**"Universal Bank of Syria"**

Once again, the IB, the PCB, the REB and the SB are all merged to become a universal bank with a particular focus on private retail banking. This would include the following actions:

- Integral to the merger process would be:





- The restructuring of the new bank, including institution building (as described under scenario 1 above);
  - Improving efficiency e.g. through consolidation and closure of unnecessary support functions and branches;
  - Harmonising and where appropriate upgrading IT and Management Information Systems;
  - Licensing the bank to undertake foreign exchange operations;
  - Level playing field with private banks.
- Close co-ordination and co-operation with the Ministry of Finance throughout this process would be necessary to ensure that the objectives were clear from the outset so that the best possible results were achieved.

## **Main Advantages**

- Four of the Public Banks would be consolidated to create a new Universal Bank with a focus on the private retail sector;
- The new bank would provide strong competition for the CBoS and at the same time would be acceptable to the international banking community;
- Restructuring will capitalise on existing institution building.

## **Main Disadvantages**

- Consolidation of loan portfolios of four banks is a daunting task;
- A potentially high capitalisation requirement;
- A four-bank merger is a potentially risky and difficult operation because the consolidation process is likely to be complex.

## **“SME Bank of Syria”**

At the same time as the four banks are merged to form the “Universal Bank of Syria”, a new “SME Bank of Syria” is established to focus specifically on the smaller and medium enterprise market in Syria. This would require the following actions:

- Promulgation of an Enabling Law (if necessary);
- Preparation of a Feasibility study;
- Issue of full banking Licence including for foreign exchange operations;
- Preparation of Articles of Association / Statutes;
- Appointment of Board of Directors and key management.
- Preparation of a Business Plan (including definition of strategic objectives and pro-forma financial statements and forecasts);
- Recruitment of staff;



- Institution building (which includes establishing “best practice” corporate governance, strategy planning, definition of key objectives, marketing and business development, risk management, and financial accounting and management).
- Licensing the bank to undertake foreign exchange operations.

## Main Advantages

- A professionally managed and focused institution from the outset;
- No restructuring requirements and tailored specifically to SME needs.

## Main Disadvantages

- Time-consuming and risky exercise to establish a new bank;
- Difficult to establish a market niche for itself, with new depositors and new loan customers, in the face of strong competition from other public and private sector banks;
- High capitalisation requirement;
- Difficult to find suitably qualified personnel.

## Scenario 3

Scenario 3			
Bank	Target	Pre-Requisites	Pros & Cons
Industrial Bank Real Estate Bank Savings Bank	Merge to form a Universal Bank	<ul style="list-style-type: none"> <li>• Improve efficiency</li> <li>• Harmonise IT/MIS</li> <li>• Upgrade institution building</li> <li>• License for F/X operations</li> <li>• Ensure level playing field</li> </ul>	<ul style="list-style-type: none"> <li>• Acceptably strong new bank to compete with CBoS and other private banks</li> <li>• Restructuring will capitalise on the existing institution building</li> <li>• <i>3 bank merger risky but less than 4</i></li> </ul>
Popular Credit Bank	Transform to an "SME Bank of Syria"	<ul style="list-style-type: none"> <li>• Improve efficiency</li> <li>• Reform institution building and downgrade to focus on SMEs</li> <li>• Modernise IT/MIS</li> </ul>	<ul style="list-style-type: none"> <li>• Restructuring will capitalise on the existing institution building</li> <li>• <i>Capitalisation requirement to compensate NPL transfer to DDI</i></li> </ul>

This scenario supposes a combination of mergers to create a second universal bank (alongside CBoS), and at the same time the transformation of the PCB into the “SME Bank of Syria”.

### “Universal Bank of Syria”

Here the IB, the REB and the SB are all merged to become a Universal Bank. This would include the following actions:

- Integral to the merger process would be:



- The restructuring of the new bank, including institution building (as described above);
- Improving efficiency e.g. through consolidation and closure of unnecessary support functions and branches;
- Harmonising and where appropriate upgrading IT and Management Information Systems;
- Licensing the bank to undertake foreign exchange operations;
- Level playing field with private banks.

## **Main Advantages**

- Creation of an acceptably strong new bank to compete with CBoS and other private banks;
- Clean background as it seeks to establish its reputation and image with the international banking community;
- Reduction from six to four Public Banks;
- Restructuring will capitalise on the existing institution building.

## **Main Disadvantages**

- A three bank merger carries risks, but less so than a four bank merger.
- The merger and consolidation process is likely to be complex and time consuming.

## **“SME Bank of Syria”**

At the same time as the three banks are merged into a new universal bank, the Popular Credit Bank is transformed into a specialised new “SME Bank of Syria” (see definition of SME Bank in Chapter 6.4.1). to focus specifically on the SME market in Syria. This would be in addition to the existing relationships and activities that the other banks maintain banks with the SME sector rather than in substitution of such relationships and activities.

- Integral to the transformation process would be:
  - The reformation and re-alignment of the new bank to focus on SMEs;
  - Institution building (as described under “SME Bank of Syria” above);
  - Improving administrative efficiency;
  - Where appropriate upgrading IT and Management Information Systems
  - Licensing the bank to undertake foreign exchange operations;
  - Level playing field with private banks.



**Main Advantages**

- An institution dedicated to SME interests;
- PCB currently has a loan portfolio dedicated to individuals and small business;
- The bank has a good network of branches though which to provide services to micro and SMEs; The bank has a good deposit base;
- Restructuring will capitalise on existing institution building.

**Main Disadvantages**

- A Potentially high capitalisation requirement may be needed to compensate for NPL transfer to DDI.
- Currently a very large number of limited income loans.

**Scenario 4**

Scenario 4			
Bank	Target	Pre-Requisites	Pros & Cons
Industrial Bank Popular Credit Bank	Merge to form an "SME Bank of Syria"	<ul style="list-style-type: none"> <li>• Improve efficiency</li> <li>• Reform institution</li> <li>• Downgrade to SME</li> <li>• Modernise IT/MIS</li> </ul>	<ul style="list-style-type: none"> <li>• Restructuring will capitalise on the existing institution building</li> <li>• Fairly large bank for SME promotion</li> <li>• <i>Capitalisation requirement to compensate NPL transfer but less than Scenario 2 (S. 2.) above.</i></li> </ul>
Real Estate Bank Savings Bank	Merge to form a Universal Bank	<ul style="list-style-type: none"> <li>• Improve efficiency</li> <li>• Harmonise IT/MIS</li> <li>• Enhance institutional capacity</li> <li>• License for F/X operations</li> <li>• Ensure level playing field</li> </ul>	<ul style="list-style-type: none"> <li>• New bank to diversify the bank sector</li> <li>• Liquidity shortage of REB offset by liquidity surplus of SB</li> <li>• Comparatively low restructuring requirement of REB</li> <li>• <i>Rather small asset base</i></li> </ul>

This scenario supposes a combination of mergers to create a second smaller universal bank and at the same time the transformation of the IB and the PCB into an "SME Bank of Syria".

**"Universal Bank of Syria"**

Here the REB and the SB are merged to become a Universal Bank. This would include the following actions:

- Integral to the merger process would be:



- The restructuring of the new bank, including institution building (as described above);
- Improving efficiency e.g. through consolidation and closure of unnecessary support functions and branches;
- Harmonising and where appropriate upgrading IT and Management Information Systems;
- Licensing the bank to undertake foreign exchange operations;
- Level playing field with private banks.

## **Main Advantages**

- Diversification of banking sector to create a second universal bank to compete with CBoS and other private banks;
- Clean background as it seeks to establish its reputation and image with the international banking community;
- Reduction from six to four Public Banks;
- REB's mismatch positions offset by SB's large and stable deposit base;
- Restructuring will capitalise on the existing institution building.

## **Main Disadvantages**

- The bank would have a relatively modest asset base.

## **“SME Bank of Syria”**

At the same time as the REB and SB are merged, the IB and PB are merged to form a new “SME Bank of Syria” to focus specifically on the SME market in Syria. Here again, this would be in addition to the existing relationships and activities of the other banks with the SME sector rather than in substitution of such relationships and activities.

- Integral to the transformation process would be:
  - The reform and re-alignment of the new bank to focus on SMEs;
  - Institution building (as described above);
  - Improving administrative efficiency;
  - Where appropriate upgrading of IT and Management Information Systems;
  - Licensing the bank to undertake foreign exchange operations.
  - Level playing field with private banks.

## **Main Advantages**

- An institution dedicated to SME interests;
- Good sized bank for SME promotion;



- Restructuring will capitalise on existing institution building.

## **Main Disadvantages**

- Dubious logic to combining these two banks given the nature of the portfolio and business of the IB;
- Possibly high re-capitalisation requirement to compensate for NPL transfer to DDI and relatively low capitalisation of the PCB;
- A complex and risky consolidation process.

## **Implications of Restructuring**

The BAI Team's diagnosis of the seven<sup>30</sup> public institutions (Chapter 4 and Annex 2) fully supports the Government's concerns relating to their weak institutional, operating and financial condition. The necessity for a profound restructuring of the Public Banks is obvious.

Concerning the financial health of each institution, the BAI Team has made its comments based upon the information provided during the reviews of each bank. However, it has not been possible to verify the accuracy of this information, particularly in so far as it relates to the status of the loan portfolios of the individual banks for which indeed little useful or usable information was provided. Only detailed assessments of the loan portfolios of the individual banks can identify the true nature and seriousness of their problems.

In general, improving governance, strategy and accounting practices are amongst the key steps in a best practice oriented restructuring process. An overall institutional development approach will allow the Phase 2 BAI Team to tackle a number of issues related to the merger and restructuring of the Public Banks simultaneously, building upon the groundwork undertaken in the Feasibility Study of Phase 1.

The evolutionary process, aiming at Public Bank restructuring, through which the Phase 2 BAI Team would pass, is found in section 7.1.1. It presents an initial overview of the methodology that the Phase 2 BAI Team would use to accomplish the first step in the merger and restructuring process. This then would be validated by the Inception Report that the Phase 2 BAI Team will produce, prior to beginning its implementation. Some of the key issues that will be addressed, both during the merger process and following on from it during the course of the restructuring, are described below.

## **Corporate Governance**

The GoS has informed the BAI Team that it supports transitioning the current opaque organisational structure presently found in the Public Banks into one which would completely reflect current best practice. The first and foremost step in that process is to install good governance in any merged institution by establishing a clear distinction

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<sup>30</sup> This includes the ACU since a diagnosis of this institution was carried out alongside that of the six Public Banks.



between the rights of shareholders and the responsibilities of Boards of Directors, and secondly, the precise definition of the respective roles of Boards and management. The former is responsible for defining the bank's policy and strategic direction, the latter for the day-to-day management of the bank including implementing the strategic direction set by the Board whilst at the same time being mindful of the stated policies.

The general outline of this work will be more fully laid out in Chapter 7 below. Briefly, the work proposed would entail writing the charters (Articles of Association and Statutes) of any new and/or merged bank. This will include, in particular, the definition of and distinction between the roles and responsibilities of the three principle governance bodies of a bank: the General Assembly, the Board of Directors and the Management Board. Independent members of the Board(s) of Directors, with profound banking experience, would need to be appointed, and senior professional bank management contracted.

The newly constituted Board(s) of Directors would then represent their Banks before the General Assembly. Each Board would set the strategy for the Bank but would delegate the day-to-day operations to a Management Board. The tasks of the Management Board, including its positive and negative covenants, will need to be carefully designed. The Management Board will be made fully accountable for its performance and will be furnished with all powers necessary for properly assuming its responsibility.

## **Further Issues**

Following on from a complete review and overhaul of Corporate Governance, the BAI Team would address a number of further key issues in the following order:

- Bank Strategy,
- Business Development (New Products),
- Marketing and developing an image for the Bank,
- Risk Management,
- Financial Management & Accounting,
- IT / MIS.
- There is general consensus on the necessity to accelerate private sector-led economic growth. The Demand Study has demonstrated how under-served, in terms of financial products, Syrian enterprises are. Only a modernised financial sector, of which banking is the dominant part, can meet these needs rapidly.

The Government has started to deal with the first two already, even if only indirectly, by implementing economic and financial reforms. Thus, the importance, and the capacity of public officials to dictate lending will lessen as the restructuring process gathers pace.



The last bullet point is of particular concern. Public Bank employees' salary and benefits support many dependants. As a consequence, and fully appreciating the long and loyal service that many public sector employees have provided the Government, whichever, if any, of the scenarios outlined above is chosen by the GoS and EIB, it must be implemented with the aim of institutional up-grading, tempered by concern for the human and social costs.

Although this issue will need to be addressed directly in Phase 2, the BAI Team believes that normally, risk-mitigation approaches would have a logical place in this Phase 1 Report. It is, however, too early in this long restructuring process to present detailed solutions aimed at mitigating the effects of redundancies. However, this is a task that Bankakademie International would wish to carry out together with the relevant Ministry officials when the numbers of employees, who are likely to be affected, have been estimated.

## **Pre-requisites**

### **On Political Level**

- GoS preparedness to continue its financial sector reform initiative, complemented by upgrading its legal, taxation and regulatory framework in order to establish a level playing field for competition between all public and private banks and other financial institutions.

### **On Legal / Regulatory Level**

- GoS willingness to amend or pass laws necessary to permit the merger and restructuring of the Public Banks. The BAI Team has not studied the legal issues related to the legality of creating a Difficult Debt Institution (see Chapter 6.2);
- GoS willingness to undertake the difficult institutional reforms proposed so that Syrian enterprises are able to obtain the financing and support they need to become the engines of rapid economic growth;
- Introduction of International Accounting Standards to become mandatory for all banks in the public and private sectors as well as for all public sector enterprises. As far as the banks are concerned, this requires promulgation of the law that is currently being drafted. For public sector enterprises, this may require amendment to the Commercial Law.
- Introduction of Unified Chart of Accounts, of which a version already exists in the Central Bank, but allegedly, has so far not been supported by the Public Banks. A unified chart of accounts is vital for effective monitoring by the Central Bank and so should not be an issue for debate.





## On Institutional Level

GoS withdrawal of direct budget support and subsidised loans to loss-making state enterprises (banks and others) by the time that the 2007 budget is prepared;

GoS commitment to establish a DDI to work out all NPLs transferred from the Public Banks;

- GoS preparedness to accept high levels of provisioning and write-offs that may be recommended;
- The transfer of selected NPLs from the Banks to the Difficult Debt Institution<sup>31</sup>;
- GoS willingness to capitalise the new and/or restructured banks to a level at least commensurate with Basle 1 requirements;

## On Governance Level

- The undertaking of the GoS, including all relevant Ministries and Public Authorities (other than regulatory and bank supervisory authorities), to withdraw from all day-to-day direction of or interference in the operations of these institutions. This should be reflected in the Charters of the new and/or restructured banks, and if necessary, in the Banking Law.
- The responsibilities and tasks of the Boards of Directors of the new and/or restructured banks will need to conform to best practice criteria;
- New Board members, with required skills and experience, will need to be appointed whilst many of the existing board members will need to be released;
- GoS willingness to make redundant existing Public Bank staff, which do not or cannot meet the required operational and service levels, even after training;

By way of caution, it is noted that opposition to the reform process may arise because:

- Politicians may believe that their ability to determine the pace of development is curtailed by being unable to influence the direction of lending;
- Government Officials may lose their power to “micro-manage” or influence decisions; and
- Employees working in the public enterprises and banks may lose security of employment.

## Conclusion

The GoS has determined that a restructuring of the public banking sector, through a possible merger of existing Public Banks, has become a desirable objective given the financial sector transformation that is currently taking place in Syria. At the same

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<sup>31</sup> The concept of the Difficult Debt Institution is discussed below.



time, with due concern for the large number of small and medium enterprises that characterise the Syrian business community, the GoS has expressed a particular interest in the creation of a bank which is dedicated to their interests and to servicing their particular financial needs.

As is well known, many individuals borrow in their own name in Syria and use the funds to finance micro and small businesses. Both the PCB and the REB have borrowers who fall into this category, so in fact either bank could form the building block for a new SME Bank, if that is what the GoS wants. However, Scenario 3 above proposes that the PCB be transformed for this purpose, primarily because the BAI Team believe that in the overall scheme of this particular scenario, the SB's large and stable deposit base would be better used to support the long-term lending of the REB than that of the PCB.

The Team also believes that in the creation of a new universal bank, the relatively straightforward business of the SB would be easier to merge with the other two Banks (IB and REB) than that of the PCB, which has a loan portfolio that includes a large number of limited income loans, the quality and collectibility of which may be uncertain. Furthermore, the PCB's orientation towards individuals and small business may better suit it for transformation into an SME Bank.

The scenarios outlined above provide a range of different alternatives each of which in its own way addresses a specific objective. Clearly, there are other combinations which could be proposed and which may have particular appeal for the GoS. At the end of the day, however, only the GoS, in combination with the EIB, can determine what merger scenario they wish to adopt. This decision is likely to be based on a number of different factors that will include:

- ***The economic impact of the merger:*** in other words, the level of growth stimulus created by the merger;
- ***Recapitalisation impact:*** clearly the lower the level of recapitalisation required, the lower the potential cost of the merger to the GoS;
- ***Branch network synergy:*** a merger of banks that provides the greatest outreach with the least number of branch closures will have particular appeal.

The merger scenario chosen may also be influenced by the outcome of the assessments of the loan portfolios of the individual banks. Finally, there may also be considerations of a political or other nature of which the BAI Team is unaware.

Whichever scenario is ultimately chosen, all are technically feasible, some are more complex and time-consuming than others, all require the whole-hearted support of the GoS, which includes major changes to the legal, environmental and regulatory framework, all carry considerable risks, some again more than others.



## **6 Options for new financial institutions / products**

### **6.1 Overview**

Apart from the BAI Team's preferred option for the merger and restructuring of the Existing Public Banks (see Chapter 5), it has examined a number of other types of financial institution and products with a view to their establishment or introduction in Syria. Each one is described in some detail. This includes, in most cases a definition of what the institution or product is; how it works; the positive and negative arguments associated with it; applicability to Syria; some of the more important prerequisites if they are to be introduced in Syria, and the BAI Team's recommendation. Finally, where the recommendation is to proceed, if applicable, some of the more important implementation implications are suggested.

The BAI Team believes in the importance of all of these options and thus presents them for consideration by the Syrian Government and EIB. Some could be put into place in the relatively short-term, some over a medium or longer-term time-scale, and some perhaps never to be implemented either during a Phase 2 or even an eventual Phase 3.

Both the GoS and the EIB need to assess some of these options as promotional tools to attract both domestic and foreign investment, and specifically to facilitate needed foreign investment in export orientated ventures in Syria. Others, such as a Difficult Debt Institution, proposed to help resolve a potential bad debt problem in some, if not in all of the Public Banks, or the establishment of a Syrian SME Bank, or the regulation and introduction of Islamic Banking, or the introduction of Leasing, have a more specific purpose. In all cases, however, they are the kinds of institutions and products that are successfully established throughout the world, including in many less developed economies, such as Syria's. To this end, they are commended to the GoS and EIB for consideration.

### **6.2 Difficult Debt Institution**

#### **6.2.1 Description**

One possibility that the Syrian Government might wish to consider for dealing with the problem of impaired assets in the Public Banks is to set up a "Doubtful Debt Institution (DDI)" – or Asset Management Company (AMC), as such institutions are more commonly known.



Asset Management Companies<sup>32</sup> have been extensively used over recent decades by governments in a number of countries<sup>33</sup>, which have suffered from either systemic or individual bank crises. They may be set up for a number of different reasons, depending very much on individual circumstances. These may include the resolution of insolvent and non-viable financial institutions, the restructuring of distressed but viable banks, the disposal and management of impaired assets, and even the privatisation of government-owned and government-intervened banks.

In any bank crisis, the cause of the problem will often, if not usually, lie in the volume of Non-Performing Loans (NPLs) on bank balance sheets. This may be caused either through poor or reckless lending policies and decisions on the part of the banks, or as a result of weakening economic conditions, which lead to corporate difficulties and failures, or perhaps a combination of both. This is certainly not unusual in developing or transformation economies where corporate governance in banks may be weak, and the necessary skills for effective loan appraisal and administration have simply not been properly assimilated.

Loan workouts are, of course, a normal function within any banking business. However, when the scale of the problem is such as to impair the viability of an individual bank, or attains systemic proportions, the setting up of one or more DDIs may become necessary or inevitable. This can, furthermore, be an institutionally efficient manner of ensuring that corporate restructuring takes place as well.

Generally, the circumstances will determine whether a “stock” solution or a “flow” solution is applied to resolve the banking problem. Where the problem is systemic, requiring perhaps the closure of unviable banks, the disposal and management of impaired assets and/or the restructuring of viable banks, a “stock” solution may be necessary. This is designed explicitly to address the stock (volume and amount) of bad debts in the banking system.

Where the problem is not systemic and where banks remain viable institutions, regardless of a significant but manageable level of NPLs, a “flow” solution may be preferred. This will usually allow banks to continue operating normally, regenerating capital through the retention of earnings and addressing the question of NPLs through a normal loan workout approach. If the NPL problem is sufficiently serious, a separate subsidiary of the bank may be established to act as a DDI into which the portfolio of impaired assets will be transferred.

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<sup>32</sup> This paper draws on “The Use of Asset Management Companies in the Resolution of Banking Crises – Cross-Country Experiences”, Daniela Klingebiel (World Bank), and IMF Policy Discussion Paper “Issues in the Establishment of Asset Management Companies”, Stefan Ingves, Stephen A. Seelig, Dong He.

<sup>33</sup> E.g. East Asian Financial Crisis 1999, Mexico 1995, Finland 1993, Sweden 1992, USA – Resolution Trust 1989, etc.



## **Ownership Structure**

When it comes to setting up DDIs, there are two alternative ownership structures that may be followed. There is the decentralised approach whereby debt restructuring and workout are done by the banks themselves. In this case, DDIs may be public or private; for example, they may be set up as subsidiaries of both public and private banks to manage the workout process on the bank's own NPLs; or they may be privately owned independent companies.

Alternatively, there is the centralised approach whereby bad debts are transferred to a centralised, publicly owned DDI charged with resolving the overhang of impaired assets. If publicly owned, a DDI may be either a free-standing entity or part of an existing government agency. For preference, however, it should not be set up either within the Central Bank, or as its subsidiary, since the balance sheet of the Central Bank should not be cluttered with large amounts of non-performing loans (public or private) of the banking system.

## **The Decentralised Approach**

In theory, banks should be better placed to work out their own problem loans because they know the customer and the history of the loan. Supposedly they also have the trained staff with the necessary skills to manage the recovery process. In addition, they also have the incentive of maximising the value of recoveries, and from the recovery experience, they should improve their loan approval and monitoring processes to prevent the recurrence of future problems. Furthermore, there is the advantage that the bank can extend further loans to the borrower, if these can be justified as an integral part of the recovery process.

An alternative would be the establishment of a separately capitalised subsidiary of the bank into which NPLs would be transferred. This route would be chosen where the scale of the problem was more serious and required a dedicated team of experts. The advantage of this would be to concentrate exclusively on the workout and/or recovery of the impaired assets, maximising focus on the recovery process and minimising the distraction of senior management from the day-to-day running of the on-going bank.

## **The Centralised Approach (Preferred Model):**

This approach has the advantage of consolidating workout skills and information technology within one agency, applying uniform workout practices, and increasing the possibility of maximising the value of recoveries through more efficient use of resources. It concentrates the ownership of collateral, thus providing potentially more leverage over debtors, while permitting more effective management of the entire process.

Moreover, NPLs are removed quickly and completely from banks, allowing them in turn to focus on their day-to-day activities. This approach may also be a particular advantage in the case of connected lending since it breaks links between banks and



corporates, thus improving the chances of recovery. Finally, a centralised agency can be given special legal powers to expedite loan recovery and bank restructuring.

However, a centralised workout unit may face problems of its own related to its size and ownership structure. It may be difficult to insulate it from political pressure, particularly where the non-performing borrowers are public sector enterprises or politically connected individuals. Additionally, if DDI assets are not actively managed, the existence of a public DDI could lead to a general weakening of credit discipline in the financial system and lead to a further deterioration of asset values.

## **Types of Difficult Debt Institutions**

If DDIs are to operate effectively, they must have clearly defined goals and objectives. These will differ from country to country and will be tailored to meet the prevailing circumstances and the specific requirements of individual governments.

Some will look to the (relatively) quick disposal of the assets acquired / transferred and will, therefore, set up rapid asset disposition vehicles. These structures will have the purpose of selling assets to the private sector as quickly as possible, so as to avoid further deterioration in value, and to minimise the carrying cost to the government. These will tend to be assets of a more liquid nature such as real estate assets, commercial real estate loans, and secured loans that can be easily sold off or securitised, assuming the existence of a broadly based capital market. For this, the DDI has need of good information about the asset it is trying to sell as well as the assurance that a market exists for such assets.

An alternative is to set up a restructuring vehicle whose objective is to restructure the NPLs through debt rescheduling or debt / equity swaps, with a view to recovering part or all of the impaired assets, or rendering them more marketable. As above, a sale will only be achieved if there is a market for such assets. A further alternative is to set up a longer-term restructuring vehicle with the specific objective of achieving a broader restructuring of corporate borrowers and Public Banks. This will normally involve separating assets into those that are viable and those that are not. In the latter case, non-viable borrowers will be forced into bankruptcy.

Regardless of their focus, all DDIs should be guided by the principle of profit maximisation or loss minimisation. Those that have well-defined goals and clear objectives are much more likely to be successful.

## 6.2.2 Positive and Negative Arguments

### Advantages and Disadvantages of a Decentralised DDI

	Within Banks	Within a private DDI
<b>Advantages</b>	<ul style="list-style-type: none"> <li>• Knowledge of the borrower may facilitate debt restructuring.</li> <li>• Access to borrower through branch network.</li> </ul>	<ul style="list-style-type: none"> <li>• Specialised skill mix.</li> <li>• Focus on restructuring function.</li> <li>• Creation of an asset management industry and secondary market for distressed assets</li> <li>• Up-front loss recognition. Cleans up the bank's books.</li> </ul>
<b>Disadvantages</b>	<ul style="list-style-type: none"> <li>• Lack of skills for restructuring of troubled debt, operations of companies, debt/equity swaps, etc.</li> <li>• Hampers "normal" banking functions (lending activities), particularly if the NPL portfolio is large.</li> <li>• Less up-front loss recognition. Does not clean up the bank's books.</li> <li>• May be problems of conflicts of interest with the parent bank as well as governance issues.</li> </ul>	<ul style="list-style-type: none"> <li>• Lack of knowledge of the borrower.</li> <li>• Bank may not have sufficient capital to recognise up-front losses associated with selling to a DDI.</li> </ul>

### Advantages and Disadvantages of a Centralised Public DDI

#### Advantages:

- Serves as a vehicle for getting NPLs out of troubled banks, based on uniform valuation criteria.
- Allows the government to attach conditions to purchases of NPLs in terms of bank restructuring.
- Achieves economies of scale through consolidation of scarce work out skills and resources within one agency.
- Centralises ownership of collateral, thus providing more leverage over debtors and more effective management.
- Allows the application of uniform workout practices.
- Breaks links between banks and corporates; thus could potentially improve the collectibility of loans.
- Can better force operational restructuring of troubled banks.
- Can be given special legal powers to expedite loan recovery and bank restructuring.



- Can help with the securitisation of assets as it has a larger pool of assets.
- Allows banks to focus on core business.
- Improves prospects for orderly sectoral restructuring of economy.

## **Disadvantages:**

- Has Management that is often weaker than in private structures, reducing the efficiency and effectiveness of its operations.
- Might be difficult to insulate a public agency against political pressure especially if it carries a large portion of banking system assets.
- Values of acquired assets erode faster when they are outside a banking structure.
- NPLs and collateral are often long-term “parked” in a DDI, not liquidated.
- If assets transferred to a public DDI are not actively managed, it could lead to a general deterioration of credit discipline, payment discipline in the financial system and further deterioration of asset values.
- Costs involved in operating a DDI may be higher than a private arrangement.
- May have difficulty, if dealing with private banks, in determining transfer prices.
- Lack of borrowers’ credit histories may place DDIs at a disadvantage to banks which have this information.
- Leaving loans in banks may provide better incentives for recovery, and for avoiding future losses by improving loan approval and monitoring procedures.
- Banks can provide additional financing which may be necessary in the restructuring process. DDIs may not have this facility.

## **Lesson learned from other countries**

Analysing the different approaches to the settlement of NPL of the national banking system, three alternative approaches can be identified. A Government may pursue a centralised approach setting up an institution for solving this problem. Alternatively, the Government may leave the problem to the local and/or international market (banks, funds and corporates acting as investors), thus decentralising the settlement of Non-Performing loans. Finally, a mixture of both, the centralised and the market approach, can be pursued.

The application of either approach depends on the nature and the size of the Non-Performing-Loans problem. If the Non-Performing Loans not only include bank loans, but also commercial debt of companies, like for example in Poland in the early 1990s, the decentralised (market) approach should be applied. If the Non-Performing Loans are limited to bank loans, like for example in the Czech Republic, also in the early 1990s, a centralised approach could be employed. However, Hungary applied a mixture of both.





Based on the available information about the nature and size of the Non-Performing-Loan problem in Syria, we assume that only the Non-Performing-Loans of banks should be restructured. Consequently, the commercial indebtedness of Syrian companies, if any, would not be included as part of the Non-Performing-Loans problem.

## 6.2.3 Pre-requisites

- Whichever solution is chosen – decentralised or centralised – a legal framework that facilitates the workout is a key element in influencing the final costs of bank restructuring. In order effectively to perform the task of managing and recovering NPLs, it is essential that the DDI has clear title to the acquired asset, no obligation to seek the borrower's consent to the sale of assets, and appropriate powers to act in the best interests of recovery.
- An effective judicial and insolvency system and properly functioning legal procedures are crucial. Where this is not the case, it may be necessary to grant special legal powers to the DDI to facilitate asset recovery and restructuring. But if this is done, it is important to safeguard against abuse of these special powers, which could lead to loss of credibility in the DDI and a weakening of legal due process.
- Equally important are laws that facilitate actions by the banks or DDIs to exercise claims on assets and to recover the proceeds of sales of such assets if debt is not serviced. Legal protection for the employees of public DDIs, in the execution of their responsibilities in good faith, should also be considered.
- Particularly in the case of public DDIs, the issue of governance is crucial to ensure independence, especially from political pressure and interference, accountability and transparency. It is easier to achieve this through a separately constituted entity that is shielded, for example, from the budgetary process, by ensuring that its operating expenses are financed from within its own balance sheet.
- It should have its own independent Board of Directors, which should include a majority of outside representatives from both the public and private sectors. The Board must have a clear mandate to establish policies and procedures and to set performance objectives. Furthermore, to ensure transparency, the DDI should be subject to internationally accepted accounting practices, publish reports at regular intervals and be subject to independent audit.
- Most of these same criteria will apply to DDIs set up as subsidiaries of Public Banks, and indeed to private sector DDIs.
- To operate effectively, a DDI must be able to attract and retain Directors, Senior Management, and staff with appropriate skills and experience to be able to maximise recovery of assets or to minimise losses. Given the fact that a DDI operates, to all intents and purposes, as a commercial enterprise, and will



normally have a finite term, it is also important to be able to incentivate staff with good salaries and performance related bonuses. These should not be related to civil service pay scales. Rather, they should be set to the levels of reward that such individuals would expect to receive in the private sector, from which perhaps a number of them will be drawn.

- One of the first issues to be examined by a DDI is what assets it will buy from which banks. Strict criteria should be applied to the selection process. For example, it may be preferable to leave loans, whose obligors are customers with which the bank would like to continue to maintain a long-term relationship, within the bank; equally those smaller credits, which the bank may be better placed to recover than a DDI.
- An important consideration will be the need to ensure a level playing field in terms of competitiveness between banks – that is not favouring one or more banks to the detriment of others. One way of achieving this is to leave an equal proportion of bad loans in all of the banks, a compromise adopted by Sweden. Such a method might be adopted in Syria, too, where the ratio of bad loans to total loans, and more specifically to capital and reserves differs markedly between the Public Banks.
- In all cases of asset transfer between bank and DDI, care needs to be taken to ensure that losses are recognised at the bank level, prior to transfer of the impaired assets, and that the transfer between bank and DDI, or bank and subsidiary (in the case of a decentralised solution), is made at fair-market value (i.e. at written down value) and not at book or higher than market value. This needs appropriate supervision and disclosure, sound accounting procedures and practices, and independent control to avoid any possibility of “window dressing” to the benefit of the bank.
- Equally crucial is the question of funding for the DDI. Firstly, it must be endowed with sufficient funding to enable it to purchase the impaired assets from the banks at written down value. Secondly, it must be able to generate sufficient income from its own balance sheet to enable it to cover its operating costs independently of the National Budget or any government appropriation.
- In the case of government-owned DDIs, this is often achieved through the issue of government bonds or through the DDI issuing its own government-backed bonds with the proviso that any losses sustained by the DDI will be borne by the National Budget. The bonds that are issued to fund the DDI should have maturities that are commensurate with the legal life of the DDI as well as in line with reasonable expectations, about its cash flow generation capabilities.



## 6.2.4 Recommendations

An assessment of the Public Banks in Syria, (that is without the benefit of a detailed assessment of their individual loan portfolios), suggests that the bad debt problem cannot be categorised as systemic, although in at least one of the banks, it may be sufficiently serious to cast doubt on its solvency. This being the case, the GoS has the choice of leaving the Public Banks to sort out their own bad debt problems, of setting up a centralised DDI, or of adopting a solution that combines these two. The attraction of this latter approach is that not all of the banks appear to have serious bad debt problems.

The Popular Credit Bank appears to have a relatively modest level of bad debts, but at the same time it is poorly capitalised. Only the Industrial Bank appears to have NPLs that significantly exceed its share capital and reserves. However, only full and complete assessments will enable the Government to determine, with any degree of certainty, the real extent of each bank's bad loan problems.

None of this should have an effect on the decision to set up a Difficult Debt Institution; indeed this might be an ideal means of helping to resolve the bad debt problem in the Public Banks, and at the same time to facilitate and accelerate the process of their rehabilitation.

Accordingly, the following recommendations are made:

- The Syrian Government should consider setting up a Difficult Debt Institution (DDI) – into which selected NPLs from the six Public Banks should be transferred for workout and eventual recovery.
- The DDI should be a “centralised,” government-owned, but independently constituted entity, and not a unit within either the Central Bank or any Government Ministry.
- The decision to set up the DDI may be deferred until such time as a detailed assessment of the loan portfolios of all the Public Banks has been conducted. Only then will the true nature and full extent of the bad debt problem in the individual banks be known, which in turn will determine the specific role of the DDI.
- If established, the DDI should be legally constituted, (it may be necessary to pass an enabling law), have its own charter and an independent Board of Directors, best practice corporate governance, clearly defined policies and objectives, targets and goals set by the Board, transparency in its accounting and reporting, and be subject to independent audit.
- It must be adequately capitalised (at least in accordance with Basle 1 standards) and funded.



- To fulfil this recommendation, it should authorise an issue of special purpose bonds, with maturities to match the expected life of the DDI. They should be sufficient to provide adequate capital to meet the estimated running costs of the entity and funding to cover the acquisition cost of the selected NPLs from the Public Banks..
- Careful consideration will need to be given as to whether all NPLs from all of the Public Banks should be transferred to the DDI, or whether some of the NPLs should remain in the banks. In order to make a reasoned choice, criteria should be established to arrive at this judgement. Initially, it is recommended that a proportion of impaired assets be left with the Public Banks, firstly, because in certain cases they may be better placed to effect recoveries, and secondly, to lighten the funding burden on the DDI, and ultimately on the Government.
- If NPLs are to remain in the banks, a decision will need to be taken as to whether these will be transferred to a separately established subsidiary of the bank or will remain in a separate Recovery Unit within the bank.
- Prior to the transfer of an impaired asset, be it to the DDI, to a subsidiary of the relevant bank, or to a Recovery Unit within the bank, adequate provisioning will need to be made for all impaired loans in all of the Public Banks in accordance with the recommendations of the portfolio assessment.
- All transfers of NPLs to the DDI, subsidiary, or Recovery Unit should be effected at their written down value, as determined by the independent assessment.
- Careful consideration will need to be given to the DDI's staffing requirements to ensure that all personnel have the necessary qualifications and skills to perform the workout and recovery tasks. If they cannot be recruited, the best candidates will receive training in order that they develop skills to undertake their job responsibilities. The Bank Sector Support II Project should be able to provide this kind of training, if required.
- All DDI personnel should be paid adequate salaries and be incentivated with performance related bonuses.



## 6.2.5 Implementation Implications

There will be wide-ranging implementation implications if a decision to set up the DDI is taken. Many of these have already been set out above in the section on Pre-Requisites and in these recommendations themselves.

If the recommendation to set up a DDI finds merit with the GoS, even though this may not be formalised until the audit of the loan portfolios of the Public Banks has taken place, much of the preliminary planning can be initiated well before then to accelerate the implementation process when a decision is taken.

## 6.3 Export Credit Insurance

### 6.3.1 Description

Export credit insurance is a specialist area combining insurance and export promotion, which although it has been in existence for some 85 years, is not generally well understood.

Often bankers are dismissive of the service because it competes, to some extent, with traditional banking products, such as letters of credit. In addition, some development economists are not keen on the service because they consider that it distorts comparative advantage.

Notwithstanding the general lack of knowledge and such adverse views, export credit insurance services, if properly set up, can be vital to export success, especially for smaller enterprises.

Export credit insurance was started after the First World War by the British Government when it realised that the Nation's exporters could not sell their products, even though they were in demand, because the War and its aftermath had all but bankrupted their foreign customers. By insuring their exporters against the risk of non-payment, the Government enabled its exporters to offer credit to their buyers with the confidence that they would be paid, either by the buyer or the insurer. For the buyer, the credit terms often enabled them to manufacture goods and to sell them before having to pay the exporter.

At the same time, the exporter could use the insurance policy as a form of collateral to obtain bank finance until paid by the foreign buyer or by the insurer. Very quickly other governments set up their own export credit insurance agencies likewise to support their exporters.

Initially, governments thought that the need for export credit insurance would be temporary. However, export credit insurance has continued to be of great value in maintaining trade, opening up new markets and assisting new entrepreneurs to start their businesses through the supply of capital equipment and materials on credit.



Critics of export credit insurance have always pointed to the potential to distort trade and to enable those from richer countries to compete unfairly against those from poorer countries, whose governments have not been able to afford to establish export credit insurance agencies.

Notwithstanding such criticisms, in most developing countries, and in many developed countries, the private sector exporters are often SMEs and their customers are either large enterprises or SMEs, like themselves. Large firms usually expect credit because they receive it from other large enterprises and will often take credit from small-scale suppliers no matter whether it is offered or not.

Moreover, larger firms tend to be less willing to issue letters of credit, largely because they see them as an unnecessary cost. This denies small exporters the opportunity of using the Letter of Credit (LC) as a means of obtaining finance from their bank.

SMEs almost always value the offer of credit terms highly, especially if they are expanding, because they often lack the track record and collateral required by banks to obtain working capital. From larger firms they can usually receive credit, but this means that potential SME suppliers are unable to compete unless they also offer credit terms.

Critics also cite the fact that only a small proportion of trade is covered by export credit insurance. Part of the reason for this is that so much of international trade is carried out by multinational companies supplying their own subsidiaries abroad. These companies do not use export credit insurance, but they often do use domestic credit insurance in the country of destination. Nowadays, most export credit insurers also offer domestic credit insurance and vice-versa.

A final criticism is that, even where the government has established an export credit insurance agency, it is not much used. This is often true, but government agencies world-wide are notoriously poor at marketing, quick responses, and at providing customer support. Marketing is vital, because many entrepreneurs have little or no knowledge of export credit insurance, nor know how to use it as part of their marketing pitch to potential buyers abroad. At the same time, when a buyer approaches an exporter, it is vital that the insurer provide a quick response as to whether or not it is willing to accept the insurance risk on the buyer.

Finally, if the exporter is unsure of how best to introduce export credit into his negotiations, he may need support during those negotiations with the buyer in order to ensure that the contractual arrangements are insurable. Where there is good marketing and support, export credit insurance is usually well used.

Over the years, world trade has increased greatly and the knowledge of national buyers has likewise grown. This increase in knowledge has enabled private sector insurers to enter the market in competition with governments. Sometimes, governments have seen their export credit insurance agencies as candidates for privatisation. In the EU, private sector insurers now exclusively undertake export credit insurance contracts relating to OECD buyers and for terms of less than two



years. However, most private insurers will also provide cover to a far wider range of countries than just the OECD, and for tenors far longer than two years.

Nevertheless, recently the EU Commission has been contemplating permitting the state owned insurers once again to provide export credit insurance to the smallest exporters whose business may be of little or no interest to the private insurers.

**Experiences of Other Countries:** An example of where the structure between the government, the export credit insurance agency and the banks seems to work well and export credit insurance is well promoted is Austria. The national export credit agency is OeKB, which is owned by the Austrian banks. It is a fully operational insurance company, issuing its own policies, and also it manages the Government's insurance window.

Being owned by the Austrian banks, the banks see the policies as a product of the respective banks and OeKB as an associate of theirs. OeKB staff members provide training to bank loan officers and branch managers on how export credit insurance works, how it helps exporters to sell their products, the documentary requirements, and how to complete a sale covered by an insurance policy. In this way, the bank officers become the marketing arm of OeKB.

An alternative way to market is by the use of brokers who are paid a commission on sales. This is an effective way to promote export credit insurance. In the UK, brokers bring more than 90% of the business to the insurers. However, it is important that the brokers are well trained and the fee structure has to be set to encourage the brokers to provide on-going services to the exporters and not just to act as introduction agencies.

Also in the UK, the major credit insurer used to be state-owned; so government export promotion officers saw part of their role as promoting the services of the insurer. Even though the short-term business was privatised more than a decade ago, the promotion officers still actively promote the service.

Policies relating to exports to the EU and other OECD countries, such as Turkey, could be insured for account of the agency and there is an international reinsurance market available to spread the risks across a wide number of contracts by retaining only 10% or 20% of any one policy. A Syrian insurer could effect such an arrangement by:

- Negotiating its own reinsurance treaties with a group of major reinsurers, such as Swiss-Re, Munich-Re (normally an insurer has treaties with a group of 6 to 10 reinsurers); or,
- Arranging a reinsurance treaty with a major export credit agency, such as Coface, that would buy all but a small percentage of each policy, which it would incorporate into its existing reinsurance treaties. The Syrian insurer would retain the remainder.

Most non-OECD export insurance policies would have to be at the risk of the Syrian state. However, many private insurers and re-insurers are now prepared to accept a



much wider range of risks than just OECD countries. This means that the state may accept a more limited range of risks than those for a term of over two years and on non-OECD countries. However, by limiting its range, there may be a greater incidence of loss due to the inability to spread the risks

Nevertheless, in order to mitigate risks for exports to Arab and North African countries and to non-Middle Eastern Islamic countries, it may be possible to arrange a co-insurance treaty with the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC) and, possibly, with the Inter-Arab Investment Guarantee Corporation (IAIGC). A co-insurance treaty may be more difficult to arrange than a reinsurance treaty as the co-insurer may wish to decide on each policy where usually reinsurance is automatic provided the insurance policy is within a series of predetermined limits or criteria.

### 6.3.2 Positive Arguments

- The establishment of an export credit insurance window or agency would be of value to Syria because the country is not well known as a source of exports and many of its traditional exports are facing competition from exporters of other countries.
- The ability of exporters to offer credit terms would enhance the attraction of Syrian products. In the absence of credit terms, negotiations tend to focus on price. Small firms often neglect to take into consideration, when negotiating, the need for retained earnings to develop their product design, specifications and quality with the result that after a period of time, the product becomes dated and no longer desirable and the enterprise dies.
- Export credit insurance often moves the negotiations away from price and onto the duration of the credit terms. It is generally recognised that buyers prefer credit terms to price discounts. Very often buyers will expect discounts of 10% or more in the absence of credit.
- With credit terms, buyers can manufacture products, market, and hopefully sell them before paying for the inputs. No matter how cheap a product is, without credit terms, a buyer may still have to approach his bank for finance.
- Some 20% of Syria's total exports, which amount to about EUR 5 billion per annum, are textiles and other manufactures. It is these sectors where export credit insurance can provide the most value added. At the same time, however, credit terms are often provided for raw materials and agricultural products.
- Also it is in these sectors of textiles and manufacturing where there are many small and medium size enterprises that need some form of marketing edge to attract customers. The capability to offer credit terms to customers can provide that edge to Syrian exporters.
- Large firms dominate world trade. Only such firms have the resources to search out suppliers, and they are usually most interested in the larger suppliers, which are more meaningful to their scale of production. However, if it is known that Syrian exporters are able to offer credit terms, smaller foreign importers will





make the effort to contact them. Such buyers, though often financially sound, may well not have the financial strength to pay up-front for products.

### 6.3.3 Negative Arguments

#### a. The cost and difficulties of establishing an export credit insurance agency in Syria

- It may be expensive and time-consuming to set up an export credit insurer in Syria without outside support. In order to be able to offer a useful service, the insurer needs a large database of information on foreign companies, which will need constant updating into order to assess the credit risks. It would be a non-starter for the insurer to make fresh inquiries about each potential customer; such inquiries may take weeks to complete.
- However, an insurer in Syria could establish a reinsurance treaty with one of the major credit insurers, such as Coface of France, Atradius of the Netherlands and UK, OND of Belgium, or Euler Hermes of Germany. Alternatively, it could establish such a treaty with one of the smaller more dynamic insurers of Eastern Europe, such as EGAP of the Czech Republic or SEC of Slovenia. Cooperating with one of the smaller insurers may create a joint venture of equals, but the downside is that the smaller insurer would not necessarily have the resources available to provide the new Syrian export credit insurer with all the assistance that it may require.
- All these insurers, mentioned above, have large databases on buyers world-wide and, especially, throughout Europe. Buyers in the Middle East and North Africa would be less well covered, but insurers, such as Coface, will have good databases of such buyers. Coface's database of Arab and North African countries includes 18,500 buyers. Moreover, Coface is part of a network of export credit insurers in 93 countries world-wide, called the Credit Alliance Network. Members of the network can approach any of the other members to ascertain the credit risk of a buyer.

#### b. The experience of Export Credit Agencies in the Middle East has not been positive

- Most export credit insurers in the Middle East do not work well and have proved not to be useful. In Jordan, the export credit insurer is the Jordan Loan Guarantee Corporation (JLGC), but the Government is unwilling to support export credit insurance policies, preferring to support instead domestic loan guarantees, which represent most of the business of the Corporation. Moreover, the Corporation lacks marketing capabilities and its services relating to export credit are hardly known amongst Jordanian exporters.
- JLGC has an agreement with Coface, but because JLGC has not invested in staff development, again partly a reflection of the lack of Government interest, all decisions about insuring export credit are taken in Paris, meaning that there



are delays in any response. In fairness to Coface, the limited amount of business provided by the JLGC, does not mean that responding to its intermittent inquiries can have a high priority. Export credit insurers in other countries have maintained good and satisfactory relations with Coface.

- However, it is not proven that Jordan would not benefit from a dynamic and market orientated export credit insurer. The JLGC's main problems are a lack of interest from government, which remains to be convinced of the value of export credit insurance and a lack of marketing capability to reach out to exporters and inform them of the service.
- In contrast, the Omani ECGA seems to provide a valued service to the exporters of Oman and has helped many to establish on-going markets in Saudi Arabia. ECGA is also part of the Credit Alliance Network.
- c. There are already regional insurers that may be able to provide the service**
  - In the Middle East, there are already two major regional export credit insurers:
    - The Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), which is based in Saudi Arabia and is part of the Islamic Development Bank, and
    - The Inter-Arab Investment Guarantee Corporation (IAIGC), which is based in Kuwait and is part of the Arab Monetary Fund.
  - Both of these organisations provide credit insurance for trade between member countries of their parent organisations. However, in recent years, they have extended the list of countries covered to include those of the OECD.
  - The business of IAIGC was curtailed for several years because it continued to insure exports to Iraq in the late 1980s, long after all other export credit agencies had ceased to insure exports to that country. As a result, it was faced with substantial pay-outs. However, in recent years, the Corporation has been refinanced and has started to operate more effectively again.
  - Given the existence of these two inter-regional Corporations, it could be argued that there is not really a need for a national export credit facility in Syria.
  - However, this would only be true if the two Corporations mentioned above were truly proactive. The basic problem with both organisations is the lack of marketing and customer support offered. In Syria, both organisations have appointed the Ministry of Economy and Trade as their representative and have hardly ever directly marketed their services in Syria. The relationship between these Corporations and the Ministry seems to be tenuous and few Syrian exporters have been assisted by the Ministry to insure their exports.
  - In other countries, the Corporations have tended to appoint a bank as their representative. This too has not been very successful because all of the other



banks in those countries have tended not to promote export credit insurance to avoid passing their clients over to the representative bank.

- If the agent for the Corporations was a proactive and market-orientated organisation, which acted as a broker and so earned an income from the insurance contract issued, then these Corporations could meet the latent demand that seems to exist, given the response to the questionnaire.

#### 6.3.4 Pre-requisites

- If an Export Credit Insurance Company is going to be of value in Syria, it needs to avoid the mistakes of most of the agencies in the Middle East and North Africa; for instance:
  - It must have the explicit support of the Government and its commitment to the provision of adequate funding;
  - There must be a solid marketing capability
  - The banks in the country must be interested in working with the agency and promoting the products
  - The agency must be able to respond quickly to requests for support and to provide confirmation that insurance will be available on a timely basis.
- There must be an appropriate legal framework for export credit insurance. This may entail changes to the existing Insurance Law, or more likely the enactment of an Export Credit Insurance Law specifically covering the activities of an Export Credit Insurer to be established in Syria.
- This will need to make specific reference to the fact that any claim under insurance policies underwritten for account of the State must be paid promptly from state funds if the Company is not to suffer a catastrophic loss of credibility. A limit is normally set in the annual State Budget and it is the responsibility of the Board of the Company to ensure that this limit is not breached.
- The Insurance Company must be adequately capitalised to support the volume of exports that it expects to underwrite, and this capital will need to be increased as demand for export credit insurance rises. The justification for any increase in capital, including any proportionate state participation if the Company is a State / private sector joint venture, is that this is likely to be directly linked to an increase in exports.
- In addition, there must be sufficient capital to ensure that the Company has adequate funds available to meet claims during the early years of its existence, when premium income may still be insufficient for this purpose.
- Provision will need to be made to reinsure policies underwritten by the Export Credit Insurer. It may choose to negotiate its own reinsurance treaties with one or more of the big international re-insurers or it may find it more appropriate, in the early years, to arrange a reinsurance treaty with one of the major export



credit agencies, such as Coface, or even one of the smaller agencies, such as EGAP of Czech Republic or SEC of Slovenia.

- The Company must have an appropriate governance structure that conforms to international best practice, not least to ensure independence, especially from political pressure and interference. It should have its own independent Board of Directors, which should include a majority of outside representatives from both the public and private sectors, and in particular individuals with practical experience of exporting and international trade. The Board must have a clear mandate to establish policies and procedures and to set performance objectives.
- Furthermore, to ensure transparency, the Insurer should be subject to internationally accepted accounting practices, publish reports at regular intervals and be subject to independent audit.
- To operate effectively, the Export Credit Insurer must be able to attract and retain Directors, Senior Management, and staff with appropriate skills and experience. These will include knowledge of insurance, and specifically of export insurance products, marketing skills and credit risk assessment skills.
- Given the fact that an Export Credit Insurer operates, to all intents and purposes, as a commercial enterprise, it is also important to be able to incentive staff with good salaries and performance related bonuses. These should not be related to civil service pay scales. Rather, they should be set to the levels of reward that such individuals would expect to receive in the private sector, from which perhaps a number of them will be drawn.

### Options

It is quite reasonable to consider that private sector insurers in Syria could provide export credit insurance for exports to buyers in OECD countries. Comprehensive information on buyers in OECD countries already exists and that information can be bought or shared between insurers as, for example, between the members of the Credit Alliance. Also such risks can find ready reinsurers in Europe.

In Eastern Europe, most of the credit insurance companies were established by the various governments and are still state-owned. However, under EU regulations, exports to OECD countries for terms of up to two years are defined as “marketable risk”. Such risk must now be underwritten for account of the export credit insurer itself (i.e. using its own capital and reserves to support such underwriting exposures) and not for account of the government. Such an approach could be followed in Syria.

Moreover, it is quite possible for Syria not to have its own Credit Insurance Agency, but only to have brokers who would place the business with well-established insurers in other countries. By way of example, insurers based in Lloyd’s of London accept risks from exporters world-wide brought to them by brokers. If such brokers, or their agents, were to set up in Syria, they could equally offer export credit insurance to exporters with buyers in Arab and other Islamic countries to the ICIEC and the IAIGC respectively.



Most risks to non-OECD countries and for tenors greater than two years would inevitably need to be insured by the GoS. However, many of those risks might be insured by either the ICIEC or IAIGC if they were to countries within their respective remits.

The question of whether the state should insure marketable risks or whether it should be left to the private sector is difficult to determine. Generally, states have been successful in setting up credit insurance agencies, but some are more successful than others; EGAP (Czech Republic) and SEC (Slovenia) have both been successful state owned insurers. EGAP, in particular, has been innovative; for instance, by providing guarantees, and not just insurance, by accepting the risk that the exporter may fail to perform during the pre-shipment period as well as that the buyer may fail to buy. However, the Export Import Bank of Romania has not been particularly successful and the Export Import Bank of Turkey has never really promoted itself well.

Much depends upon the dynamism of the head of the enterprise and whether the government can support and encourage the venture while preventing it from underwriting inappropriate or unacceptably risky business. One solution might be for the Government to promote the concept for private sector take-up and, perhaps, to offer some equity contribution as a token that the government supports the creation of an export credit insurer.

Should no private sector insurer be forthcoming, the Government might then consider setting up its own state-owned agency, or a subsidiary of or window in the State Insurance Company.

Assistance in marketing the service would also help to promote the concept and will certainly be needed if the export credit insurer is to be successful, particularly in its early years. Government export promotion officers could be taught about export credit insurance and trained to promote it – not just to help the insurer, but because offering credit would help to sell Syrian products.

Export credit to non-OECD countries, and for tenors over two years, will inevitably be for account of the state. However, as an alternative to the state setting up its own Export Credit Agency, export credit insurance for the state account could be let out to tender. In this way, a private insurer would underwrite for its own account risks for terms of less than two years on buyers in OECD countries, and for the state account risks for terms over two years on buyers in non-OECD countries. In either case, cover could be provided for both commercial and political risk, in accordance with the exporter's wishes.

Guarantees may also be provided to cover such risks as bid and performance bonds and unfair bond retention. Export credit insurance agencies have also set up working capital guarantee schemes, which would insure a lender against the risk of an exporter failing to perform prior to shipment of the export. They also provide domestic credit insurance against failure on the part of Syrian buyers to pay. However, this latter kind of insurance normally depends upon the existence of an effective credit bureau.



## 6.3.5 Recommendations

- It is recommended that an export credit insurance facility be established in Syria.
- Ideally, this should be a private sector company. However, GoS participation in the equity of this company, for example, through the State Insurance Company, would be particularly beneficial. The credit insurer could be a new company, or subsidiary of, or a window in an existing general insurer.
- It is anticipated that this new export credit insurer will underwrite all marketable<sup>34</sup> risks for its own account. It will also underwrite all non-marketable risks (at appropriate rates) for account of the GoS. The GoS would appoint the company to manage this account in return for a fee.
- If no private institution is prepared to set up as an export credit insurer, the GoS should consider setting up its own wholly owned Export Credit Agency, as has been done in Algeria, Jordan, Morocco, Oman, and Tunisia. Only in the Lebanon is the insurer a private company.
- Failing acceptance of either of these two recommendations, the GoS could consider as a further alternative participating in a company whose primary objective would be to broker export credit insurance between Syrian exporters and insurers abroad.

## 6.3.6 Implementation Implications

**Private sector company:** If a private sector company is established to undertake export credit insurance, with or without GoS participation, the following implementation steps will need to be considered:

1. The Government undertakes to insure export credit risks (for the State account) up to a predetermined limit on buyers in most Arab countries and selected non-OECD countries for durations of mainly between 1 and 6 months, and expresses a willingness to consider longer durations of up to two years and beyond, additional countries, and a higher limit at a later date, subject to demand from exporters.
2. In addition to export credit insurance, the Government may offer to guarantee bid and performance bonds, in excess of two years, issued by Syrian banks on behalf of Syrian contractors operating abroad, thereby removing the necessity for Syrian contractors to lodge collateral against the bonds. Also the Government may offer to provide insurance against the unfair retention of bid and performance bonds.
3. The Government offers a contract to manage the state's export credit insurance account to an insurance company offering to cover marketable risks at least to buyers in OECD countries and for tenors of less than two years.

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<sup>34</sup> Marketable risks are commercial and political risks on public and non-public debtors at terms of up to two years on buyers in all EU and OECD countries (if not EU members). Non-marketable risks are those that do not fall within the definition of marketable risks.



4. The Government offers to participate in the equity of the new entity up to a negotiated percentage, to be determined by the GoS.
5. The Central Bank confirms that 100% of bank loans covered by export credit insurance policies issued by the new entity may be 0% weighted for Risk Asset Weighting purposes by banks in Syria. This is to encourage banks to accept export credit insurance policies as collateral.
6. The GoS determines whether the Syrian Insurance Company will establish a subsidiary or window to provide marketable export credit insurance policies and at the same time manage the state account.
7. The state-owned and private banks in Syria are approached in order to ascertain their willingness to be partners, either in equity or in marketing, in the export credit insurance venture.
8. Approaches are made to established export credit agencies world-wide with a view to entering into reinsurance treaties and information sharing arrangements relating to marketing policies.
9. Approaches are made to the ICIEC and the IAIGC with a view to ascertaining their willingness to enter into either reinsurance or co-insurance treaties and information sharing arrangements with a Syrian export credit agency specifically with regard to exports to, Islamic and Arab member countries respectively.

**b. State owned Export Credit Agency:** If no private sector company is willing to undertake export credit insurance, the Government should consider setting up its own Export Credit Agency. For this a Feasibility Study should be undertaken, but many of the criteria outlined above for a private sector insurer will similarly apply to a state owned Agency.

**c. Export Credit Insurance Broker:** Failing either of the two options above, then the GoS might still consider introducing export credit insurance in Syria through a broker. In this case, the following steps are taken:

1. The Government offers equity finance to enter into partnership with a Syrian company, which will act as an export credit insurance broker, marketing export credit insurance to Syrian exporters, and will seek out insurers abroad to take up the risk. As the insurance risk will be the foreign buyers and not the Syrian exporters, there would be nothing to stop foreign insurers accepting the risk. Large insurers, such as Coface, Euler Hermes and Atradius, accept risks from exporters world-wide. The underwriters in Lloyd's of London do not have sales forces, yet insure risks world-wide, by relying on brokers around the world to bring them the business.
2. The representation agreement between the ICIEC and IAIGC with the Ministry of Economy and Trade will be transferred to this brokerage.
3. The marketing aspects of export credit insurance are the most challenging. If a brokerage can be successfully established, then it would not be hard to turn the brokerage into a full export credit insurance company or even to attract an insurer to buy out the brokerage and establish itself in Syria as a fully-fledged export credit insurer.



Given that the introduction of export credit insurance invariably takes time, (generally a matter of several years), the initial capital investment is likely to be modest, although a commitment to increase that investment in line with increasing demand for the product is of paramount importance.

Of equal importance is the understanding that losses incurred for account of the government have to be honoured promptly if the credibility of the agency / insurer is not to be damaged, possibly irretrievably. Accordingly, there has to be a contingency arrangement within the National Budget to meet such claims in the event that funds held within the insurance agency are insufficient to cover such claims or to support ongoing business.

The way forward outlined above presupposes private sector involvement from the outset. However, most national export credit insurers have been set up as government owned entities. Only in OECD countries have many of the state insurers been privatised and do active private sector insurers exist.

In general, the private insurers are more dynamic and profitable than state insurers. However, most of the insurers that have more recently been set up by governments in Eastern Europe, such as EGAP in the Czech Republic and SEC in Slovenia, are both active and profitable. These contrast greatly with those in the Middle East, which are mainly state-owned and have made only a limited impact; ECGA in Oman is a notable exception.

The main difference is marketing; those in Eastern Europe, which have been most successful, have committed themselves to marketing heavily. The ECGA, being part of the Omani Development Bank, is brought into the discussions with entrepreneurs at the time of their first visit to the Bank.

Ideally, the Syrian private sector should set up the export credit insurance facility, although the Government may be a partner, for example through the State Insurance Company. However, if the private sector is not forthcoming, the Government may itself set up the facility. If that is the case, the Government should turn to one of the more established insurers in Europe for technical assistance.

Coface and others have provided such help to many governments. However, it may be worthwhile considering seeking out another insurer for assistance as companies, such as Coface, have such large networks that they may not be able to provide the attention required to set up the Syrian operations well. Insurers, such as EGAP, may well be interested in such a participation in order to build up their knowledge of Middle Eastern buyers; equally, this would be of value to a Syrian insurer.





## 6.4 The Establishment of a Syria SME Bank

### 6.4.1 Description

The concept of Development Banks focussing on small and medium enterprises is very old. In the 19<sup>th</sup> century, these institutions had different names and were known as 'industrial banks'. The industrial banks provided primarily 'risk' or 'equity' capital for the projects, which promised to yield a high profit from the exploitation of new productive activities. With the founding of the World Bank in 1946, the Development Banking concept was promoted again.

Today, practically each developing country and some industrial countries, have Development Banks. Because of their differing operations in different countries, it is difficult to provide accurate statistics about the number of development banks. Taking those with a substantial proportion of operations in development financing, the world-wide total may reach about 750 institutions, with about 40% of them in Latin America.

### Rationale

To date, so many different concepts of a "Development Bank" exist, that it becomes difficult to establish a clear and generally applicable definition of what constitutes such a specialised banking institution. Nevertheless, its principle differences between a development bank and a commercial bank may be summarised as follows: The development bank's primary objective is – as already reflected by its name – to complement the Government's economic policy. It does so by focusing on selected *target groups* considered key to the economy's *development* and growth, furnishing them with *particular financial and partly also non-financial services with special terms and conditions*.

A development bank may have another name to reflect its priorities; such as "SME bank", "export bank", "investment bank", or "long-term bank". Hence, in a single country, there may be several development banks, each with their own priorities.

Profit maximisation is usually of secondary priority, though some developing banks place a higher importance on financial self-sufficiency and operational sustainability than others. The varying concepts of a development bank result from differences in the perceived economic priorities of countries, the maturity statuses of their financial sectors and the individual corporate policies of their development banks.<sup>35</sup> Examples of successful Development Banks in terms of financial sustainability, efficiency of operations and effectiveness of private sector promotion include:

- The Export Bank in the Czech Republic
- The Development Bank of Kazakhstan

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<sup>35</sup> The following elaboration concentrates only on the concept of a local development bank; i.e. multilateral donor corporations such as the "Asian Development Bank" or the "Inter-American Development Bank" are excluded.



- The Development Bank of Southern Africa
- The Investment Bank of Saudi Arabia
- The Turkish Development Bank "Turkiye Sinai Kalkinma Bankasi A.S" (TSKB)

## **Governance:**

The term "bank" is misleading. Development Banks are only licensed – and often given special privileges – for their particular purpose and in many cases, therefore, are not fully licensed. They are not necessarily authorised to conduct foreign operations, nor are they usually allowed to accept deposits. However, in some cases, deposit taking from borrowing clients would be exceptionally allowed.

A Development Bank is a usually owned by the Government, often the central government. In order to ensure a regional balance of its service coverage provincial governments may also subscribe to the equity capital of the Bank. Subject to its business principles – particularly, if financial self-sufficiency is pursued as a major objective – the equity of a Development Bank may also be open for private subscribers. Nevertheless, even if wholly state-owned, private sector representatives are often invited to sit on the Board of Directors. This serves to ensure harmonisation with the commercial financial institutions. It would also facilitate a continued fine-tuning of the Bank's services to the financial demands of the private sector in general or specifically to the Bank's target group(s).

Most Development Banks are created by a special law that furnishes them with specific privileges such as customs and tax exemptions. Additionally, they are often not subject to the supervision of the central bank, although some Banks voluntarily adhere to the prudential regulations and banking laws stipulated by the central bank.

## **Decentralisation:**

Here, basically three different alternatives exist.

1. *No branching out.* a Developing Bank without an own branch network operates without an own branch network, from either its Head Office only, or in conjunction with partnering banks. In the latter case, the Development Bank acts as a second tier financial institution. Such an institution provides lines of credit to selected banks and other eligible non-bank financial institutions, which are then on-lent to the target group(s) at clearly defined terms and conditions.
- *Advantages:* the Bank may keep its own institution building and, hence, its administrative cost burden low. By the same token it may capitalise fully and immediately on the branch network of its partnering banks.
  - *Disadvantages:* the Bank has no direct access to its target group(s) and can only partly influence the performance of the partnering banks. Furthermore, its monitoring ability is dependant on the reporting capacity and preparedness of the partnering banks. This could often prove to be poor. Finally, the credit risk of the target group is assumed entirely by the partnering banks. Hence, the Bank



may not be as interested in a high quality of the target group loan portfolio as compared to one, which undertakes direct lending.

2. *Branching out* Here, the aforementioned advantages and disadvantages would be reversed. By maintaining its own branch network, the Bank follows the objective of a direct outreach to its target group(s). For this purpose a substantial investment in institution and capacity building is required. In view of the direct credit risk to be assumed, special emphasis must be placed on the quality of the loan processing, monitoring and risk management. As a result, the Development Bank may eventually enjoy a high quality portfolio but with a volume not matching the Government's high and demanding expectations.
3. *Limited Branching out* This is a compromise between the above two concepts, and as such, may provide an advantageous solution. The Development Bank would locate its branch network on the main economic hubs of the country. In parallel, it would collaborate with selected eligible banks by funding them with target group oriented refinance facilities. Hence the Bank would additionally capitalise on the branch network of its partnering banks. In such a scenario, the advantage of a comparatively low administrative burden could be combined with a high outreach to its target group. Furthermore the direct lending of the Bank would serve as a benchmark for the partnering banks to follow or to exceed. The main condition for the success of this alternative is to establish a level playing field for all banks to ensure fair competition and to avoid any preferential treatment or status of the Development Bank.

Under all three cases a Development Bank additionally qualifies as a domestic financial vehicle, with which bi- and multilateral donor organisations could collaborate.

### **Business Conduct**

The principle objective of a Development Bank is to complement and to support the existing financial sector. The Bank should neither crowd out commercial banks, nor distort market mechanisms by offering financial services at subsidised terms. It should rather focus on financial services that are crucial for economic development but have so far not been supplied adequately to the market, most specifically to the private sector.

With the lapse of time, the strategy, business policy and organisational structure of a Development Bank is subject to change. Circumstances of different origin and of different magnitude lead a Development Bank into a process of continuous adjustment of its business profile and organisation. Changes of business policy and organisation regularly result from:

- Government policies change, and force the direction of financing efforts to particular sectors of the economy or particular target groups of clients.
- The expansion of the economy brings about structural changes of the industry.



- Economic development and liberalisation of the markets requires further development in the financial sector. New financial institutions and products should emerge to cover the requirements of the markets.
- The Development Bank senses new opportunities for business, such as the expanding demand for export credits, demand to provide risk or equity capital or others.

*Target Group(s):* Traditionally Development Banks serve one or more of the following three types of customers depending on their perceived importance for the economic growth. All customers are either in the private or in the mixed sector (i.e. joint ventures between private and public companies):

- *Start-ups:* In economies with high unemployment rates, start-ups play a pivotal role in job creation. However, banks are usually reluctant to finance start-ups because of their high failure risk. In developing countries, commercial banks also often lack the competence necessary to undertake proper due diligence as well as monitoring skills required by "green field" projects.
- *Small and Medium-sized Enterprises:* The overwhelming majority of private companies, in a developing economy, are of small and medium size. Given their limited institution building and assets, lacking either quality or value, and thus not eligible for collateralisation, SMEs are more often than not denied access to long-term loans, which are crucially required for expansions or modernisations.
- In addition, commercial banks – as in Syria – lack adequate funds to match with the long-term loans required for fixed asset finance. These banks are also often equally unable to conduct a cash flow oriented project appraisal (due diligence) and therefore base their lending merely on the availability of collateral. As a result, financial services to SMEs are mostly limited to short-term working capital finance. As a consequence, the restricted finance opportunities represent a major impediment to SME growth.
- *Larger Enterprises:* This target group is served only in exceptional cases, which are considered crucial for the overall and balanced development of the economy. The most pertinent examples deal with the financing of infrastructure investments (water, waste water, electricity, telecommunication, roads), without which private companies would not be able to efficiently and effectively conduct or expand their businesses.

*Financial Services:* The objective of a Development Bank to complement and not to compete with the financial sector, inevitably leads to narrowing its range of financial services. In essence, these are usually restricted to medium- to long-term loans, but in some cases may include export-financing facilities.

*Lending Currency:* In highly dollarised economies Development Banks may grant loans both in foreign and in domestic currency. Otherwise only local lending would be feasible, unless the borrower is export-oriented and can prove access to foreign currency earnings.



*Terms and Conditions:* The interest policy represents the most critical part within a Development Bank concept. This factor is decisive for harmonious integration of the Bank into the financial sector or whether its operations cause a market distortion. Unfortunately – and since Development Banks are usually established by political decision, and are also governed by a Board of Directors predominantly composed of government officials – the interest rate policy tends to be below market, thereby fuelling a crowding out of commercial banks.

As a result even financially strong companies, who have access to commercial loans, prefer borrowing from the Development Bank. Thus, subsidised lending causes an accelerated consumption of the Development Bank's funds. This is disadvantage to other less well-positioned enterprises that - because of their risk profile - have so far been neglected by the commercial banks. Eventually, these neglected and weaker enterprises pay the costs of the subsidised lending policy.

*Lending Methodology:* In a best-case scenario, a Development Bank should prioritise the methodology of a cash flow oriented lending coupled with a prudent monitoring and risk management. Lending decisions should not be primarily collateral based, even though collaterals should continue to be taken to ensure the borrowers' serious commitment. Instead, the prime criteria for granting a loan should be the borrower's ability to service his loan from corporate earnings. This approach would significantly broaden the deal flow of eligible borrowers. The visible build up of a dynamic, quality oriented, and profitable loan portfolio, could trigger a replication of this methodology by the commercial banks. In cases of direct lending, a Development Bank would come to additionally represent a best practice showcase, thereby motivating commercial banks to replicate its outreach to SMEs. The benefits are obvious for both: the commercial banks expand their range of business; the target groups gain an enhanced and reliable access to longer-term funding from the formal financial sector.

## **Funding**

Development banks often enjoy a larger capital base when compared with commercial banks. Their comparative disadvantage of not taking deposits is usually compensated by their preferential access to bilateral or multilateral donor funding (long-term concessional loans or even grants).

*Example:* The Development Bank of Kazakhstan (DBK) developed a particularly successful model for a sustainable funding strategy. DBK is not authorised to deploy its equity capital for lending purposes<sup>36</sup>, but is committed to maintain its capital base as a security for its funding leverage. DBK secures its funding through donor loans but to a larger extent through the market issuance of debt securities. These securities have a maturity of up to 15 years and meanwhile trade freely on international capital markets. DBK's prudent conduct of business has earned it a triple B (BBB-) rating,

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<sup>36</sup> With the exception of short-term export finance



which has now additionally qualified the bank for commercial lending from local and external banks.<sup>37</sup>

*Foreign Currency Risks:* Where Development Banks depend on donor funding, but may only lend in local currency, the question of hedging against foreign currency risks immediately arises. A total hedging of this risk is either impossible or would cause the bank to incur prohibitive costs. However, alternative hedging vehicles have been successfully developed to absorb at least some of the currency risk and, hence, soften the burden of foreign currency losses. One such vehicle is the "Exchange Risk Cover Fund" designed for the "Turkish Development Bank (TSKB)", which basically aims at covering only those exchange rate losses that exceed priced-in market expectations.

## 6.4.2 Positive and Negative Arguments

The main pros and cons of a Development Bank have been already implicitly mentioned above. They are further highlighted in this section.

The principle question is: With a banking sector already in place or evolving, why would the addition of a "Development Bank" be necessary? The answer to this question is particularly relevant because of the abundance of negative experience, established around the globe, with various Development Banks. In summary, negative examples share at least one, if not almost all, following features:

- Politically motivated and non-transparent governance.
- Weak general management and insufficient risk management.
- Loan products including terms and conditions not suitable to target group.
- Distortion of financial markets caused by subsidised lending and non-prudent selection of eligible borrowers.
- Poor collaboration with and insufficient motivation of partnering banks.
- Unprofessional public relations' policy, including poor collaboration with donors.

And as a result thereof:

- A bad to an extremely bad reputation (especially in cases of verified corruption).
- An unsatisfactory loan portfolio growth.
- A high level of non-performing loans.
- Total dependence on public or donor funding (in case of the latter including high Foreign Exchange losses).
- Funding bottlenecks due to the growing reluctance of donors to co-operate with poorly performing Development Banks.

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<sup>37</sup> It should be mentioned though that the Kazakh economy is rather dollarised and therefore DBK conducts most of its lending in USD without Foreign Exchange risk concerns.



- No integration of the Development Bank into the financial sector.

Conversely, successful Development Banks may effectively contribute to equalising sectoral imbalances, efficiently promote selected target groups and significantly support the overall development and growth of the economy if conceptually well planned and professionally executed. Correspondingly, successful Developing Banks:

- Focus exclusively on such target groups and such financial services that have so far not been respectively adequately serviced or provided for by the financial sector.
- Implement clear and transparent governance supported by strong prudential regulation and supervision as well as sound accounting and disclosure regimes.
- Establish an institution building (organisation, systems and procedures, IT/MIS) and ensure professional staffing conducive to a proper conduct of business.
- Adopt a cash flow oriented lending methodology; respectively assist the partnering banks in adopting this methodology.
- Operate in accordance to the principles of operational and financial self-sufficiency including the application of market and risk-oriented lending terms.
- Diversify funding sources with a particular emphasis on long-term funding from commercial capital markets.

In principle, a Development Bank should be established for a temporary period only. Its status should change as and when the commercial banks have sufficiently expanded and matured adequately to substitute for the Development Bank. In such cases, a Development Bank may be transformed to a commercial bank, be privatised or it would even wound down and its liquidation proceeds returned to the Government as a budget relief measure. However, a Development Bank may also find a niche where it can provide a worthwhile service whilst remaining profitable and without subsidy. Examples may be the European "Dexia" and the "Saudi Investment Bank"; both are private, profitable and provide specialised services not so well performed by other commercial banks.

### 6.4.3 Pre-requisites

Following needs to be in place to ensure a successful implementation:

- *Political Will:* The clear commitment of the Government to best practice when it establishes a Development Bank. Such intention should be substantiated by approving sufficient capitalisation and initial funding of the Development Bank. Furthermore it shall endorse a competitive salary scheme suitable for attracting professionals with adequate expertise for implementing and running the Bank. The Government should also manifest, that no state organisation or official (other than the Board of Directors or other authorities mandated by law) will intervene in any strategic decisions or in the day-to-day management of the Bank.



- *Legal Clarity:* A special law should be enacted for the purpose of establishing and running the Development Bank. The Law would define the mission and the objective of the Bank as well as to establish the range of products to be offered and the tools to be therewith adopted. Furthermore, the roles and responsibilities of main governance bodies need to be defined in addition to the determination of their relevant powers and limits. Finally, its tax and custom exemptions need to be determined.
- *Long-term Funding:* Establish the necessary regulation and supervisory mechanisms to allow the Development Bank to issue long-term debt securities. It is important to enable the Development Bank to establish a diversified refinance basis and to avoid an entire dependence on government allocations or donor contributions. Examples of Banks achieving this are the Czech Export Bank and the Development Bank of Kazakhstan, which are state-owned but have raised finance on the international capital markets in their own name.
- *Foreign Currency Risk Hedging:* Where donor contributions in foreign currency are foreseen, a hedging facility against the Foreign Exchange risks should be established. Neither the Development Bank nor its partnering banks nor their final borrowers should be exposed to uncontained foreign currency risks.
- *Organisational Structure:* There is no unique or ideal organisational structure for all Development Banks. Nevertheless, an efficient and transparent organisation tailored to the specific objectives of the Bank is mandatory for its success. The Bank's resources for administrative, operational and market activities need to be harmonised and concentrated under the prerogative of productive market penetration.

#### 6.4.4 Recommendation

The failure risks of a Development Bank are substantial as evidenced by negative experience around the globe. On the other hand successful Development Banks have significantly enriched the financial sector and tangibly contributed to enhancing the access of its target group to demand-oriented services of the formal financial sector.

The recommendation of a "Syria SME Bank " is facilitated by the current features of the country's financial sector: the immature – albeit evolving – status of the financial sector; its poor institution building and inability, particularly, to cover loan demand both in terms of volume and type. This has been hindering the majority of the private sector to finance necessary investments for expansion or modernisation purposes. The result is the negative impact on the overall economic growth and job creation.

In conclusion, the BAI Team advocates the establishment of a "Syria SME Bank" . The unconditional requirement for a careful execution in accordance with best practice, together with the adoption of clear and transparent good governance and the complementary support of the commercial banks are hereby reiterated.





## **6.5 Factoring**

A form of asset-based<sup>38</sup> finance, factoring provides short-term funding secured by commercial accounts receivable. Other assets, against which loans could be secured, include revolving credit, and debt or production contracts for goods and services. The amount of credit extended is explicitly linked on a formula basis to the liquidation value of commercial accounts receivable (assets) used as collateral. This link is continuously monitored to ensure that the asset value always exceeds the amount of the loan.

Factoring is the acquisition of accounts receivable, by banks or specialised financial institutions (factors), at a discount to their face value. A secured loan carries a rate of interest higher than best market rate. Businesses receive cash to meet their immediate working capital needs. The purchasing financial institution collects the face value of the asset from the businesses' clients. If the total value of the accounts receivable is collected, the difference is repaid, less interest and expenses, to the borrower.

### **Non-recourse Factoring**

The financial institution carries the risk of non-payment by the borrower's clients. If the client does not pay, the lender does not have recourse (claim) against the borrower to recover the unpaid funds. Borrowers pay a higher interest rate and the value of the assets more heavily discounted to cover this additional risk of client default. It is most used in developed countries.

### **Recourse Factoring**

The borrowers retain the non-payment risk if their clients do not pay. Thus, the financial institution has recourse against the borrower to recover its funds. It is most used in developing countries because the lender is less able adequately to assess the risk of default of the borrower's clients.

### **Notification/Non-notification**

The borrower's clients are informed that their accounts (their payables) have been sold to a financial institution. The borrower typically furnishes the lender with delivery receipts, an assignment of the accounts, and duplicate invoices that clearly indicate to the borrowers' clients the identity of the lender and the fact that their accounts have been purchased.

### **Factoring Services**

Other than finance, they can include: account receivable management, account debtor credit analysis, credit insurance, and collection management. Additionally,

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<sup>38</sup> The complete package of asset-based finance products is only available in countries with good secured lending laws, electronic collateral registries, and quick and efficient judicial systems, rarely available in developing countries.



Credit Registries provide clients' payments history, which can lower factoring costs because client risk (default) can be more effectively assessed.

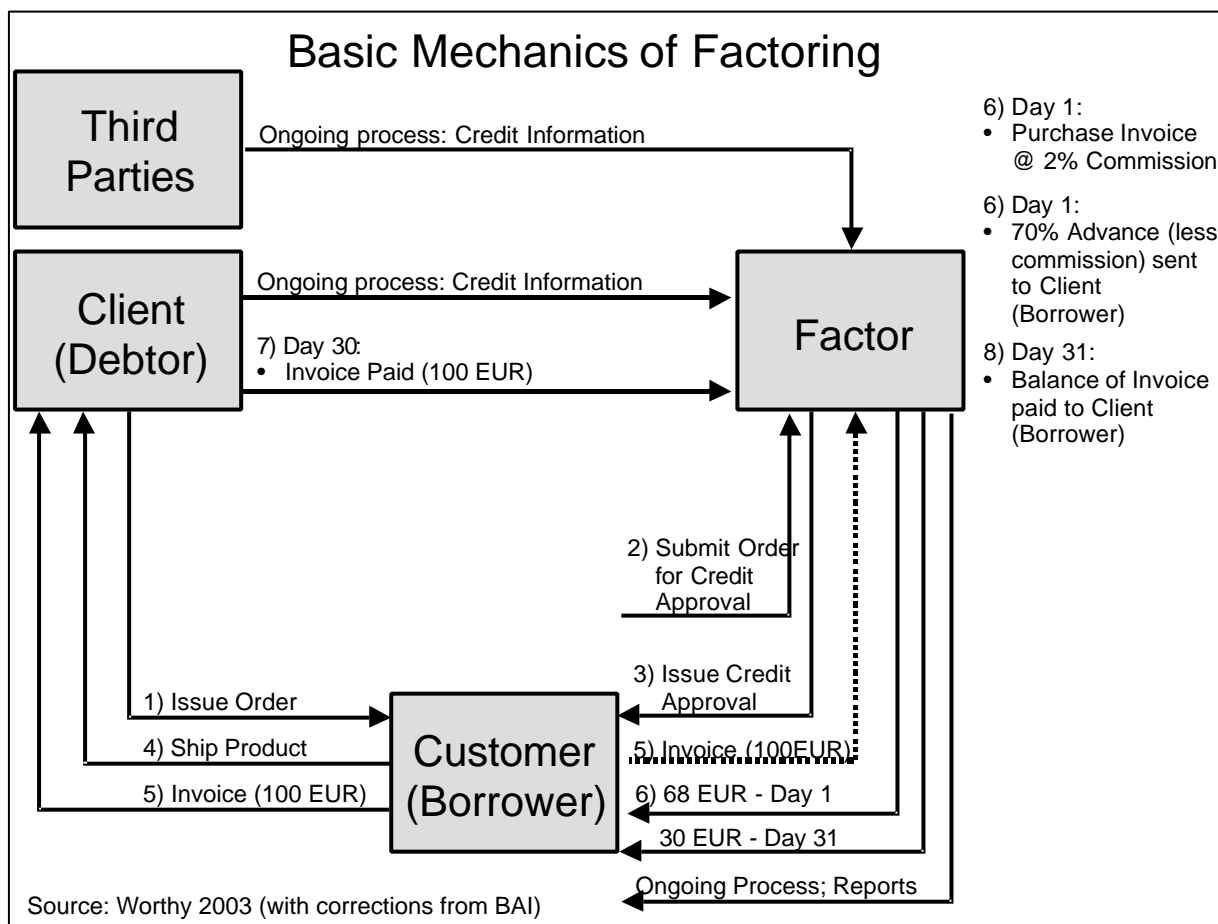
## 6.5.1 Description

Syria lacks key information infrastructure. No IAS have yet been introduced, thus few if any of its enterprises have acceptably audited statements. There are no Credit Registries. Factoring mitigates this lack of information. Lending is based primarily on the quality of the underlying accounts receivable, not the quality of the borrower. In other less developed countries, financial institutions have developed proprietary databases on account payment performance to lower default risks. This process is facilitated when the underlying firms' accounts are more transparent, which lowers the lender's risk.

Additionally, risk is also lessened when a borrowing SME has receivables from larger enterprises or, even better, if it has foreign receivables to pledge, from firms in countries with a stronger information infrastructure. Thus, factoring is extremely useful to the development of SMEs, which export to more developed economies. Large factors that operate in an importer's country will likely already have generated information about the importer's payment record. Indeed, it may be easier for Syrian financial institutions to develop their factoring business around foreign rather than domestic receivables.



The following flow chart presents how this product operates.



### Public Policy Issues

Factoring could facilitate attaining the two following objectives, which would be to:

- Enhance and develop existing products for Public Banks
- Provide alternative source of needed funding to Syrian SMEs

### Legal Overview

Syria has a weak legal and judicial environment. Thus, a key issue to resolve relates to whether its commercial law views factoring as a sale and purchase transaction rather than as a loan. If it does, creditor rights and loan contract enforcement may be less important for factoring. Factors are not creditors, public financial institutions however may be. If a firm went bankrupt, its factored receivables would not belong to the bankruptcy estate. They would be the property of the factor.

However, creditor rights and contract enforcement are important for at least two reasons. First, they define the environment in which the lender engages in collection activities. This will affect underwriting standards because the lender must take into account the anticipated cost and efficiency of its collection activities when it makes



credit decisions about which accounts receivable to purchase. Second, under recourse factoring, the factor has a contingent claim against the borrowing firm if there is a deficiency in the collection of a receivable. This contingent claim can be secured or unsecured depending on whether the factor files a security interest against some or all of the firm's assets, a secondary source of repayment.

The current weak rule of law will make a financial institution's collection activities more costly and less efficient. It decreases the value of the institution's recourse against its borrowers when it provides this factoring product. The institution is faced with the same problem if it takes a security interest in the borrower's other assets to better secure its factoring loan.

## **Institutionalising of Factoring**

Formalising factoring activities would benefit from increased use of this product by public financial institutions. Eventually, it could lead to the development of specialised financial institutions (factors) providing only factoring loan funding. To do so, it would be necessary to:

- Define factoring in civil and commercial codes and other financial sector legislation.
- Allow tax-deductible provisions for bad receivables.
- Mandate the use of the same accounting standards for all financial institutions which introduce factoring as one of their products so that their financial statements may be audited and then compared using the same standards that apply to their parent owners, particularly when these owners are banks.
- Recognise the unique nature of factoring companies' credit exposures when setting provisioning rules for large and connected exposure limits applicable to banks and bank-owned financial subsidiaries (such as factoring companies).

## **Potential Impact of Factoring**

Factoring has become an important source of financing—especially short-term working capital—for small and medium-size enterprises (SMEs) and corporations, reaching a world-wide volume of EUR 760 billion in 2003<sup>39</sup>. As such, it is an important source of external financing for SMEs. A key benefit of factoring is that SME riskiness is not necessarily a barrier to them receiving funding via the product. It depends on the quality of the underlying assets and whether they have sufficient liquidation value. This makes factoring well-suited to SMEs, risky or not. It should become more important to public financial institutions.

It is of note that Syria has a significant amount of private debts held between companies and individuals. Factoring could permit them to be monetised. However, customers' and suppliers' debts are not formally registered (for taxation reasons), and because of this, they are not discountable at Public Banks. Additionally, the

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<sup>39</sup> Ibid "Global Growth in Factoring—and Its Potential in Eastern Europe Financing Small and Medium-size Enterprises with Factoring, p iv, Executive Summary.



Central Bank has not rediscounted private debts for decades. Monetising these debts would create liquidity and from this could develop faster economic growth. If this monetisation took place, the common practice of companies delaying their credit payments to other companies or suppliers would be mitigated as well<sup>40</sup>.

## 6.5.2 Pre-requisites

### Initial

- Created or upgraded bankruptcy and collateral legislation to international best practices to strengthen creditor rights.
- Restructured public financial institutions capable of developing factoring portfolios.
- Bank Staff trained in factoring

### Secondary

- Audits of SMEs produced by following International Accounting Standards
- Credit Registries in place
- Specialised Factoring Financial Institutions (Factors) created

## 6.5.3 Recommendation

Factoring is not a product that the BAI Team recommends for Phase 2. Its development and spread could, however, facilitate the development and growth of Syrian SMEs in the medium-term. In that regard, the BAI Team would propose, that the soon to be created SME Support Agency, actively promote this product.

## 6.5.4 Implementation Implications

There are no implementation issues for Phase 2.

However, this is a product that could be a platform upon which Bank Sector Support Project II could begin focused public financial institutions training. As such, training bank staff in the use of this short-term financing product, directed initially to exporters and then to SMEs, should be considered a priority as the BSSP II Team develops its first Annual Work Plan (AWP).

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<sup>40</sup> This paragraph has profited from "Country Profile Syria, Financial Chapter, written by Samir AITA & Samir Siefan, draft July 2005.



## 6.6 Islamic Banking

### 6.6.1 Description

Islamic banks and their associated financial products are based, in their objectives and operations, on *Qur'anic* principles: the giving and taking of interest (the Arabic term is *riba*) is prohibited in all transactions. This interdiction makes an Islamic banking system and its banks differ fundamentally from that of a conventional banking system or banks with concomitant implications. Financial systems based on Islamic tenets are dedicated to the elimination of the payment and receipt of interest, in all forms. "Conventional" financial institutions have no such religious preoccupations. Islamic banks provide commercial services to their clients without interest in compliance with the religious injunctions of Islam.

Financial intermediation is at the heart of all modern financial systems, no matter whether Conventional or Islamic. Thus, the central question is what replaces the interest rate mechanism in an Islamic framework. Even in conventional banking approaches, Profit and Loss Sharing (PLS) mechanisms can substitute for interest as the method of resource allocation and financial intermediation, as in venture capital financing. So it is with Islamic banking; Islamic financial institutions operate primarily upon PLS principles. As such, an Islamic bank participates in the yield (profit), if any, and it suffers the loss as well resulting from the use of its lent funds.

Likewise, depositors share in the profits of the bank, if there are any, according to a predetermined ratio. Thus, a partnership is created between the Islamic bank and its depositors on one side, and between the bank and its investment clients on the other side. In contrast, conventional banks borrow their funds, paying interest on deposits, the liability (credit) side of the balance sheet. They lend those funds, the asset (debit) side, charging interest.

Six key principles drive the activities of Islamic banks. In addition to the prohibition of *riba*, these are:

- Risk sharing - the heart of the Islamic system;
- All financial transactions must be asset-backed; making money from money is unacceptable;
- Prohibition of speculative behaviour;
- Only Shari'a approved contracts are acceptable;
- The sanctity of contracts.



## Prohibition of financing “*Haram*” products

Islamic law identifies business activities as *Haram* when they generate profits in unacceptable ways. *Haram* businesses include:

- Alcohol
- Interest-based financial products
- Pork
- Gambling or Gaming activities
- Weapons or Defence products
- Tobacco
- Pornography

Acceptable business activities are Halal.

## Islamic Banking Products

The complexity of Islamic banking is found in the variety (and nomenclature) of the instruments employed, and in its application of the Shari’a (Islamic law). There are:

- **Murabaha:** means a sale at mutually agreed profit. It has been adopted by Islamic banks as a key mode of financing. The asset transferred to the client at the time of purchase, and the client provides securities and collateral. Technically, it is a contract of sale in which the seller declares his cost and the profit. The technique involves the purchase of goods by the bank as requested by its client. The goods are then re-sold to the client with an agreed mark-up.
- **Musharaka:** (Joint Venture Financing): brings together two parties who both provide capital towards the financing of a project. The parties share profits on a pre-agreed ratio, but losses are shared based on equity participation. Management of the project may be carried out by both the parties or by just one party.
- **Ijara:** means leasing. It is an arrangement under which the Islamic banks lease equipment, buildings or other facilities to a client, against an agreed rental.
- **Istisna’a:** is a contractual agreement for manufacturing goods, or providing commodities or implementing a project, allowing cash payment in advance and future delivery, or a future payment and future delivery. The terms may include a given price for delivery at a given future date. The price can be paid in instalments or gradually, as agreed upon between the parties. This product is therefore capable of financing the manufacture of capital equipment or the construction of houses, plant, or projects, and the building of bridges, roads and highways etc.
- **Mudarabah:** (Trust Financing) is an agreement made between two parties. The Bank is the Mudarabah, providing 100% of project capital and has no control



over the management of the project, and another party, known as a *Mudarib*. The persons manages the project (fund) using his entrepreneurial skills. Profits arising from the project are distributed according to a predetermined ratio; losses are borne by the provider of capital.

- **Salam:** is a contract in which advance payment is made for goods to be delivered later. The seller undertakes to supply some specific goods to the buyer at a future date in exchange for being paid in advance. The seller receives the full sale price at the time of contract. Normally, according to Shari'a, no sale can be executed unless the goods are in existence at the time of the bargain. However, *Salam* sales constitute an exception to the general rule, provided the goods are defined, and the date of delivery is fixed.

## Regulatory issues

An Islamic banking law is in place. The first banks are expected to begin operations in 2006. The demand study found that 34% of those not requesting a bank loan did so for religious reasons. This clearly indicates that this type of financial institution and their products will have a market. Thus, a key issue to resolve relates to Islamic regulation.

- **Types**

In order to appreciate the different regulatory regimes that are needed for Islamic banking, it is essential to distinguish between two different types of Islamic banks.

1. The first type of Bank is one that commingles the Investment Account Holders' (IAH) funds with its own funds and invests both amounts together. The financial outcome (profit or loss) on investments are shared between the Bank and the IAH, proportionate to their respective capital.
2. The second type of Islamic bank separates IAH funds from the Bank's funds. The IAH funds are spread over different types of investment possibilities, depending on the account holder's risk profile. In this instance, the Bank maintains separate income statements and balance sheets for each fund.

- **Commonality with Conventional Banks**

Islamic and conventional banks have common features. Both accept funds from the public, investing them for profit. At the same time, Islamic banks operate similarly to conventional mutual funds as they treat an IAH as a liability. Likewise, they create investment funds orientated to meet the differing risk profiles (from risk-averse to risk-taking) of their clients.

- **Islamic Bank Risks – Cautions for Regulators**

The supervisory and regulatory authorities of Islamic banks have to take into account their special nature, whilst subjecting them to the core principles issued by the Basel Committee. This is specifically the case when devising suitable capital adequacy criteria, as clearly laid-out by the following examples.





- The current methodology for assessing capital adequacy, as recommended by the Basel Committee, covers credit risk (the assessment of counterparts) and market risk (the ease with which financial assets may be liquidated). It does not, however, take into account the fact that Islamic bank lending (investment) is asset backed and must be backed by tangible real assets: buildings, machinery, aircraft, etc. Even so, such assets are still subject to changing valuations up or down. This is quite apart from their natural depreciation. Clearly, this creates a problem and is a risk if the bank needs to liquidate the assets. This is in addition to borrower default (credit) risk.
- Concerning investment accounts, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) issued its Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks in March 1999. According to this statement, Islamic banks' own capital is exposed to normal commercial risk, fiduciary risk and displaced commercial risk. The concept seems to need continual review in concert with a capital adequacy framework for Islamic banks within the Basel Committee's capital adequacy framework.

- Thus, the current position is that:

"The capital regulations for Islamic banks should be capable of enhancing the fiduciary roles performed for risk-averse depositors (Investments Accounts), and the agency roles performed for risk-taking investors (Mudarabah – Musharakah)".

However, the consideration of investment account is still unclear, whether it is capital or only deposits. Thus, depending on the type of investment account, it should not be classified as capital, since Islamic banks are not permitted to utilize these funds to pay the creditors of the banks, nor can they be regarded as deposits since an Islamic Bank is acting as *Mudarib*. In addition, the call on the capital of an Islamic Bank can only be made when the bank has undertaken negligence or misconduct in managing the investment account holder's funds.

- Finally, "displaced commercial risk" is commonly associated with Islamic Banks. They remain under commercial pressure to pay a rate of return to their IAH accounts, which is lucrative enough to induce these investors to maintain their funds with the bank. If this return is lower than the rate currently payable in the marketplace, then the bank may be under pressure to forgo some of the share of its own profits to make up the rate. It, thereby, utilises profits attributable to *Mudarib*.

Failure to do this may result in a large volume of withdrawals of funds by investors. This may jeopardise the bank's commercial position and competitiveness, even leading to the bank's closure. In conventional banks, this is known as a run, when more depositors want their money back than the bank can immediately provide.



In this way, Central Bankers may be able to regulate the money supply through the interest rate on treasury bills, and hope (expect) that Islamic banks will react in the same way as the conventional banks. That is, as interest rates rise so will the return paid by Islamic banks to their IAH accounts and so will the mark-up charged to their customers. The reverse would occur as interest rates fall. However, this is a rather blunt instrument, as Islamic banks may not react in this way if they are intent on gaining market share (by keeping their mark-up low) or decide to focus on less risky projects (by curtailing deals). A “run on the bank” would only occur if investors or customers feared for the bank’s solvency.

## **Training**

Islamic banking is very different from conventional banking with regard to both sides of the balance sheet. It is in fact very different from many perspectives. There are important differences with regard to legal, regulatory and supervisory issues.

These various issues make it essential, when Islamic banks begin operating in Syria, that extensive training programmes are introduced.

### **6.6.2 Pre-requisites**

- Regulatory and supervision framework developed and approved
- Audits standards, if other than IAS, be developed
- Bank Management and Staff trained

### **6.6.3 Recommendation**

The BAI Team does not recommend that the Phase 2 BAI Team deal with the creation and then development of either Islamic banks or products. However, without prejudice to its own activities, the Phase 2 BAI Team would be supportive of Islamic product development. This is because leasing and equity finance, two of its preferred recommendations, are also comparable to Islamic products, as both can be structured not to be based upon “Riba”.

### **6.6.4 Implementation Implications**

There are no implementation issues for Phase 2. However, as the BSSP II goes forward in restructuring the Central Bank, both Teams should consider regulatory issues. This is an important matter, even given the amount of effort required for restructuring the Central Bank. Thus, the BSSP II team should seriously assess how it could integrate this activity into its first AWP. If it cannot, it should make it a priority when developing its second AWP in May 2007.



## 6.7 Leasing

### 6.7.1 Description

It is commonly accepted in free market economies that the availability of leasing facilities not only stimulates the growth of a country's economy but also are fundamental to its development in terms of employment and subsequent revenues from tax. As leasing tends to be asset based financing, a potential lessee can acquire critical assets for his business and spread the cost of ownership over the life of the asset thus leaving his banking facilities to be used for working capital. The use of the asset should create wealth for the lessee and enable him to employ additional staff to operate the asset. The additional income from the use of the asset will be taxable and the additional employees required to operate the asset will also pay tax on their enhanced incomes received from the lessee.

In economies where companies operate in the informal ("grey or black") markets, it has been noticed that there often is a visible move into the formal ("white") economy because, although leasing companies normally require less securities than banks, they do still require tangible proof of legal incomes to support the cash flow required to make the repayments of the leasing rentals.

Leasing companies tend to use three key indicators when assessing risk:

- A customer's ability to repay
  - This is usually derived from financial information presented by the lessee
- A customer's willingness to repay
  - This is usually derived from past repayment behaviour of the customer either with the leasing company itself or with other financial institutions or trade creditors
- Its equity in the asset to be leased
  - The leasing company will always assess the future remarketing opportunities of a leased asset in the event that it must repossess and resell the asset.

### Creating an environment for leasing

Many governments have promoted leasing as a way of encouraging investment<sup>41</sup>. But leasing offers other benefits: Leasing provides an alternative means of financing projects and may provide competition to other providers of finance for projects, which ultimately will be to the benefit of entrepreneurs by ensuring that the cost of finance remains reasonable. It also introduces businesses and financiers to innovation, such as cash-flow-based credit analysis.

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<sup>41</sup> See Annex 3 Country Comparisons for a table showing the Market Penetration of Leasing in selected countries.



Moreover, leasing is a product that was asked for by entrepreneurs in the questionnaire undertaken for this project. Even though leasing does not currently exist in Syria in a form that is comparable to the service more generally available in free market economies around the World, the introduction of this financial service to Syria may still be relatively straightforward and quick. Where leasing seems to be currently available in Syria, it is mainly with respect to properties.

Three Islamic banks are intending to set up in Syria in the near future. The Islamic bank product "Ijara" is similar to leasing, although there is no interest component, rather the Islamic bank "leases" the product to the customer for a fee, which includes a mark-up over and above the purchase price, to reflect the service provided as well as a return for the bank.

The fact that there soon will be Islamic banks operating in Syria does not mean that there will be no longer any scope for a specialised leasing company or that the conventional banks operating in Syria cannot also offer leasing.

The two critical issues for the development of leasing as a financial service in Syria are legislation and education:

### Legislation

- Both leasing companies (lessors) and their clients (lessees) must be comfortable that the terms and conditions of any contractual relationship that exists between these two parties are defined in legislation that is both specific and relevant.
- The critical parts of any leasing legislation must include the clear definitions of:
  - Lessor
  - Lessee
  - Financial leasing
  - Operating leasing
  - Repossession
- In addition to these definitions, any legislation that is imposed on the lessors and lessees must also either specifically define or alternatively refer to relevant taxation issues.
  - **Lessor:** corporation tax treatment on received leasing rentals from i) financial lease agreements and ii) operating lease agreements
  - **Lessee:** corporation (or personal) tax treatment on paid leasing rentals from i) financial lease agreements and ii) operating lease agreements
  - **Depreciation:** the amount, beneficiary and timing, and/or writing down allowances
  - **VAT (value added tax):** although this tax does not currently exist in Syria, it is believed that it will be developed within the next few years. The



payment and recovery of VAT payments by both lessor and lessee should be a simple matter to define and administer, but many state authorities in other developing countries have given this tax so little consideration when creating legislation that, in several countries, the VAT legislation has become a barrier to entry for leasing companies. (See the Section on VAT below.)

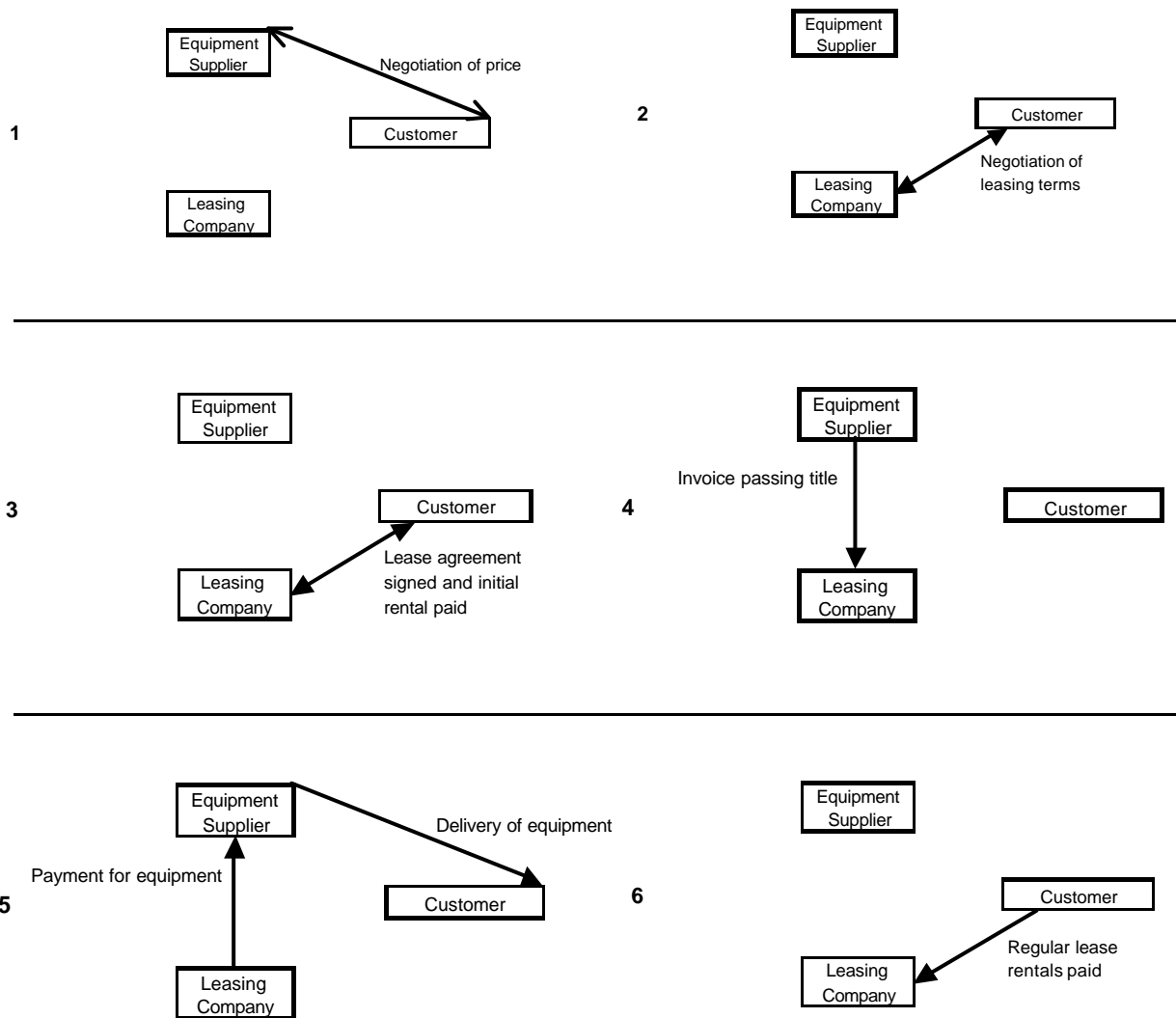
- The legislation should not only be written in a very clear and transparent manner must also be able to be consistently interpreted. Courts and court officials who are called on to use the legislation in the event of a dispute between a lessee and his lessor must be bound to deliver verdicts in such a manner that reflects the outcome that was intended by the writers of the legislation. Other countries have created leasing legislation that has initially attracted leasing companies to invest, but has also seen their swift departure when the legislation has been badly interpreted by court officials or unreasonable delays have occurred in the court process thereby delaying the leasing company's ability in claiming for losses against a lessee.

## Education

- If leasing is to become a new financial service within Syria, it is critical that all parties involved in a leasing transaction fully understand the fundamental issues relating to leasing.
- Parties involved in a leasing transaction are:
  - **The lessor** – the leasing company
  - **The lessee** – the customer or client of the leasing company, which can be a private individual or a company
  - **The funder** – the person, company or institution providing the funds to the leasing company
  - **The asset supplier** – the person or company that sells the asset to the leasing company.
  - **The insurance company** – the company that carries the insurable risk on the asset.



The key stages of a leasing transaction





1. The customer, having decided to use leasing to finance the acquisition of the asset, will approach a leasing company (or of course several within a competitive market) and enter into negotiations with the leasing company.
2. If the leasing company and the customer can agree the terms and conditions of the lease agreement, a leasing contract will be signed by both parties and the customer will pay the leasing company the required initial payment on the lease (also variously known as a down payment, advance payment, deposit or up-front payment) and probably, as well, a transaction fee.
3. The supplier of the asset will raise an invoice in favour of the leasing company and will pass title (ownership) of the asset to the leasing company when
4. The leasing company pays the supplier for the equipment (at this time the asset will be delivered to the customer).
5. The customer is then obligated to make regular repayments to the leasing company to enable him to retain the usage of the asset.

## **Leasing: a financial service**

Leasing companies are similar to banks in as much as both institutions lend money to their customers. However the similarities tend to end at this point. Leasing companies are asset-based financiers. Furthermore, leasing companies do not accept deposits from their customers. Moreover, leasing companies tend not to be regulated by Central Banks (mainly because they do not accept deposits).

Although leasing companies tend to charge slightly higher interest rates than banks do, this is justified by the leasing companies' attitude to balancing risk and reward. Banks will always maximise the available security when making lending decisions and tend towards taking collateral over a customer's assets far in excess of the value of any loan or facility that they may grant thus reducing a borrower's capacity to raise external funds. In most leasing agreements, the leasing company will only have the value of the asset being financed as its security in return for providing a leasing facility to its customers<sup>42</sup>. However, when the asset value is deemed low by the leasing company or where the customer's creditworthiness is below the acceptable benchmark, the leasing company may ask its customer to provide additional security. In this respect the leasing company will more resemble a bank in its attitude to "lending".

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<sup>42</sup> This feature is dependant upon legislation enabling the lessor to recover his asset from the lessee with a minimum of trouble and to be able to re-lease the asset to another lessee.



## 6.7.2 Positive Arguments

Leasing has world-wide addressed an unmet demand from new SMEs and attracted borrowers away from traditional bank loans. It offers advantages to all parties:

### a) The Lessee

Although leasing is a high-spread business, it offers potential advantages to the lessee:

- *Simpler security arrangements:* Because ownership of the items being leased remains with the lessor means that the lessor is less interested in track record for security and more interested in a project's cash flow potential, SMEs can generally access lease finance more easily than bank loans.
- *Availability:* In developing countries leasing is often the only form of medium- to long-term finance available for purchasing equipment.
- *Convenience:* Leasing often can be arranged more quickly and simply than conventional loan financing because security over assets outside of the project often is not required by the lessor.
- *Lower transaction costs:* Despite the relatively high mark-ups expected by leasing companies, the costs of assigning collateral, documentation, and slower processing times for bank borrowing can be significant, particularly for smaller borrowers.
- *Comparatively little cash required:* Leasing can finance a higher percentage of the capital costs spent on equipment than banks would normally agree to, partly because the down-payment required by lessor is often less than the amount of equity required before loans are granted. This is partly due to the more secure title the lessor has over the equipment being leased.
- *Flexibility:* Leasing contracts are often structured to meet the expected cash flows of the lessee; there is a tendency for interest on bank loans to be paid on specified calendar days.
- *Tax incentives:* In many countries lessees can offset their full lease payments against income before tax, compared to just the interest on bank loans. Furthermore, the lessor may pass on tax benefits associated with their depreciation to lessees via reduced financing costs. Governments often grant special tax incentives to leasing because they recognise that it enables new small firms to access financing for investment.

### b) The Leasing Company (Lessor)

- *Ownership of the asset:* Gives the lessor strong security. In countries where weak collateral laws hinder bank lending, leasing offers the advantage of (often) not requiring collateral beyond the security of leased asset itself, and of simpler repossession procedures, because ownership of the asset lies with the lessor.





- *Dedicated use of funds:* Because the lessor purchases the equipment directly from the supplier there is no opportunity for the lessees to misuse the funds for other purposes.
- *Relatively simple documentation:* Because ownership of the assets remains with the lessor for the duration of the contract, the contractual arrangements are simple, leading to lower transaction costs, allowing leasing companies to achieve high leasing volumes efficiently.
- *Lighter regulation:* Because leasing companies are not usually deposit takers they tend to be less tightly regulated than banks.
- *Flexibility:* Moreover, lessors have a good knowledge on how best and where to dispose of assets repossessed from defaulting borrowers. They are, in most cases, able to lease reclaimed assets to others and, in this way, contain their credit risk better than banks. Hence, the exit cost from a leasing contract to an entrepreneur may not be as expensive as the cost of disposing of the same assets, if bought directly by the entrepreneur.
- *Acceptability:* In Islamic countries, leasing is acceptable as an Islamic product and so those entrepreneurs, who are concerned about such matters, may find leasing inherently attractive, even if it were to be more expensive than interest-bearing forms of finance.

### 6.7.3 Negative Arguments

The idea of leasing may well be attractive, but in practice it will be difficult to attract an experienced leasing company to set up in Syria. This may only be partly true. The principle of leasing is also an Islamic banking product and three Islamic banks are currently interested in setting up in Syria. However, the type of leasing being discussed here is leasing assets to enterprises; the leasing that the Islamic banks and others may be more interested in is consumer durable leasing.

### 6.7.4 Pre-requisites

Arising from international experience, following six factors are necessary to enable leasing companies to flourish:

1. *Good, Experienced Management:* A high standard of cash-flow-based credit analysis and supervision of clients, complemented by follow-up and equipment insurance procedures are critical.
2. *Competent partners:* In many markets where leasing is being introduced, it is important to have an active, committed and competent foreign technical partner (at least contractually committed or, preferably, as equity investor) who should: establish and monitor systems and procedures; train local staff; advise on lease pricing, marketing and administration; and ideally second to the project the first general manager.



3. *Funding*: The single biggest obstacle to the growth of a leasing company is often access to long-term local currency funds. Access to term deposits from insurance companies or pension funds or to a local bond market helps overcome this problem.

Moreover, every leasing company will have to raise finance to purchase the assets to be leased. Again, those with capital to invest may find investing in a leasing company more acceptable than in a conventional bank. Hence, the finance available for leasing may be fairly easily raised and, possibly, more easily than for traditional banking.

4. *Asset-liability matching (ALM)*: Leasing companies must match fixed-rate lease with fixed-rate term funding, or if only floating rates are available (locally or internationally), it need a regulatory framework that allows periodic adjustments of lease rates.
5. *Attractiveness to lenders*: Given their high debt-equity ratios, leasing companies must remain attractive to lenders. Security sharing agreements that establish equal rights to a pool of the leased assets, collateralised for the senior lenders are often used for this purpose.
6. *Regulatory framework*: Leasing companies need a regulatory, legal and fiscal environment that at least provides equal treatment compared with other sources of capital investment financing. Clear, simple and effective legal procedures are important, particularly:

**Clarity in defining a lease contract, leased assets, and responsibilities and rights to a lease contract:** There needs to be definitions of what constitutes a lease transaction, a leased asset, and the responsibilities and rights of the lessor and lessee.

**Liability:** Clarifying responsibility for liability of third-party losses arising out of the operation of leased assets is important because ownership and use of an asset is separated in Leasing. This is particularly relevant with assets such as vehicles because the risk of causing third-party losses.

**Priority of lessor's claim over leased assets:** The basis for leasing advantage over lending is if the lessee/borrower becomes bankrupt. As the equipment owner, the lessor's claim to the asset should be superior to any claim creditors may have on the lessee.

**Repossession:** Easy and rapid repossession of leased assets is one of the main advantages a lessor has compared with lenders. The legal framework should permit non-court repossession, so that lessors can repossess leased assets without legal proceedings, as long as the lessee does not contest the repossession. When repossession is legally and judicially easy, lessors can lend to riskier businesses and price their leases with a lower risk premium, making leasing available more cheaply.



## 6.7.5 Recommendations

Leasing is a worthwhile financial product to be introduced into Syria,. Because of the way leasing is structured, there is a tendency for leasing companies to agree to lease more quickly than traditional banks agree to lend.

Again, because lessors tend to look more carefully at the project and the ability to generate funds to pay the lease charges than bankers seem to do, leasing may assist more new entrepreneurs with good project ideas, but who may lack collateral, into business.

Hence, leasing is a simple but very effective financing product that has a good future in Syria.

In order to create a leasing sector within Syria, the Government must work closely with local and international banks; with international financial institutions; and with international equipment vendors to create an environment and legislative system that will bring this form of financing to the individuals and businesses of Syria.

This process need not be a long one. Legislation that operates successfully in other countries can be adapted for use in Syria. The technical know-how required to develop leasing companies (within critical areas such as: risk assessment, funding, sales and marketing, and collections) can be brought to Syria to work with the Government and also potential lessors. The Government can develop incentives to bring key international financial institutions and vendors to Syria.

Specifically, there are a series of recommended steps that the Government must undertake to make leasing a realistic option for entrepreneurs. They are:

1. The Law needs to be reviewed in order to ensure that leasing is legally possible and that the ownership of the assets being leased clearly and unequivocally remains with the leasing company for the duration of the lease. It is important that an entrepreneur cannot argue in court to be allowed to retain the assets, even if they remain legally owned by the leasing company, because, without them, the enterprise would cease and the employees would be redundant. That may sound harsh, but no leasing company can function unless they can be assured of regular and timely payments of the agreed amounts. Most leasing companies would be sympathetic to customers in temporary difficulties for the simple reason that reclaiming and then disposing of the assets would usually be more expensive in effort and cost than negotiating a compromise solution.
2. The Government should consider what incentives could be offered to attract leasing companies to set up in Syria;

Ways that the Government could act as a catalyst, rather than waiting and hoping that private investors will set up, are as follows:



1. The Government could offer to subscribe, as seed capital, a minority equity sum (e.g. 10%) in the first two leasing companies, which would be orientated to leasing buildings and equipment to entrepreneurs, to set up in Syria.
2. If it were possible for the Government to invite some international finance institutions also to invest, the attraction of the Fund would be increased and, similarly, the interest of international leasing companies in managing the project would increase.

There would be an added advantage in securing the management by an international leasing company in that it could, and most probably would, promote its services in Syria to its customers in other parts of the World. Hence, the leasing company would assist in promoting Syria as an investment location.

## 6.7.6 Implementation Implications

For leasing to take off in Syria in the way that has been described, it is absolutely necessary for the Government to review the Law in order to see if it is necessary to pass a special law on leasing, which is the possibly case.

Similarly, it will be important to provide some incentives, and those mentioned above in terms of the treatment of tax would seem to be the most important.

## 6.8 Gap Management (CDs to fund MT/LT Loans)

A key element of banking is the management of risk. Financial risks may be identified under a number of different headings, for example Market Risk, Credit Risk, Liquidity Risk, Operational Risk, Legal & Regulatory Risk, and Human Factor Risk. Our concern here is with two elements of Market Risk, specifically *Interest Rate Risk* and *Gap Risk*. We seek to identify the causes of these risks and the controls and remedies that may be applied to manage and thereby, mitigate these risks.

By way of explanation, Interest Rate Risk relates to the potential negative effect on net cash flows and values of interest bearing assets and liabilities caused by movements in interest rates.

Gap Risk relates to the amount by which sensitive assets exceed sensitive liabilities (see below). The gap is negative if sensitive liabilities exceed sensitive assets. Under rising short-term rates, the positive gap will increase the interest margin. The converse will be true under falling short-term rates.

At the heart of the matter is the management of assets and liabilities on a bank's balance sheet in such a way as to distinguish between those that are sensitive to changes in short-term interest rates and those that are not. Examples of sensitive assets will include money market placements, short-term and variable rate loans, and short-term securities. Sensitive liabilities will include demand, savings and other short-term deposits, and money market borrowings. Non-sensitive assets will include fixed-rate loans, long-term securities and bank premises. Non-sensitive liabilities will



include long-term Certificates of Deposits (CDs), other forms of long-term debt and equity capital. The point at issue is not so much the maturity of the asset or liability but rather its sensitivity to changes in interest rates<sup>43</sup>.

The purpose of this introduction is to highlight the fact that the Public Banks, which engage in long-term lending, are using sensitive liabilities (short-term deposits) to fund their non-sensitive assets (long-term, fixed-rate loans) – in other words they are borrowing short and lending long.

## **Certificates of Deposit**

Certificates of Deposit are already issued by some of the Public Banks in Syria but terms are commonly six months or one year. There is, as yet, little incidence of longer term CDs or term deposits, and where they do exist, terms will not exceed a maximum of three years. Matched against fixed rate loan assets, with maturities running out to fifteen years, this is clearly totally inadequate.

The definition of a Certificate of Deposit is a short or medium-term, interest bearing, debt instrument, offered by banks and savings institutions. CDs tend to offer higher rates of return than most comparable investments in exchange for tying up invested money for the duration of the certificate's maturity.

The minimum maturity for CDs is seven days. There is no maximum maturity on CDs. Most CDs with maturities of one year or less will pay interest at maturity. CDs with maturities longer than one year normally pay interest on a semi-annual basis. The payment is calculated using the actual number of days divided by 365. Any fixed income security, sold prior to maturity, may be subject to a substantial gain or loss. If sold prior to maturity, CDs may be sold on the secondary market subject to market conditions.

Fixed rates are common, but CDs may be offered with various forms of variable rate. In this case, the coupon is subject to periodic change in accordance with a predetermined formula interval. The change in coupon will be linked to a determined benchmark [equity linked, London Inter-Bank Lending Rate (LIBOR) linked, or other indexes].

## **Negotiable CDs**

These are normally issued in large denominations and are usually bought by institutional investors who are interested in low-risk investments. Negotiable CDs are usually in bearer form, and have secondary markets that are highly liquid. They have all the same characteristics as ordinary CDs, but in addition, may be sold or transferred to another party by simple endorsement and delivery.

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<sup>43</sup> Cf "Bank Management – Text and Cases", George H. Hempel, Donald G. Simonson, Alan B. Coleman.



## How CDs Work

Banks will normally issue a paper certificate to the customer, although it has become common practice in developed markets for a CD to consist simply of a book entry and an item shown in the customer's periodic bank statements – in other words, there is no "certificate" as such.

Interest payments may be accumulated. They may also be paid by cheque or transferred into a current or savings account. The method of receiving interest will generally have to be selected at the outset of the transaction.

At maturity, the customer has the choice of renewing the CD at the prevailing rate, or of withdrawing the principal and accumulated interest. In the absence of any instructions from the customer, the bank will often automatically renew the CD for a further period of time.

Cancellation of the CD, prior to maturity, will usually be subject to a penalty sufficient to discourage such action by the customer. This may be equivalent to 3 or 6 months interest, or whatever is the cost to the bank of replacing the cancelled deposit, with alternative funding of a similar amount and remaining term to original maturity.

### 6.8.1 Description

There is a total absence of suitable investment instruments in the Syrian market, available to the banks, through which they can generate the term funding they require to match their term lending. These instruments will include bonds or other forms of debt instrument, issued by the banks at varying terms and in various denominations. It will also include long-term deposits and CDs.

At the same time, the institutional infrastructure, to support such medium and longer-term investment instruments – e.g. a capital market through which, for example, bonds can be issued, and a secondary market on which they, and indeed CDs, can be freely traded – is also absent at the present time. However, with the establishment of the Board of Trustees for a Syrian Capital Market Authority, in February 2006, it is foreseen that the Capital Market will open in August 2006.

### 6.8.2 Pre-requisites

- The establishment of such markets, which will require active intervention, encouragement and regulation on the part of the relevant government authorities, is beyond the scope of this paper to address. However, they would greatly facilitate the raising of long-term funding by the banks, which in turn would contribute significantly to their ability to manage the interest rate risks to which they are currently exposed. In the meanwhile, however, this systemic deficiency is outside of the control of the banks to manage or to influence.
- Far more susceptible to change are the Public Banks' own internal risk management systems. Here, the first conditionality is the introduction of effective Balance Sheet and Liquidity Management through the establishment of



an Asset Liability Committee (ALCO). It normally acts as a sub-committee of an independent Board of Directors, operating within clearly defined terms of reference. This whole issue of Corporate Governance will be addressed elsewhere in this Report. Nevertheless, there can be no doubt that the absence of such mechanisms, within these banks, contribute significantly to their mismatch, or gap positions.

- The only way that banks can address the question of matched funding is to ensure that there is a broad balance between their sensitive and insensitive assets and liabilities, in other words, that any imbalance between sensitive assets and liabilities is the result of a conscious management decision, based on a rational expectation that short-term interest rates will either rise or fall in the near future.
- In a sophisticated market, where financial instruments can be issued and traded on a properly regulated Stock Exchange, the issuance by banks of long-term bonds to finance their insensitive assets (investments, term loans and premises) is common practice. In Syria, where the appropriate institutional framework has yet to be established, realistic options will, for the time being, be restricted to the issue of CDs.
- The Government has taken a key decision to address this matter by establishing an institutionalised capital market supervisory body, the Syrian Securities and Exchange Commission. Additionally, it should also encourage the development of a secondary market untrammelled by persistent government interference and intervention.
- An appropriate regulatory and supervision framework needs to be developed and approved.
- Audit standards, if other than IAS, will need to be developed and introduced.
- SSEC Board, Management and Staff will need to be suitable trained.

### 6.8.3 Recommendations

#### For the Government

In current circumstances, investors have little incentive to place money with the banks at terms of more than one year. Because the differentiation between short, medium and longer-term rates is minimal, it is hardly surprising that banks are unable to attract longer-term deposits. Therefore, the following are recommended to the Government for its consideration:

1. It is incumbent upon the Credit and Monetary Committee (CMC) to re-examine its interest rate policy. Its objective should be to establish a clear distinction between interest rates payable on local currency deposits for differing terms, with specific emphasis on the encouragement of medium and longer-term investment and the discouragement of short-term savings.



2. Whether or not there are local investors in medium and longer-term CDs, consideration should be given by the appropriate authorities to permit the issue of negotiable CDs. Until a secondary market exists, the CMC should permit banks, both public and private, to trade or broker such instruments between ready buyers and sellers, if available.
3. The Public Banks themselves need to introduce effective risk management systems and control to ensure better management of their balance sheets and liquidity positions. In addition, for those banks currently engaged in long-term lending, it is of paramount importance that they cease lending at fixed rates funded by short-term deposits, and move to variable rates referenced against a clearly identifiable bench-mark rate (as in Bank of England Base Rate or US Prime Rate) set by the CMC.

## **6.8.4 Implementation Implications**

As Phase 2 implementation goes forward, the general issue of risk management will be addressed including the specific question of asset liability management. Additionally, the BSSP II should work with the Banking Supervision Department of Central Bank in order that it can better assess this mismatch problem when it undertakes its supervision missions of the Public Banks.

Both teams should work with the Government in order that the Capital Market undertakes its rightful role of providing the financial products necessary to minimise the mismatching of Balance Sheet Assets and Liabilities within the life of both projects.

The training issues related to risk management are important for assuring the long-term success of restructuring the Public Banks. Thus, the BSSP II team should seriously assess how to include risk management training modules into its second AWP in May 2007.

## **6.9 Equity Finance**

### **6.9.1 Description**

Equity finance can be a risky form of investment, which means that the capital funds invested may be partially or totally lost. Additionally, this type of investment may not earn a comparable or better rate of return to that which an investor could earn by investing in an alternative project. On the other hand, if the enterprise in which the investment is made, succeeds, the equity financier, individual or institution, will reap the benefit of his risk taking.





## **There are two types of equity investor:**

- Individual:

This is someone who normally places funds in listed Stock Market enterprises. It can also be a wealthy financier, through equity investment, diversifies risks by making private placements.

- Institutional:

There are various different kinds of institutional investor. The most important are Insurance Companies, Pension Funds and Unit Trusts which place their funds in equities, often matching long-term liabilities, (for example payment of insurance benefits or retirement pensions), with long-term assets, (buy and hold in enterprises). There are also equity funds, of which venture capital funds are one example.

### **6.9.1.1 Due Diligence**

Before an equity investor, either individual or institutional, funds a project or invests capital in an enterprise, a thorough due diligence is undertaken. This involves, amongst other analyses, a detailed investigation of the enterprise. In particular, the existing assets, liabilities and other equity investors are carefully appraised. Moreover, if the financier is not the implementer/manager of the project, the investor will also assess with extreme care those who will run the project. This scrutiny is to ascertain whether or not the managers can implement the project or run the enterprise from which the equity investor will receive his anticipated investment return, through capital appreciation, dividends or both.

However, the key assessment is focused on the entrepreneur's capabilities and his/her management team. Additionally, and perhaps most important, is the capital investment that the entrepreneur himself is prepared to make in the project since his decision to invest, and how much, is a positive indicator of the enterprise's potential success.

### **6.9.1.2 Impact**

An equity placement from a serious independent investor, not a friend or member of the family, sends a positive signal to the enterprise's clients, suppliers and banks. The banks are more likely to be repaid and clients to receive orders be paid on time. Employees may have a heightened sense of longer-term job security, and as a result becoming more productive. It could even improve recruitment of better staff and managers.



## 6.9.1.3 Sources of Equity Finance

### Stock Exchange

The best known way of attracting equity investors, individual or institutional, is to sell equity (stock) through an IPO, either through the stock exchange or by means of a private placement (see below). This is both a costly and a lengthy process, particularly in less developed countries like Syria where only the largest, best known enterprises are able to raise capital in this fashion.

The Due Diligence requirements are stringent: normally three years of fully audited accounts, to International Accounting Standards as a minimum, plus a prospectus setting out the enterprise's 3 to 5-year business plan. If the enterprise passes these tests, the company's shares are listed on the stock exchange and are freely traded at their daily market value.

### Private Placement

Developing countries often lack capital markets. However, private placements offer enterprises the possibility to receive funds from direct sale (placement) of shares to individual or institutional investors. In the case of individual investors, these are usually wealthy financiers with considerable capital who are willing to place a small proportion of their funds in higher risk equity investments. The appraisals may be less costly but normally are very professional, sometimes as extensive as for a Stock Market IPO.

### Equity/Venture Capital

A widely known type of equity investor is the venture capitalist. These financiers are associated with placing capital in start-ups. As specialist financiers, in most cases, they understand the risks, because that is their business. Nevertheless, the very high returns achieved with some projects compensate for other investments where the returns are low, or even where all capital is lost.

### Equity Finance Exit

The absence of stock exchanges is always a problem for any equity investor, whether short-term (for example venture capitalist) or long-term buy and hold (for example private placement). The former seeks out high return investments, normally associated with start-ups, turnarounds or well-positioned firms, which can gain market share through expansion. They look to exit from their investment early in the growth cycle, which carries the most risk, and hence the greater returns. The latter, and particularly in the case of life insurers and pension funds, has to reap benefits periodically, selling equity for cash, in order to meet insurance payouts or pay pension benefits.

Additionally, the entrepreneur will have a contractual pre-emptive right either to purchase the shares or even to veto a sale to third party investors, after making a sale to Equity Fund and/or Private Placement investors. This makes the exit, and in



the process realising good or at least acceptable returns, much more difficult, and therefore a serious issue for either type of investor to assess prior to placing funds.

#### **6.9.1.4 Equity Funds**

The BAI Team believes that this type of equity investment offers the best opportunity for Syrian enterprises to access long-term finance other than bank loans. Equity Funds are institutional investors that attract funds in much the same way that banks attract deposits. They must pay returns, but at the same time, the investors must be willing to take risks in order to obtain these returns. But to attract financiers' funds for placement, the Equity Funds must have professionally trained, experienced management, with excellent track records, particularly for probity.

The European Bank for Reconstruction and Development (EBRD) provides a good example of how Equity Funds can be established, as it has set-up several funds in Eastern Europe and Central Asia. These funds provide equity investment in local enterprises. This enables them to seek bank loans as well as to attract foreign joint venture partners. Often the funds have invested in newly privatised ventures, again to attract other investors and support local investors.

The EBRD took initial capital participations itself in these Funds in order to attract other investors, who could have been put-off by such risk taking. It hired professional financiers to manage the Equity Funds, and they had to subscribe about 5% of the equity as a demonstration of their commitment. In addition, associated with each Fund was an on-going technical assistance fund. The concept is neither new nor restricted to Eastern Europe and Central Asia. The International Finance Corporation (IFC) set up a very similar fund for the South Pacific.

#### **Syrian Context**

The Focus Groups, particularly those held after the questionnaire survey was completed, revealed considerable interest in equity finance (Cf. Annex 1.2). This finding is at variance with other Middle East entrepreneurs, reputed to be quite secretive about their businesses. By permitting equity investment, they are inviting investors to participate in their businesses ending any pretence of confidentiality. However, Syrian entrepreneurs have a specific interest in private equity placements with clearly defined entry and exit points. They want the funds for a 3 to 7 year period after which they would wish to have the right to buy back the equity holder's capital stake. It is worth repeating that no Capital Market currently exists in Syria even though equity has been sold. (Cf. Chapter 2.2, SSEC)

A second reason for Syrian entrepreneurs' interest is that it is a classic Islamic banking product. Thus, many focus group participants, respecting their religion, are against usury (*Riba*), or even paying non-usurious interest for loans. For further information on Islamic banking and its products, refer to section 6.7. The type of investors, which the focus group participants might be willing to accept, was not discussed. Only during phase 2 could this issue be more fully investigated.



## 6.9.2 Positive Arguments

There are several arguments for setting up an equity-funding vehicle. For any kind of investor, however, is it individual or equity fund:

- It would have the expertise and resources to assist an entrepreneur if difficulties emerged;
- It would insist on accurate and timely accounting as conditions for investing;
- It could attract other risk capital.
- It provides confidence to the bankers, suppliers and customers of the enterprise
- It enables the enterprise to borrow more within prudential limits by increasing the equity, thus facilitating expansion or the ability to seek new markets.

## 6.9.3 Negative Arguments

The determination of a fair market value for an unquoted enterprise is the biggest challenge for an equity investor. In a normal negotiating process, the equity investor is looking to pay the lowest possible price for the equity whilst the existing shareholder is looking for the highest. This process is even more important in absence of a functioning stock exchange. This is the case in Syria. The enterprises, with which the BAI Team met, would not be candidates for a Stock Market listing.

The major risk in Syria is the lack of viable, bankable enterprises, with acceptable financial statements in which equity placements can be made. Additionally, only a few entrepreneurs are ready to have outsiders in their businesses. Finally, there is an entire financial support infrastructure that must be put in place. See pre-requisites below.

## 6.9.4 Pre-requisites

- A functioning Stock Exchange.
- Legal & regulatory Issues:
  - Laws governing equity investments and divestments;
  - Simplified, clear registration procedures, changing title as shares are bought and sold;
  - Establishment of minority rights.
- For foreign direct investments:
  - State guarantee regarding no confiscation or nationalisation of private property, except during a clearly defined “state of emergency”, and then only with full and fair compensation with the right of appeal, preferably to a specialised international court, and the right of subrogation of the property to an insurer;



- Free transfer and retransfer of capital and dividends in a fully convertible currency.
- Tax issues
  - No double taxation of dividends;
  - Exemption from capital gain tax;
  - GoS should enter into double taxation agreements with as many countries as are willing;
  - No taxation of foreign currency gains on foreign currency brought into the Country by foreign investors.

## 6.9.5 Recommendations

It is recommended that the GoS undertake a feasibility study for establishing an equity finance vehicle. The study would aim to determine the potential market for such equity placements, whatever the source of funding, as well as the most propitious sectors. During the study, all legal and regulatory aspects would need to be assessed. How this product operates within or outside the Syrian Securities and Exchange Commission would also be a matter of prime importance.

If deemed feasible, the study would propose options concerning the best structure for the entity and the implementation steps necessary to attract funds from the any source (public, private or mixed) including international investors. It would propose options related to the most appropriate management structure.

## 6.9.6 Implementation Implications

The BAI Team cannot address this issue until such time as the results of the recommended feasibility study are known.

## 6.10 Credit Registry

### Introduction

Consumer Credit Registries emerged in Austria, Sweden, Finland, South Africa, Canada, Germany, USA and Australia in the late 19th century. Most of the early Credit Registries were co-operatives or non-profit ventures set up by local merchants to pool the credit histories of their customers and to assist in collections activities. Others were established by local finance companies or the local chamber of commerce.

Credit Registries (CR) obtain historical account data from member institutions, sort and aggregate these data into personal credit histories, and disseminate this information to members at their request. The benefit to members from sharing this information clearly depends on its accuracy and timeliness. However, members also



share the cost of providing information to the bureau. The more costly it is to provide this information, the less attractive it will be for a lender to join a bureau.

A credit reporting system is an important pillar in an economy. Further, a good credit reporting system can greatly reduce the time and costs of providing credits and can stimulate the private sector development. A credit reporting system affects the whole credit cycle in an economy. The effects of credit information registries can be highlighted as follows:

- Decrease information asymmetries between borrowers and lenders.
- Allow lenders more accurately to evaluate risks and improve portfolio quality.
- Ease adverse selection problems and lower the cost of credit for good borrowers.
- Increase credit volume and portfolio quality.
- Create “reputational collateral”.

The sources of information are financial institutions and businesses. The created Credit Report might be provided for a fee, while there should be no payment for the delivery of information to the credit registry.

## **Major Advantages of Credit Registry for the Banking Sector**

Research data<sup>44</sup> show that if banks have access to both positive and negative data, default rates are lower. In this regard, small banks reduce their default rates by 78%, while large banks have a reduction in defaults of 41%. In the same vein, credit reporting can improve access to finance, as it is associated with an increase in private credit, which then increases Gross Domestic Product growth.

Based on data<sup>45</sup> from 5,000 firms in 51 countries, small firms reported higher access to finance as a constraint (49%) without a Credit Registry but only 27% experienced this problem when their credit histories were provided by a Credit Registry. Their probability of obtaining a bank loan was 28% without a Credit Registry, but reached 40% with it.

## **Credit Registry Forms**

In general, there are no reasons to establish more than one Credit Registry in one country. In case of more than one CR, the need for more data exchange would exist, which increases costs unnecessarily, or would cause the loss of information for different parties. Depending on the current economy, a public or a private CR should be established. Two different models are explained below, but these examples are not exclusive:

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<sup>44</sup> Majnoni, Miller, Mylenko and Powell (2003) “Public Credit Information Systems: Evaluating Available Information”, World Bank

<sup>45</sup> Love & Mylenko, 2003, World Bank



- Model 1:

A CR will be established, either public or private, which will save positive and negative information about the loan businesses of banks and other institutions, and will communicate this information when requested to do so. A connection to the Central Bank does not exist. The Central Bank receives the same information from all public and private banks for supervision reasons, but does not pass this information on.

- Model 2:

The Central Bank receives all information necessary for the supervision of all public and private banks, and establishes a CR. The public and private banks, and other institutions (contracting parties and/or members of the credit office), provide positive and negative information about their loans. Specific software for a CR ensures that only relevant information is delivered.

### **Contracting Parties/Members**

Contracting parties and/or members of the CR should be differentiated: financial institutions (A-contract partners) and businesses (B-contract partners).

A-contract partners are all kind of financial institution, such as:

- Public and Private Banks
- Credit Suppliers
- Leasing Institutions
- Credit Card Institutions
- Microfinance Institution
- Financial Corporations,

Which are delivering positive and negative information about their credit users.

B-contractual partners are businesses, which have credit risks through the delivery of goods and services in advance, such as;

- Retailers, etc. providing revolving credits
- Telecommunication Companies
- Water and Energy Providers
- The Insurance Sector,

Which are providing and receiving negative information only.



## Products/Services and Pricing

A Credit Registry produces and provides different products/services:

- *Current Reports*

Current Reports secure the exchange of data of different institutions and ensure appropriate decisions. If a credit user of bank A is taking further credit from bank B, the information from bank B to the Credit Registry will be passed on to bank A. If the credit from bank A becomes negative, or the payment remain outstanding, bank B will receive information about the bad loan.

- *Credit Reports*

A Credit Report is a financial transaction's history produced for either businesses or individuals, which is used by lending institutions to facilitate the decisions-taking process to approve, or not, credits to prospective borrowers. This document is a key source of information in determining the creditworthiness of potential borrowers (businesses or individuals).

- *Credit Scores*

Credit Scores provide a number representing the possibility that a borrower may default. It is based upon the borrower's credit history and is used to qualify a borrower for a loan.

- *Credit Appraisals (Scoring)*

This is an evaluation system used by both Credit Registries and lending institutions in order to assess and then determine the relative creditworthiness of a business or an individual. When evaluating businesses, it generally considers factors such as overall repayment history, new credit sought by the business owner(s), the financial strength of the business and its longevity.

- *Loan Risk Assessments*

The risk category assigned to a borrower, by both Credit Registries and lending institutions, which estimates the probable risk of future delinquency or loan loss.

- *Other Services*

Depending on the economy, the Credit Registry can provide other services. For instance, if the user of a bad loan disappears from his/her residence, the Credit Registry registers the user as lost and keeps the data until the person uses other services of another contracting party and/or member of the credit office.

- *Pricing*

In order to make the Credit Registry (either public or private) sustainable, the contracting parties of the Credit Registry should pay for the information they are





receiving. In case of a free delivery of information, the Credit Registry would always need funding. However, the Credit Registry should not pay the contracting parties for the information they are providing. In case of a payment, costs would increase and the price for the information would rise.

## 6.10.1 Legal Framework, Control and Public Relations

Appropriate, accurate and complete credit information increases transparency and promotes and supports economic stability. However, regarding the exchange of data and the functioning of the CR according to 'best practice', the promotion of save sharing and the development of credit information must be supported by relevant policies and an appropriate legal framework.

One crucial requirement is that the CR's system should ensure secure data exchange on the one hand and on the other, it needs to be transparent (e.g. every credit should have access to data on his/her file). Within a Data Protection Act and/or even a CR law, the framework for the work of the CR and the consumer rights should be embodied.

Such a framework should clearly state, how much information should be saved by the CR. In terms of data to be provided to the CR, a differentiation needs to be made between data, that is relevant for the CR and data that is relevant for the credit institution/business providing goods/services in advance. Equally, in terms of information gathered, a differentiation needs to be made between companies and private customers (e.g., balance sheets, income, monthly expenditures).

The classification of data includes but is not limited to:

- Personal information (Name, Date of Birth, Identity Number(s), Address, Father's Name, Mothers Maiden Name, Income, etc.).
- Financial Information (Credit type, Amount of Finance/Requested Credit Limit, Number of Instalments, Payment Frequency, etc.)
- Information About Other People Associated with the Application (Guarantor(s) Authorised User(s)).
- Credit Decision (Accepted / Rejected / Pending (in progress) / Cancelled)

- *Data Protection Act*

A Data Protection Act regulates the handling of data. It is not just a law for the CR, but for both, the private economy and for other (public) institutions. A Data Protection Act exists primarily in countries, where the Credit Registry was established before the promulgation of such an act. For instance, in Germany the SCHUFA was established in 1927, while the Data Protection Act came into force in 1978.



- *Credit Registry Law*

The Credit Registry Law is particularly aligned to a CR and contracting parties/members of the CR, which offer goods and services with certain credit risks. It has naturally many things in common with a Data Protection Act.

Both kinds of law should specify only the framework for the work of the CR. Specifying the work and responsibilities of the CR vary much in detail, and adjustments to the law would become necessary, in case of changes in the market. In most countries, this is usually a very lengthy process and restrains the development of the Credit Registry and the economy.

An important issue is, whether the participation of the lending institutions within the data exchange with the Credit Registry can be enforced by law. If it could be, the Credit Registry would develop an extensive database in a very short period and would be able to work efficiently in a very short space of time. Moreover, a scoring system could be developed very quickly. On the other hand, such an obligation needs to be weighed against the principle of the free-market economy. However, there are countries in Western Europe, which have both, the free-market economy and the obligation of participating in the CR.

- *Control*

Within a CR law, a *board of control* should be specified, which should be public and which should have appropriate rights and obligations. The main objectives of such an authority are to observe and control, whether legal guidelines are kept by the CR (Security of data abuse, safety software, etc.). Such a board of control would have access to the data of the CR only in case of complaints in individual cases. Under no circumstances would the authority have the right to require data without important reason. The authority will be the point of contact for all individual complaints. For example, if a citizen or a company does not agree with the data stored, maybe because it is incorrect, the person can contact directly the authority, which is obliged to support the complaining party.

A further control element is the CR's internal commissioner for data protection. The commissioner needs to ensure, among others things, that the Credit Registry adheres to all rules and legal requirements that it exercises controls over access to its office space and its software. The commissioner is subordinated directly by the head of the Credit Registry, but is entitled to ignore his instructions, if these offend against the law. As such relationships can lead to conflict situations, the rights of the commissioner need to be embodied in the law, e.g. protection against dismissal.

Furthermore, the CR laws should specify the right of the individuals and companies to obtain information about their own stored data, which is automatically another form of control.



- *Public Relation*

The collection and exchange of (personal, business internal) data requires the trust of affected individuals and businesses. In order to build up the required trust, it would be necessary to keep all parties appropriately informed during the establishment of a CR and during the continuing Credit Registry processes.

## **CR in Case of Syria**

The BAI Team is convinced that a CR would be vital for the Syrian economy. It would encourage people to pay their debts and, if set up correctly, would reward borrowers who respected their obligations. Foreign export credit insurers would insure credit given to known good payers. Insurers, as well as other financial institutions, need to be (re)paid, before other services can be delivered.

Given the work necessary to put this financial institution in place, Government would need to provide rapid support for the creation of either a public or private CR. Moreover, some institutional reporting systems are required.

However, the problem with creating a CR in Syria is multi-faceted. The first is to note that there is currently no foundation upon which to build one in the near future. The Central Bank does not have detailed credit files from the banks it supervises, as it has only restarted bank supervision in the last two years. In the same vein, the Public Banks, 100% owed by the Syrian government, have rarely, if ever, made provisions for bad loans. Thus, the base information, from which credit histories could be created, even if only for what is called negative information does not exist in any readily usable form that is transferable to a public registry. With these basic institutional building block issues in mind, this section will lay out 'best practice' aiming to inform the GoS as to the importance of this institution. It will endeavour to place it within the context of restructured Public Banks as well as in the context of an equally restructured Central Bank.

Consequently, in order to establish a CR, the BAI Team highlights, following elements:

- Restructured Public Banks, including the Central Bank;
- International audits of each of these institutions;
- Legal, regulatory and supervision framework developed and approved;
- Public or private registry needs to be authorised;
- Registry staff will need to receive training.

### **6.10.2 Recommendation for Implementation**

Due to the complexity of a CR and the length of time required for setting up, the BAI Team does not recommend that the Phase 2 BAI Team deal with the creation and



development of a CR. It is a process that a Bankers' Association could promote together with the Bank Supervision Department of the Central Bank. Nevertheless, alongside of its other activities, the Phase 2 BAI Team would be supportive of the establishment of a Credit Registry.

It is recommended that the GoS should retain an advisor for drafting of the necessary legal and administrative acts, for proposing the establishment/adjustment of the necessary institutions and the development of an appropriate implementation strategy. Such an advisor should provide follow-up support over a defined number of years.

## **6.11 Deposit Insurance Scheme**

### **6.11.1 Description**

#### *Definition and Objectives*

Deposit insurance is a measure taken by banks in many countries to protect their clients' savings, either fully or in part, against any possible situation that would prevent the bank from returning said savings. Deposit insurance institutions are for the most part government run or established, and may or may not be a part of a country's central bank.

#### **International Experience**

In the past 20 years 90 countries around the world have experienced over 112 banking and financial crises. Costs incurred to deal with these crises in some cases have reached 30-50 percent of the total GDP which imposes a heavy burden on the state budget, halts the economic development of the country and increases unemployment.

Most countries have adopted deposit insurance in response to, or following, periods of banking distress. However, the severity of the banking problems has varied considerably, as has the timing of action on deposit insurance in relation to the timing of banking system distress. Establishment of the US deposit insurance system occurred in the midst of the worst economic and financial crisis in U.S. history. Banking problems of "crisis" magnitude also occurred in Argentina, Brazil, Japan, Korea and Mexico. However, in other cases, the adoption of deposit insurance came after the economy and banking systems had stabilised, often through the efforts of government-sponsored bank restructuring programmes (Hungary, Jamaica, and Jordan). In Hungary's case, bank failures occurred in the wake of liberalisation of a state-run economy and the banking system, while in most other countries, macroeconomic forces precipitated bank failures, thereby uncovering weaknesses in the banking and bank regulatory systems.



## Organisation and Governance of a Deposit Insurance Scheme

A deposit insurance scheme regulates the relationship of three parties: the insurer, the insured financial institution and the depositor. The insuring party may be organised as a private organisation, a government organisation or a combination of the two. Many, if not the majority of existing deposit insurance providers are public-sector corporations or agencies. In most cases, the deposit insurance system has a legal status that implies some independent position within the public sector. At the same time, government, central bank, or other banking agency officials serve as ex officio members of the governing bodies, and other members may be appointed by government agencies or may be approved by the legislature. Such a governance structure reflects a desire to avoid the possible moral hazard<sup>46</sup> effects of a purely government entity and the potential conflicts of interest in a private sector deposit insurance system.

The combination of a separate legal status, including an independent management structure with a government dominated board membership, is an attempt to balance the independence of the deposit insurance system and its ultimate accountability to government. Within the Syrian context, where the banking sector will continue to be dominated by the Public Banks for quite some time, a governance solution comprising an independent but government related organisation with a board of directors composed of public and private sector representatives would appear to be the most suitable and also workable solution.

A deposit insurance organisation may be structured as a "paybox" system, which is largely confined to paying the claims of depositors after a bank has been closed. Such a system normally does not have prudential regulatory, neither supervisory responsibilities, nor intervention powers. Another alternative would be that of a "risk-minimiser" deposit insurer with a relatively broad mandate and correspondingly greater powers. Some risk-minimisation systems have the power to set regulations, as well as to undertake enforcement and failure-resolution activities. As a general principle, a deposit insurer should have all powers necessary to fulfil its mandate. All deposit insurers require the ability to contractually set appropriate requirements, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.

### Membership

Deposit insurance is legally or effectively compulsory for all institutions that accept retail deposits. This will include the branches of foreign banks licensed to operate in the country, although whether these are covered by their home country deposit insurance scheme or that of the host country will depend on the circumstances of the host country concerned. Clearly, for example, the relevant authorities in a host country would not want depositors in the branch of a foreign bank to benefit from a better scheme than depositors in locally registered banks. In the European Union, all branches of Member States operating in other Member Countries are covered by

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<sup>46</sup> See 6.6.2 for more details on "moral hazard"



their home country deposit insurance schemes and not by those of the host countries.

The motive for making insurance mandatory is to avoid adverse selection, whereby the strongest institutions withdraw from the system, which is left to insure only the weakest. In most cases deposit insurance is automatically granted to any institution that has received a license from the supervisory authority or central bank. Deposit insurance is generally terminated when the licensing authority revokes the institution's license or the institution is closed. In the U.S. and Canada, the deposit insurer has authority to take action to terminate deposit insurance.

Automatic membership for all banks may be the simplest option in the short-term. However, the deposit insurer may then be faced with the difficult task of having to accept banks that create an immediate financial risk or that pose other adverse consequences for the deposit insurance system. Alternatively, banks may be required to apply for membership. This option provides the deposit insurer with the flexibility to control the risks it assumes by establishing entry criteria. It also can serve to enhance compliance with prudential requirements and standards. In such cases, an appropriate transition plan should be in place that details the criteria, process and time frame for attaining membership. The criteria should be transparent.

### **6.11.1.1 Coverage**

The issue of coverage refers to the type of deposits that are eligible for insurance as well as the level of compensation in case of a bank failure.

Some countries have introduced an explicit "blanket guarantee" during a financial crisis to fully protect all bank depositors and creditors. However, blanket guarantees can have adverse effects if retained too long, notably an increase in moral hazard. A transition from a blanket guarantee to a deposit insurance system should be as rapid as a country's circumstances permit. Many deposit insurance systems exclude deposits held by depositors who are deemed capable of ascertaining the financial condition of a bank and exerting market discipline. Examples include deposits held by banks, government bodies, professional investors such as mutual funds, and deposits held by bank directors and key officers. In some cases, deposits held by individuals who bear responsibility for the financial well-being of a bank are excluded from reimbursement. In this regard, supervision should play an important role in monitoring strategy, management policies and performance.

The decision whether to cover deposits denominated in foreign currencies depends heavily on a country's usage of foreign currency. When usage is high, it would be of little value to institute a deposit insurance system without covering these deposits.

Once the scope is determined, the level of coverage can be set. This can be done through an examination of relevant data, such as statistical information describing the size distribution of deposits held in banks. This provides an objective measure, such as the fraction of depositors covered, with which to assess the adequacy of a certain level of coverage. Whatever coverage level is selected, it must be credible and



internally consistent with other design features, and meet the public-policy objectives of the system.

As a rule of thumb the insurance coverage per individual should equal three times GDP per capita, which in the case of Syria would equal about 200,000 SYP (USD 4,300). In general the coverage should be equivalent to up to 20% of the aggregated savings of the eligible depositors. Normally all retail deposits of a single depositor within a specific bank are considered as a whole, regardless over how many accounts they may be spread. One of the principles behind the capping of coverage is precisely to address the issue of moral hazard on the basis that if a depositor carries some of the risk, however small that may be, he is likely to take greater care over the quality of the institution in which he is investing. In some deposit insurance schemes, cover is limited to, e.g. 90% of deposits covered by the scheme.

## **Funding**

Sound funding arrangements are critical to the effectiveness of a deposit insurance system and the maintenance of public confidence. A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims. Inadequate funding can lead to delays in resolving failed banks, to significant increases in costs and to a loss of credibility of a deposit insurance system.

In countries which already have a strong and well-established banking system, it is only equitable that the banks themselves contribute to such a scheme, one of whose purposes is to increase confidence in bank deposits as against other forms of financial investment. Elsewhere, however, where banks may be less able to support the level of compensation that may be required in a time of crisis, government itself, directly or through the Central Bank, may need to finance compensation to depositors through one mechanism or another.

In principle, there are two approaches available to establishing a deposit insurance fund. One approach is to assess a steady premium rate over time sufficient to build up such a fund. Provided that claims on the fund are infrequent, resources within the fund may be increased through investment. Contributions to the fund will generally be in the form of a fixed percentage levy on, for example, total insured deposits of each bank. This levy will normally be set at a rate of between 0.01% and 0.5% p.a.

The alternative approach involves developing a premium system designed to maintain a target fund ratio or range. If the target fund ratio method is chosen it should be sufficient to reduce the probability of the fund's insolvency to an acceptable minimum, although estimating probabilities of loss is very complicated in practice.

A choice can be made between a flat-rate premium system, as described above, or a premium system that is differentiated on the basis of individual-bank risk profiles. The bases and criteria used in a risk-adjusted differential premium system should be transparent to all participants. Risk-adjusted differential premium systems precondition that necessary resources are in place to administer the system appropriately. In case of risk-adjusted differential premiums, consideration should be



given to the advantages and disadvantages of keeping the risk profiles of individual banks confidential.

## 6.11.2 Positive and Negative Arguments

Whilst deposit insurance schemes established around the world differ greatly in terms of overall concept, mandate and powers, governance, membership, coverage and funding yet they all target the same principle objectives:

- To promote financial stability and improve confidence in the banking system,
- To protect unsophisticated depositors and hence contribute to social stability as well.
- To provide a mechanism for the orderly disposition of failed institutions.
- To increase banking deposit taking activities to enhance financial intermediation and thereby support the development of the real economy.

However, if designed poorly, a financial safety net, such as a deposit insurance scheme, might even contribute to increasing financial stability risks:

*Moral hazard* refers to the adverse incentive for excessive risk taking by banks or those receiving the benefit of protection. Such a moral hazard may arise, for example, in situations where depositors and other creditors are protected, or believe they are protected, from losses or when they believe that a bank will not be allowed to fail. In the absence of regulatory or other restraints, weak banks can then attract deposits for high-risk ventures at a lower cost than would otherwise be the case. Moral hazard can be mitigated by creating and promoting appropriate incentives through good corporate governance and sound risk management of individual banks, effective market discipline and frameworks for strong prudential regulation, supervision and laws. These elements involve trade-offs and are most effective when they work in concert.

*"Bailing out"*: Some critics fear that the government will, for very large banks (which they consider "too big to be allowed to fail"), use the insurance fund money to "bailout" a large bank, rather than letting it fail. These critics believe that there is not enough money adequately to use insurance deposit funds to "prop up" banks. Alternatively banks should be entirely left to free market mechanisms, which would lead to the best net result. Some advocate the compromise of privatising the deposit insurance, with the caveat of disallowing the "too big to fail" system.

*In conclusion*: explicit, limited-coverage deposit insurance ("a deposit insurance system") is preferable to implicit protection if it clarifies the authorities' obligations to depositors and limits the scope for discretionary decisions that may result in arbitrary actions. To be credible, however, and to avoid distortions that may result in moral hazard, such a system needs to be properly designed, well implemented and understood by the public.





### 6.11.3 Pre-requisites

A deposit insurance system needs to be part of a well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced, and sound accounting and disclosure regimes, in particular:

- The stability of the financial system: current monetary and fiscal policies, inflation, the condition of financial markets; the soundness of the banking system (including the condition of banks' capital, liquidity, credit quality, risk-management policies and practices).
- The ability of the legal regime to enforce laws: the efficiency of the judicial system, the effectiveness of creditors' redress mechanisms, the ability of a legal regime to support early intervention and prompt corrective action, and the ability to close troubled banks, and provisions for the clear and orderly liquidation of assets and resolution of creditors' claims.
- The strength of prudential regulation and supervision: strong prudential regulation and supervision should allow only viable banks to operate. Banks should be well capitalised and follow sound and prudent risk management, governance and other business practices. Effective licensing or chartering regime for banks, regular and thorough on-site examinations.

### 6.11.4 Recommendation

To date there is no national deposit insurance scheme in Syria. Though the deposit taking of the private banks is developing dynamically, yet about 93% of all deposits are still placed with the Public Banks. Since Syrian banks have all been state owned for almost half a century, people have developed a general expectation that the Government has been and will continue to guarantee retail deposits (current and saving). Such expectations constitute a potential and severe risk to the state budget.

This expectation applies in particular to the public banks, but with the arrival of the private banks, the public may legitimately expect that this "implicit" guarantee applies to them as well. Without a specific denial on the part of the Government, (which could be highly detrimental to the private banks), or the establishment of an "explicit" deposit insurance scheme, the Government remains at risk that it is "implicitly" guaranteeing all retail deposits, (and maybe all term deposits, as well) in the banking system, not just those in the Public Banks.

A deposit insurance scheme therefore would in particular hedge the Government or the Central Bank of Syria against adverse developments in the banking system, which could lead to a run on one or more banks. The establishment of such a scheme would be in the material interest of the Government, which could otherwise be obliged to support the Central Bank financially in cases of risk, with negative impact on the State budget. This appears to be of particular relevance at the present time in view of the Government's strategy to liberalise the banking system and to restructure the Public Banks towards more financial sustainability and self-sufficiency.



State-owned banks present a unique issue for deposit insurance systems in view of the implicit government guarantee involved. Yet some countries have chosen to include them in their systems. Main reasons are: to facilitate privatisation; to ensure competitive equality with private-sector banks in terms of the level of coverage and premium contributions; to provide a mechanism to bring such banks under the same prudential, regulatory and supervisory rules applicable to other banks; and to diversify the deposit insurer's risks and increase its funding base.

The Syrian banking sector is currently undergoing a gradual transition from state-operated banks to a combination of smaller private banks and state banks, which are expected to be subject to deep rooted restructuring and rehabilitation measures. In addition further reform efforts are required by the Syrian Government to improve the regulatory and operating environment in order successfully to accommodate a deposit insurance scheme that gains the confidence of the general public. In the long run, however, the objective of such a scheme should be to complement the country's financial system and to facilitate further economic development.

In conclusion, it is recommended that the Government give serious consideration to the establishment of a Deposit Insurance Scheme with the specific objective of extending some degree of cover for all retail deposits held by the public in both the public and the private banks.

## 6.12 Preferred Options

The sections above describe ten different types of institution and product all of which have some relevance to the Syrian financial sector. As noted in the introductory Overview, some will be of more immediate interest and benefit, others perhaps more distant prospects. To a greater or lesser extent, the establishment or introduction of all of them will require the active support of the GoS, and in many cases modifications to the existing legislative and/or regulatory framework, or even the introduction of new laws.

The BAI Team has selected three which it believes would be of particular benefit to the Syrian economy. These are:

- The establishment of a **"Difficult Debt Institution"**;
- The establishment of a **Syria SME Bank**; and
- The establishment of an **Export Credit Insurance facility**.

It is proposed that initial efforts should commence on the introduction or establishment of each of them during Phase 2 of this project. A methodology for each is set out in Chapter 7. This describes the particular details of the proposed institution or product, how its introduction or set-up might be achieved, and an Action Plan for Phase 2 that sets out an implementation strategy for each of them.



## **7 Methodology and Implementation – Phase 2**

### **7.1 Synergies with other Donors and Projects**

Throughout Phase 1, the Team has sought to inform itself of other Multilateral and Bilateral Donor projects that are running in Syria, and particularly those that are relevant to this Feasibility Study. It is noteworthy how many projects are running with apparently similar objectives. By way of example, the Central Bank of Syria (CBS), vital both to the economic and the financial reform processes, is working with two Monetary Funds, Arab and International; two external Central Banks, British and French; and two European Union (EU) Projects – Banking Sector Support Program II (BSSP II) and Institutional and Sector Modernisation Facility (ISMF) – both of which are providing technical assistance. Concerning the two Monetary Funds, it seems that they provide very much the same advice, but their assistance was requested by different GoS entities.

It is clearly crucial that all these different donor projects work in harmony with each other in order to enhance their individual contributions to the overall Syrian economic and financial reform processes. It is recommended that the GoS discuss with its various partners, what are the specific responsibilities of each, to ensure that they do not duplicate or even contradict each other's efforts and work in synchronisation with the GoS in order to achieve its reform agenda.

#### **7.1.1 Banking Sector Support Programme II<sup>47</sup>**

The following assessment was provided by the Banking Sector Support Programme II Project Team, at the request of the Ministry of Finance, with the concurrence of the European Delegation in Syria and the European Investment Bank. This assessment is crucial to guarantee synergies between the two projects.

At this point in time, the situation in Syria differs from best international practice as the Central Bank of Syria is not fully independent comparable to those in most market economies. With the new Credit and Monetary Council, in which the Central Bank has strong influence, Syria is moving towards a two-tier banking system. However, further major reform measures are needed to bring the country's monetary policy and its financial sector in line with international best practices. With this overview in mind, the remaining part of this section will outline the summary of the findings of the initial assessment conducted at the Central Bank, and approaches of this Project should take within the basic tasks for which any modern Central Bank takes responsibility.

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<sup>47</sup> This section is written by the BSSP II Team. The BAI Team did not include the CBS in the bank due diligence.



The findings of this initial assessment are as follows:

- CBS has been receiving a considerable amount of technical assistance as indicated above (Cf. 71)
- A considerable amount of input has been made by the IMF team of experts, particularly in drafting regulations addressing: credit risks, internal control and corporate governance, market risk management, and other banking risk and reporting forms. Despite such efforts, the Capital Adequacy Ratio, within the framework of Basel I, has not yet been defined and measured, nor have efforts been made to assess each of the Public Bank's Loan Portfolios.
- Additionally, these Banks have yet to comply with most regulations as they lack the technical expertise and the CBS has provided no clear guidance to the Banks.
- A substantial amount of work has been carried out as Technical Assistance (TA) in areas such as banking supervision and prudential reporting, management of foreign exchange reserves, unification of charts of accounts and compliance to IFRS, etc. However, there appears to be no clear strategy as how such TA has contributed to the better functioning and efficiency of the CBS, as for the moment no donor has provided TA related to the core banking system issues. Furthermore, it seems that many of such missions, conducted by these experts, have been made on an ad hoc basis with no prioritisation as to what particular operational areas should receive TA.
- The new CMC has been allowed to set interest rates but lacks the mandate for monetary policy. Aside from changing short-term interest rates, it does not have the requisite instruments to implement policy,
- Currently the CBS is very limited in its ability to manage the GoS' foreign denominated currency positions. If/when the transfer of the GoS foreign currency assets, held by the CBoS, is made to the CBS; it will need to expand its instruments to manage foreign exchange.
- A key infrastructural part of the CBS is missing as it relates to Information Systems, which are inadequate and almost obsolete in their current configuration, unable to support a central bank requirement. As examples, an insufficient local network exists in the Head-Office (HO) in Damascus. No networks exist in the regional offices. No links exist between the Head-Office and the different regional offices. A project is under way to upgrade the network in the HO, implement LANs in the offices and establish a secure WAN.
- From the applications level, no central banking system core exists, as all previous attempts to implement one have been unsuccessful. Bits and pieces of applications exist with no integration, thus directorates are either not, or only slightly, automated. Those 'islands of information' with duplication and discrepancies between them, lead to waste of time, poor productivity and efficiency. Sharing of common databases, even within the same directorate, is not common practice, due to the lack of adequate infrastructure and systems.



- The level of manual work is still huge, and no automated settlement, clearing and reconciliation systems exist. No responsibilities are assigned to take care of existing, or under implementation, applications.
- The lack of a global view and strategic plans for the installation of a complete IT and Management Information System, coping with the global business strategy of the Central Bank and providing the technological means and tools within an acceptable time frame and budget, has a high negative impact on the development of the Central Bank's role and capabilities.

The underlying needed assistance from BSSP II to the Central Bank of Syria would be as follows:

### **Donor Co-ordination Unit:**

BSSP II intends its assistance to the CBS to be overarching in the approach; this is because of its team's physical presence in the CBS over the next 3.5 years. As such, it will work with the CBS in order that it would maintain harmonious working relations with relevant international institutions, bodies and forums, when it would represent GoS' interests. In this regard, as mentioned above, it is receiving technical assistance from the IMF, the AMF, the EU, several Central Banks and other donors. However, these interventions are not taking place within a well structured cohesive approach. Therefore, BSSP II recommends the creation of a **donor co-ordination unit** inside the CBS to monitor and co-ordinate all such programmes.

### **Monetary Policy:**

One of the focuses of this assistance will be on creating a specific strategy related to the successful management of monetary policy. The strategy would be based on economic and monetary analysis. They form the core from which any monetary policy strategy operates. When this data gathering framework is in place (see statistic below), the CBS would be capable of producing the required analysis. Thus, the BSSP II will, within its scope of activities, assist CBS on the development of these frameworks. Nevertheless, any monetary policy is based on the existence of a monetary market i.e., available tradable money market instruments such as Treasury Bills, Notes, commercial paper etc. Short-term interest rates can only be effective if such a monetary market is in place and in operation, to react on the impetus given by the Central Bank. That actually is not the case in Syria, unless the ongoing assistance of the Banque de France will, in two or three years, produce such a market. Failing that BSSP II will have to provide assistance and expertise able to create such a market.

### **Reorganisation of the Central Bank of Syria:**

This activity will redefine the operational functions of the CBS' within the context of modern central banking benchmarks. This would be based an analysis and then an elaboration, of a task oriented Flowchart diagram representing all functions of the CBS.



## **Management of GoS Foreign Assets and Currency Reserves:**

Likewise, this issue was referred to earlier in this chapter. BSSP II adds its comments, given the importance of this matter as well as the TA role it will play. However, this section will only deal with Foreign Currency Management. Foreign exchange operations include: (1) Portfolio management, (2) Interventions to smooth currency fluctuations or (3) Commercial transactions.

CBS is currently restricted to GoS foreign reserves holdings. Foreign Exchange Swaps is such an instrument, which the GoS could use in the future. The BSSP II would provide TA support in developing the human resources necessary to manage such instruments. Additionally, until formal support/intervention agreements are in place, which could include AMF amongst others, the CBS will continue to conduct foreign exchange interventions on its own (unilateral interventions). In future, it should work to establish its general currency intervention strategy in order that it is executed within the framework of co-ordinated interventions involving other central banks (concerted interventions).

As to the day-to-day tasks, the CBS should establish a plan to pro-actively manage its foreign reserves portfolio, ensuring that the CBS has sufficient liquidity to conduct its foreign exchange operations as well as managing its portfolio. In doing so, the CBS would be directly responsible for the risk management of these portfolios, which is addressed below. As would be the case for Monetary Policy, BSSP II would assist CBS to establish an overall portfolio strategy following a single portfolio management philosophy. In developing its vision, the CBS, with BSSP II TA, would define the purposes of each portfolio aiming to achieve the best possible returns.

## **Risk Management**

It involves three key areas: developing rules governing strategic asset allocation, compliance of how traders work, and the measurement and reporting of performance on a daily basis. To avoid potential conflicts of interest, strategic benchmarks or reporting on performance and risk should be established with reporting made directly to the Executive Board. The development of independent reporting of risk and performance would be a key feature of the CBS's organisational framework, and in order to do the BSSP II envisages providing TA support for this important activity.

## **The promotion of a smoothly operating payment system:**

As the CBS goes forward with the above two priority responsibilities (Monetary Policy/Foreign Asset Management), with BSSP II TA support; it would begin work on the putting in place of a country-wide payment and settlement system. The key piece in the payment system process is Real Time Gross Settlement (RTGS), a prerequisite of a modern banking sector. Once in place, it would eventually cover all domestic Syrian national and international payments. These have grown in importance over the past two decades, increasing in both volume and value of transactions. These cover money, and capital and foreign exchange markets. As both the CBS and the BSSP II go forward on this point, they would pay close attention to its smooth functioning, aiming to reduce the related potential risks.



Finally, RTGS impacts the currency and thereby the conduct of monetary policy through financial markets, as well as the maintenance of banking and financial stability.

## **Banking Supervision:**

Even though a substantial amount of work has been done in this area by the IMF team, BSSP II, in close collaboration with other experts, would review and make improvements to both off site and on site banking and financial sector supervision within an appropriate prudential reporting framework, according to the best international practices. In addition, recommendations will be made on compliance with Basel I assessment and advice on compatibility with the future Basel II risk based banking supervisory requirements. Relevant training will be provided in these areas.

## **Statistics and Documentation:**

In co-operation with other Syrian Government Departments the CBS would collect statistical information necessary for fulfilling its tasks, either from other national authorities or directly from economic agents. The BSSP II will assess what it can provide in TA, which can facilitate the CBS undertaking this responsibility in a well-organised manner as well as assist the CBS in the documentation process and concept for a standard annual report module.

In order to most effectively provide positive skills transfer BSSP II will work closely with the CBS on systems design and staff training required to make both efficient as rapidly as possible. This outline will be complemented by the Inception Report that BSSP II will produce end April 2006.

## **7.2 Preferred Option – Public Banks Mergers and Restructuring**

For the reasons set out in Chapter 5, the BAI Team has concluded that its preferred recommendation to the GoS with regard to four of the Public Banks is that they be consolidated and restructured to become an efficient source of funding for Syrian enterprises with a special focus on the evolving private sector. As noted above, the GoS has determined that this merger and restructuring process should not apply to the CBoS and to the AG although both of these banks would be subject to a detailed assessment of their loan portfolios as well as to institutional reform and capacity building.

The Methodology for this rehabilitation or restructuring process was outlined in Chapter 5 and will address the following issues:

- Corporate Governance
- Strategy
- Marketing and Business Development
- Risk Management



- Financial Management & Accounting
- Financial Planning
- IT Systems / MIS
- Organisation Structure

Each of these is described in more detail below.

## 7.2.1 Corporate Governance

New charters (Articles of Association and Statutes) will need to be written for each bank. These will define and distinguish between the roles and responsibilities of the three principle governance bodies of the bank – the General Assembly, the Board of Directors and the Management Board – and will set out the powers and responsibilities of each of these bodies.

The OECD has published a number of papers dealing with the issue of Corporate Governance. This section draws heavily on the guideline principles set out by the OECD for State-owned Enterprises (SOEs).<sup>48</sup> Hereafter, the BAI Team will revert to public enterprises (PE) in place of SOE as this is the Syrian terminology.

### Legal & Regulatory Framework

In the first instance, it is important that the legal and regulatory framework for the public and the private banks be the same in order to ensure a level-playing field between them and to avoid market distortions where they compete. This is particularly relevant to Syria where the merger and restructuring process, which the BAI Team has recommended, will be designed to set the Public Banks on a path towards greater efficiency and greater productivity, precisely to enable them to compete more effectively in a freer market economy with the private sector banks.

Furthermore, the legal and regulatory framework should allow sufficient flexibility for adjustments in the capital structure of the public Banks when this is appropriate or necessary for achieving their objectives.

The principles of good corporate governance state, “inter alia”, that there should be a clear separation between the state’s ownership function and other state functions that may influence the conditions for public enterprises, particularly with regard to market regulation. The legal form and operational practices under which the Public Banks operate should be simple and straightforward and should allow creditors to press their claims and to initiate insolvency procedures.

These banks should not be exempt from the application of general laws and regulations. Stakeholders, including competitors, should have access to efficient redress and an even-handed ruling when they consider that their rights have been violated. Furthermore, they should face the same competitive conditions regarding access to finance as any other public or private sector enterprise.

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<sup>48</sup> OECD Guidelines on the Corporate Governance of State-owned Enterprises





## Ownership Policy

The government's ownership policy should be clearly defined together with its role in the corporate governance of the banks, and how their ownership policy will be implemented. First and foremost, no government entity should be involved in the day-to-day management of the banks, which should have full operational autonomy to achieve their defined objectives.

The charter of each bank should clearly stipulate how the government's ownership rights will be exercised. In some countries, this has been facilitated by setting up a state holding company, or co-ordinating entity, which is held accountable to representative bodies such as Parliament. The charter should stipulate to whom and how the Board of each Public Bank will be held accountable.

The government's ownership rights, as defined in each bank charter, will include:

- Representation at the general shareholders meetings and voting the state shares;
- Establishing well structured and transparent Board nomination processes and actively participating in the nomination of all Public Bank boards;
- Setting up reporting systems allowing regular monitoring and assessment of the performance of each bank;
- Ensuring that remuneration schemes for Board Members are set at appropriate levels to foster the long-term interests of the bank and to attract and motivate qualified professionals.

## Board Responsibilities

The Boards' of the Public Banks should be fully independent of government and empowered to exercise their responsibilities as defined in the charter of each bank. They should be fully accountable to the owner and act in the best interests of the bank. They should act with integrity and be held accountable for their actions.

They should be vested with a clear mandate to carry out their function of strategic guidance and monitoring of management, subject to the objectives set by the government as owner. They should have ultimate responsibility for the bank's performance and towards this end, have the power to appoint and remove the Chief Executive Officer (CEO). Good governance practice calls for the Chairperson to be separate from the CEO.

If employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and contributes to the enhancement of the Board's skills, information and independence.

When necessary, the Board should set up specialised committees to support the full Board in performing its functions, particularly in respect to audit, risk management, asset liability management, and perhaps remuneration. The Board will determine the functions and responsibilities of these committees and will provide them with clear



and detailed Terms of Reference. They should also carry out an annual evaluation to appraise their performance.

## **Transparency & Disclosure**

The Public Banks should observe high standards of transparency, which should include the introduction of a Unified Chart of Accounts, accounting practices in accordance with IAS, and the presentation of fully and independently audited accounts (to international standards) at regular and timely intervals.

The Banks should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the Board and to a newly established Audit Committee. Terms of Reference for such a Committee will be developed during the course of this Governance Review process.

All material information should be disclosed as well as any matters that might be of significant concern to the government, as owner, and to the general public. Examples of such information might include:

- A clear statement to the public of the bank's policy objectives and their fulfilment;
- Any material risk factors and measures taken to manage such risks;
- Any financial assistance, including guarantees, received from the state and commitments made on behalf of the Banks.

Once the details for effective Corporate Governance have been finalised for each Public Bank, a strategy for each bank will be developed. Whereas the Corporate Governance structure will be similar, if not the same, in all of the banks, it would be appropriate that an individual strategy be developed for each bank which emphasises its strengths, and the opportunities that derive from those strengths, whilst addressing its weaknesses and the perceived threats that it faces.

The following section deals with strategic matters.

### **7.2.2 The Principles of Strategy Planning**

Strategic Planning is a discipline that all businesses should undertake on a regular basis if they are to develop and progress in today's competitive environment. The absence of planning, leads to lack of direction and focus, dispersion of effort and resources, loss of opportunity and wasted cost. This applies as much to banks as to any other business enterprise. As banks grow, they become more complex organisations, offering a wider range of services to their clients, providing a larger and more diverse choice of distribution channels, and relying on the development of more complex information technology systems.

In order to control and direct these complex organisations, there is a need to ensure that well defined strategies are established by the Boards of Directors of each of the Banks, and that all managers and staff have a clear understanding of what is



required of them in completing key tasks and in achieving business objectives and budgets. With the rehabilitation of the Public Banks in Syria, it is anticipated that this process will accelerate in each of them, thereby emphasising the need for the setting of clear strategic objectives.

It is essential therefore that strategies, objectives and targets be fully documented to ensure that there is clear identification and communication of the demands on senior management and staff. This is a primary function of the Strategic and Business Planning process. The principles of strategy planning can be summarised as follows:

- |                                |  |
|--------------------------------|--|
| <i>Strategy</i>                | <ul style="list-style-type: none"><li>• To identify, in the context of the environment in which the bank is operating, a viable strategy for the bank which it has the capabilities to deliver.</li></ul>  |
| <i>Financial Goals</i>         | <ul style="list-style-type: none"><li>• To ensure that acceptable financial results will be achieved during the plan period.</li></ul>   |
| <i>Development of the bank</i> | <ul style="list-style-type: none"><li>• To ensure that the key initiatives needed for the development of the bank (including information technology, product development and staff initiatives) have been documented.</li><li>• To ensure that senior managers responsible for key initiatives are aware of what is required of them and the dates by which key tasks must be completed.</li><li>• To ensure that the financial, staff and systems resources necessary for the achievement of the plan have been identified and can be made available.</li></ul> |
| <i>Risk Management</i>         | <ul style="list-style-type: none"><li>• To ensure that all external and internal risks to the achievement of the plan have been recognised and, where possible, their impact minimised.</li></ul>  |

### 7.2.3 Strategic Objectives

At the outset of this planning process, each Bank should start by addressing four basic questions, which will establish the structure for the preparation of a Strategic Plan:

- What if any are the Bank's history and characteristics?
- What are its objectives?
- How will it achieve its objectives?
- How will it implement its plans?

### History and Characteristics

In order fully to understand the business of each bank, the BAI Team will review the recent histories and characteristics of these banks. The purpose of this review is to set the background and context within which each Bank's medium-term strategy is to be established.



## Objectives

Having summarised the current position and perceptions of each Bank, the BAI Team will undertake a more detailed analysis of the existing business of each Bank and of its various activities. The purpose of this exercise is to determine what kind of institution the Bank seeks to be and how it sees itself developing over the next few years. An integral part of this examination will be the preparation of an analysis of strengths, weaknesses, opportunities and threats (SWOT).

The Phase 2 BAI Team will then assist each Bank in identifying its principal objectives in such areas as:

- Market perception (e.g. small/medium size, adequately capitalised, prudently managed, predominantly retail/corporate/residential housing-oriented Bank offering a quality service to its customers);
- Meeting real market needs (e.g. client driven);
- Percentage Market share (of retail deposits);
- Direction and priorities;
- Innovation (e.g. product development);
- Productivity (e.g. in terms of overhead ratio, liquidity, capital adequacy);
- Growth (e.g. of deposits, loans, other interest-earning assets, fee and commission income, etc.);
- Resources (financial, human and other);
- Profitability;
- Return on equity (ROE);
- Return on assets (ROA);
- Competition;
- Customer service;
- Quality of products and services;
- Public responsibility;
- Employee participation (e.g. performance management, profit sharing, communication);
- Working environment.

In general, challenging targets are set against each of these objectives, all of which would move the Bank towards achieving its strategic goals. In the case of Syria's Public Banks, such planning and management by objectives are as yet almost wholly unrecognised. As part of the restructuring process, it will be one of the key tasks during Phase 2 to assist the Public Banks in moving towards a far greater awareness of the need to set such strategic objectives. Pre-determined steps towards their



achievement can then be used as key measures of management and employee performance.

## **7.2.4 Marketing and Business Development**

One of the key elements in the planning process is detailed market research. Particular emphasis is placed on a comprehensive analysis of the competitive environment. Each Bank should identify its most successful competitors in its chosen market segment(s) and understand the reasons for their success. In so far as it can, individual Banks must try to differentiate themselves from their competitors in product and/or service so as to offer more perceived value.

### **Client Focus**

As a service based organisation, each bank must pay particular attention to satisfying the needs of its customers. In an increasingly competitive environment, and particularly one in which more and more private banks are opening, there is a choice of financial institutions offering a diversity of products. Banks that do not provide what their clients want, and whose presentation and quality of service is perceived to be inadequate, will see customers moving to competitor banks. Once gone, it is extremely difficult to attract them back.

Accordingly the Phase 2 BAI Team will assist each bank in examining:

- The image it portrays in the minds of customers and potential client groups;
- The quality of service it provides to its customers including service levels;
- The quality and pricing of the bank's products.

Products and services are also a crucial area of focus for the bank's research. It should examine what products and services it already offers. It has knowledge, experience and resources invested in existing products and services, and it should know its chosen market segment. It is likely to be more cost effective to exploit this to the maximum than to try to penetrate new markets in the short-term.

During Phase 2, guidance will be provided to each bank in assessing and improving its customer focus.

### **Business Development and Relationship Management**

When it comes to business development, the bank can adopt one of two approaches, a passive approach (the old-fashioned way in which banks wait for customers and business to come to them), or a proactive approach (where banks have trained customer relationship officers assigned to each customer and constantly following up business opportunities with them). In an increasingly competitive market, a passive approach is likely to accelerate the loss of business to competitors as customers react favourably to the more attentive advances of other banks.



The concept of Relationship Management is easy enough to understand. Each nominated Relationship Officer is responsible for proactively managing and expanding a portfolio of customers, providing each of those customers with a professional, technically efficient, focused, personal service, and acting as the focal point of contact in the bank for discussion of all of the customer's financial requirements.

The objectives in adopting the concept of Relationship Management are:

- To develop and expand the bank's customer base by building close, attentive and proactive relationships with all existing and potential customers, and by generating new business, in particular with target customers;
- To obtain comprehensive knowledge of an the operations and intentions of customers;
- To be proactive in discussing and satisfying customer needs or potential needs;
- To generate mutual trust and respect with each customer.

Granted, in less developed banking environments, as is the Syrian case, it is not always easy to introduce this concept. The prevailing expectation of any aspiring CEO, or Financial Officer, is to talk to no one other than the Chief Executive of the bank. It is a concept, therefore, that can only be introduced successfully over time and with the active encouragement of bank senior management. They have to make it clear to customers, that day-to-day issues in the management of customer/bank relationship(s), are handled by technical experts within the bank, specifically trained for that purpose.

## **7.2.5 Risk Management**

Ensuring the presence of sound risk management processes, and strong internal controls, is one of the most important responsibilities of the Board and management of a financial institution. Taking, and then, managing risks are fundamental to the business of banking. As new technologies, product innovations and the size and speed of financial transactions change the nature of banking markets, risk management becomes ever more important.

All supervisory authorities place significant emphasis on the adequacy of a bank's risk management, including its management information systems and internal controls. Failure to establish a management structure, which adequately identifies, measures, monitors, and controls the risks involved in its business, is considered unsafe and unsound conduct. Equally inappropriate risk management is that associated with any serious lapses or deficiencies in internal controls, including inadequate separation of duties.

A bank's objective must be to ensure the safety and soundness of the institution whilst providing customers with a wide selection of products and services at accessible prices in a competitive environment. In this context, a bank must establish its risk management policies by evaluating:



- The quantity and extent of its risk exposure; and
- The quality of the risk management systems in place to control those risks.

Risk Management is an important component in assessing the overall quality of a bank's management. Adequate risk management programmes will vary considerably in sophistication, depending on the size and complexity of the bank and the level of risk that it accepts. Smaller banks that engage in traditional banking activities, and whose senior managers and directors are actively involved in the details of daily operations, – as is the case with the Public Banks in Syria – may find a relatively basic risk management system to be adequate. This might initially consist of:

- Written policies addressing material areas of operations (e.g. lending or investing);
- Basic internal control systems;
- A limited set of management and board reports.

Clearly, with the increasing sophistication of MIS and the prevalence of on-line reporting between branches and Head Office, there is little or no excuse for senior management not to have access to sufficiently detailed and comprehensive information to be able to run the bank efficiently and effectively.

Preliminary information, obtained during the course of Phase 1, suggests that there are significant deficiencies in the risk management structures and procedures in each of the Public Banks. During the course of Phase 2, the BAI Team will assist each Public Bank in reviewing the manner in which it identifies and manages its risks. It will then make recommendations in regard to possible improvements in its risk management procedures based on that review.

### 7.2.6 Financial Management & Accounting

All of the Public Banks currently follow Syrian accounting practices, which have fallen significantly behind current IAS. None of them has yet adopted IAS in spite of the fact that this is a requirement of Law 28 of 2001. Furthermore, the Central Bank has not yet made it a requirement that all banks in Syria, both public and private, follow the same Unified Chart of Accounts (UCA). The BAI Team has presented these issues as pre-requisites (Cf. Chapter 5 above) to any successful Public Bank restructuring. Thus, both of these issues must be addressed as a matter of urgency.

**Recapitalisation:** With regard to this issue, as noted above, much will evidently depend on the results of the detailed loan portfolio assessments of each of the Public Banks. Depending on the scale and nature of the problems identified, (which are likely to differ markedly from one Bank to another), and the manner in which the GoS chooses to tackle these problems – for example through the setting up of a DDI (see Chapter 6.2) – the method used to capitalise or recapitalise the Banks that need it will have to be considered.



Initially, the simplest solution for the GoS – and possibly the one that it would prefer – would be that those Banks that needed additional capital should issue new shares, which the Government would purchase. To raise the necessary funding for this purpose, the GoS might consider the issue of what could be called “Recapitalisation Bonds”.

Alternatives that the GoS might wish to consider include:

- IPO: all Syrian nationals might be eligible to purchase shares;
- An International Agency could buy shares issued by the respective Public Bank(s) for an agreed period of from, e.g. five to seven years. At the end of this period, the GoS would have the option to repurchase and/or to resell the shares; or
- One or more institutions or private financial investors might buy shares.

It is recognised however, that these may not be options that the GoS would wish to consider at this point in time although they might still be options for a future date, for example once the Banks were merged and restructured (if applicable) and operating as fully viable institutions in their own right.

## 7.2.7 Financial Planning

In order to achieve its strategic objectives, each bank should assess its resource needs. These can be grouped under three principal headings:

### **Financial:**

- Customer Deposits (needed to fund the bank’s interest earning activities);
- Interbank funding (to cover short-term liquidity needs and to make up for any short-fall in deposit growth);
- Loans and investments (to generate revenues to fund costs, expenditures – e.g. on personnel, training, etc. – and profit);
- Capital (to maintain continuing capital adequacy and to fund fixed asset investment);
- Other (if any, e.g. long-term debt instruments, subordinated debt, etc.).

### **Personnel:**

People are one of the Bank’s most important assets. Therefore the bank:

- Should prepare new job descriptions based on the newly defined strategic needs;
- Should find the right people for those clearly defined jobs;
- Provide internal/external training programmes for staff at all levels;





- Monitor individual performance against pre-set targets.

If the Bank wishes to attract and retain high quality people, and most specifically senior management, it should be prepared to offer them most if not all of the following:

- Participation in the decision making process;
- Personal advancement opportunities;
- Growth opportunities for the bank;
- Personal support and encouragement;
- Incentives and rewards, in accordance with performance management achievements.

### **Other**

In order to be able to deliver efficient and cost effective products and services, the bank should review what other resources are needed in such areas as:

- Information technology systems, upgrades and new requirements;
- Equipment and Premises;
- Infrastructure;
- Other.

### **Annual Business Plans**

Generally, during the third or fourth quarter of each year (depending on the size and complexity of the bank), annual Business Plans should be prepared by the individual business units (profit and/or loss centres) and, then, consolidated into a single Business Plan for the bank as a whole. The final version should be approved by the Board of Directors and reviewed at least on a quarterly basis to ensure that progress towards meeting the bank's objectives is being made, as well as that it remains consistent with the bank's overall strategy.

Planning guidelines are needed so that each business unit understands the overall operating environment in which it is required to establish its operating objectives for the plan period. These plans should show what each unit intends to achieve to ensure the successful attainment of the bank's overall plan. They will normally be issued by the Chief Executive or the Management Board in the form of a memorandum to the heads of each division and operational business unit in the bank.

The planning guidelines should contain:

- An outline of the agreed strategy for the bank.
- An outline of the key business objectives for the bank for the plan period.



- The format in which business unit plans are to be submitted.
- A copy of the overall planning time-table for the bank.
- The deadlines by which submissions of business unit plan proposals are to be returned to the Planning business unit.

Following completion of business plans by the individual business units, the annual Financial Plan (sometimes known as the Budget) is prepared for the bank as a whole, a function normally performed in the Finance Department. As with the annual Business Plan, the annual Financial Plan should be approved by the Board of Directors and reviewed at least on a quarterly basis.

The bank's Budget is a consolidation of individual business unit budgets (where profit centre accounting is sufficiently devolved to permit this). These latter are not normally as detailed as for the Bank as a whole and may well not include a full balance sheet and profit and loss statement.

## **7.2.8 Organisation Structure**

The organisation structure of a bank should be designed to facilitate the achievement of its strategic objectives. During the course of Phase 2, and as an integral part of the Rehabilitation process for each bank, each bank's organisation structure will be examined and then revised. This revision will openly reflect chosen strategies, ensuring effective separation of responsibilities where appropriate (e.g. between business development / lending units and credit risk approval officers), and, thereby, streamlining the decision-making process.

## **7.2.9 Conclusion**

The Rehabilitation process for each of the Public Banks needs to be carefully planned and structured in order to ensure successful outcomes for each organisation. There are areas in which this process will be very similar in all of the banks. This is not only recommended because it will facilitate and accelerate the implementation process. It will also greatly facilitate any future merger, break-up or restructuring of Public Banks that the GoS may choose to contemplate.

As stated at the beginning of this Chapter, the Rehabilitation process will be conducted under distinct headings. The principle tasks to be performed under each of these headings, and the responsibility for performing these tasks, if not the Phase 2 BAI Team, are set out in the Table below.

This may be considered as the basis for an Action Plan for Phase 2, to be set out in greater detail in the Phase 2 Inception Report.



<b>Preferred Option – Rehabilitation of the Six Public Banks</b>	
<b>CORPORATE GOVERNANCE</b>	<ul style="list-style-type: none"> <li>Review and revise for each of the Public Bank (existing, new and/or merged), including but not limited to, the following:</li> </ul>
<b>Charters:</b>	<ul style="list-style-type: none"> <li>Review and revise individual Bank Charters</li> </ul>
<b>Legal &amp; Regulatory Framework:</b>	<ul style="list-style-type: none"> <li>Up-date, change as required, responsibility of GoS</li> </ul>
<b>Ownership of Public Banks:</b>	<ul style="list-style-type: none"> <li>Separate clearly GoS ownership function from its other public functions</li> <li>Select institutional share structure: Holding company or continued ownership as at present?</li> </ul>
<b>Boards of Directors:</b>	<ul style="list-style-type: none"> <li>Select and empower, and ensure full independence from Government</li> <li>Empower to exercise responsibilities as defined in Bank Charters</li> <li>To be fully accountable to owner</li> <li>Vest with clear mandate to carry out function of strategic guidance and monitoring of management including appointment/dismissal of CEO</li> <li>Appoint specialised Committees (e.g. Credit, Asset Liability Management, Audit, Remuneration)</li> </ul>
<b>Transparency &amp; Disclosure:</b>	<ul style="list-style-type: none"> <li>Follow best practice related to transparency including Unified Chart of Accounts, IAS, audited accounts, external auditors (implementation a GoS responsibility)</li> <li>Develop internal audit procedures</li> <li>Provide disclosure of all material information</li> </ul>
<b>STRATEGY</b>	<ul style="list-style-type: none"> <li>Boards of Directors of individual Banks to establish well defined strategies</li> <li>Use principle of Strategy Planning</li> </ul>
<b>Strategic Objectives:</b>	<ul style="list-style-type: none"> <li>Develop history and characteristics</li> <li>Set Objectives</li> </ul>
<b>MARKETING &amp; BUSINESS DEVELOPMENT:</b>	<ul style="list-style-type: none"> <li>Conduct market research and analysis of competitive environment</li> </ul>
<b>Customer Focus:</b>	<ul style="list-style-type: none"> <li>Satisfy customer needs</li> <li>Analyse existing products and services</li> <li>Diversify products</li> <li>Enhance/create new positive image</li> <li>Provide quality service</li> <li>Practice quality pricing</li> </ul>
<b>Business Development &amp; Relationship Management:</b>	<ul style="list-style-type: none"> <li>Decide on approach: proactive or passive</li> <li>Develop concept and objectives of Relationship Management</li> <li>Ensure Senior management involvement</li> </ul>
<b>RISK MANAGEMENT</b>	<ul style="list-style-type: none"> <li>Review of risk management processes and internal controls in each of the Public Banks</li> <li>Assess independent risk management function</li> <li>Quantify risk exposures</li> </ul>



Preferred Option – Rehabilitation of the Six Public Banks	
	<ul style="list-style-type: none"> <li>Review quality of risk management information systems to control exposures</li> <li>Review and revise of credit risk approval procedures</li> </ul>
<b>FINANCIAL MANAGEMENT &amp; ACCOUNTING</b>	<ul style="list-style-type: none"> <li>Undertake external Audit of Public Banks (GoS/Auditor responsibility)</li> <li>Introduce accounting procedures in accordance with IAS (GoS/Auditor responsibility)</li> <li>Introduce Unified Chart of Accounts (GoS responsibility)</li> </ul>
<b>FINANCIAL PLANNING</b>	<ul style="list-style-type: none"> <li>Assess resource needs: <ul style="list-style-type: none"> <li>Financial resources</li> <li>Personnel resources</li> <li>Other (e.g. IT, premises, infrastructure, etc).</li> </ul> </li> <li>Prepare annual business plans</li> <li>Produce planning guidelines</li> <li>Prepare annual financial plan (or budget) for Bank as a whole</li> </ul>
<b>IT SYSTEMS &amp; MIS</b>	<ul style="list-style-type: none"> <li>Appoint independent auditors to review (GoS/Auditor responsibility)</li> <li>Defer decision on Project Team assistance to be provided during Phase 2 pending outcome of this review</li> </ul>
<b>ORGANISATION STRUCTURE</b>	<ul style="list-style-type: none"> <li>Review and revise structure to ensure that it: <ul style="list-style-type: none"> <li>Reflects strategic objectives</li> <li>Adequately separates distinct functions</li> <li>Streamlines the decision-making process</li> </ul> </li> </ul>

## 7.3 Preferred Options

### 7.3.1 Syria SME Bank

Before starting to plan for this institution, three principle questions need to be answered in relation to the operating environment in Syria. The answers will define the framework, within which the Bank should be designed:

- Which target group to promote?
- What types of financial products to offer?
- Whether to establish a new institution or transform existing institution(s)?

#### Which Target Group to Promote?

According to the demand analysis, the private Syrian companies are significantly under-served by the existing financial institutions. This results in an extremely high ratio of equity capitalisation and the consequential incapability to finance fixed asset investment for further growth. This relates, in particular, to smaller companies, which neither are prioritised by any of the public or private banks nor enjoy access to offshore banks, such as in Jordan or Lebanon. As in other developing countries a clear definition of what constitutes an SME is aggravated by insufficient statistics and



the general desire of enterprises to under-report their earnings in order to decrease the tax burden. In absence of a more suitable definition and in line with other country's practice, an SME is hereby defined as a formal or informal enterprise employing up to 50 workers. Micro enterprises are defined as having up to 5 workers.

In the particular case of Syria, special attention should be placed on start-ups. Its private sector is characterised by a comparatively small number of institutionally underdeveloped and financially weak enterprises. The sector is currently incapable either to contribute significantly to overall economic growth or to offer enough jobs to decrease unemployment, which is exacerbated by the continuous inflow of new labour market entrants. The private sector needs to grow significantly both in terms of size and number in order to capitalise fully on its potential to fuel economic development and job creation.

The Agency for Combating Unemployment (ACU) has so far spearheaded the promotion of small-scale start-ups, albeit with doubtful effectiveness. But the Agency appears to have lost its political backing and may be downgraded to a consulting and training institution by the end of 2006. This information was received late in the mission after the BAI Team had analysed the ACU in the same way as the banks. This analysis can be found in the Annex.

*In conclusion*, there are two target groups, which play a crucial role for the future economic growth and employment generation in Syria and which require a particular financial promotion: SMEs and small-scale<sup>49</sup> start-ups.

## **What Types of Financial Products to Offer?**

Both the demand and supply analysis conducted by the BAI Team arrive at practically the same results: The lending business of loans is mainly restricted to short-term loan facilities, which are predominantly used for working capital and trade purposes. Fixed asset investments are currently being financed through revolving short-term loans. Banks lack the basic pre-requisites for successfully developing a portfolio of long-term loans: (1) access to long-term funds (either through a larger capital base or through long-term deposits); and (2) the institutional and legal ability to carry out a cash flow oriented due diligence of company loans. The result could not have been better reflected by the demand analysis: 68% of all sampled companies have so far not taken a bank loan and the ratio of equity capital to total assets was exorbitantly high.

*In conclusion*: The lack of mid- to long-term loans constitutes a crucial deficiency within the Syrian banking system and adds to the incapability of the above two target groups to finance fixed asset investment for further growth.

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<sup>49</sup> Small-scale start-ups exclude larger green field projects, that would normally be financed by banks through project finance instruments either on recourse or non-recourse basis.



## **Establish a new institution or transform existing institution(s)?**

The pros and cons of these two alternatives are rather obvious. Establishing a new institution consumes a considerable amount of time until commencement of operation. It requires a substantial amount of costs and efforts to create an effective institution adequately staffed and fully functional on the basis of clear good governance and administration structures. Following-on, senior management capacity must be created and quality staff trained. The necessary efforts will further increase, if an extended branch network is required for securing a countrywide outreach to the target group(s). Contrary hereto, transforming an existing institution and capitalising on its active infrastructure would certainly bring about a quicker result. In addition, the probably idle capacity of the institution, which is to be transformed, would then be turned productive instead of being wasted.

On the other hand, the reform and rehabilitation that may be necessary to an existing institution may be substantial. Efforts and costs involved may prove to be higher than establishing a new institution. Furthermore, systemic deficiencies of an existing institution are symptomatic of its corporate culture. These would therefore be particularly difficult to eradicate.

*The Case of Syria:* To date the country maintains three organisations, which would in principle qualify for a transformation:

- *The Popular Credit Bank:* It has 63 branches and a mandate for servicing small-scale enterprises. The Bank has so far benefited from an easy placement of its abundant surplus liquidity in the Public Debt Fund, but is now required to withdraw its deposits gradually to ease the burden on the state budget.
- *The Industrial Bank:* It has 17 branches and a mandate to providing medium and long-term loans to private sector industries and handicrafts. The loan portfolio of this Bank is assumed to be substantially in default, which - if adequately provisioned - would inevitably deplete double the amount of the Bank's equity funds.
- *The ACU* with 14 branches in the governorate capitals and a mandate to contribute to employment generation through financially and technically promoting SMEs and in particular start-ups. The lifetime of the ACU will expire at the end of 2006 unless the GoS approves an extension or a change in status.

Strikingly, all three organisations face acute sustainability risks and will certainly not be able to keep their "status quo" for much longer. Whilst the two banks may be subject to a merger, the ACU would most likely be downgraded to a mere consulting and training facility. However, in absence of a second tier financial institution, such as the ACU, small-scale start-ups will probably lose what moderate access to finance, they currently enjoy. This would be a very unfortunate set back for this target group. It would also put at risk the GoS endeavours to accelerate private sector growth, which is the motor for job creation.



On the other hand, rehabilitating the Industrial Bank and the Popular Credit Bank and then transforming both to universal banks may not be the most beneficial scenario for improving the intermediary role of the Syrian banking sector. The private banks are branching out dynamically and will grow to serious competitors to these two rather small Public Banks. In addition, owing to their enhanced institution building and superior reputation, private banks will continue to enjoy a competitive edge over the Public Banks. This will be the case for quite some time (or until the rehabilitation of the Public Banks has been finalised and sufficiently appreciated by the general public). Conversely, the private banks will continue to pursue exclusively the objective of sustainable profitability in a competitive environment. They are neither committed to economic developmental goals nor the above cited target groups.

Therefore, rehabilitating these two banks to be a universal bank – regardless of whether they may be kept separate or merged was considered, but not deemed to be the most optimal solution. It is rather recommended to transform one or both of these two banks to financial institutions with special mandates. The value-added of transforming both banks to universal banks should, within the Syrian context, be less than the comparable value of downsizing one or both of them to specialised banks.

In conclusion, it is therefore recommended to establish **"Syria SME Bank" with the special purpose of providing mid- to long-term loans to existing and new SMEs. The Bank shall be established through the merger of existing Public Banks. The target groups of the Syria SME Bank will also receive training and consulting services.**

It is suggested to implement above recommendation through following principle steps:

- Transform either the Popular Credit Bank or the Industrial Bank into the "Syria SME Bank".
- The Bank would focus on the promotion of SMEs including start-ups.
- The Bank should be institutionally and financially empowered to assume the responsibility of furnishing the target group of SMEs and start-ups with mid- to long-term loans on the basis of a cash flow oriented methodology.
- The Bank should play the dual role of a first tier and a second tier financial institution. Hence, it would engage in direct lending and, thereby, assuming the full credit risk of its own portfolio as well as refinancing partnering banks in order to maximise its outreach to its target group(s): SMEs and Start-ups.

The BAI Team is aware, that this recommendation comprises the aforementioned problems and risks therein associated, with transforming an existing institution, rather than establishing a new one. Furthermore, the recommended solution represents a particularly ambitious type of Bank in view of its envisioned complex role: direct lending; bank refinance; training and consulting of individuals and SMEs. Yet the BAI Team believes that its recommendation, nevertheless, combines the benefits of (1) a most efficient deployment of already existing banking infrastructures, and (2) the



institutional set up of a financial organisation, which would be best suited for addressing the crucial deficiencies of the Syrian financial sector.

The ultimate features of a Syria SME Bank following a finalised transformation of one of the above Public Banks would be as follows:

<b>Term Sheet for the Recommended "Syria SME Bank"</b>	
<b>Overall Objective</b>	Enhance the development of the private sector and support its role in stimulating a broad based economic growth other than the oil and gas sector.
<b>Specific Objective</b>	Countrywide promotion of existing and new SMEs. Promote domestic and possibly also foreign investment in Syria.
<b>Legal Status</b>	Independent financial institution established – if necessary - by a special law clearly defining its mandate and empowering it sufficiently for this purpose.
<b>Governance</b>	<p>The Bank will have an institution building sufficient for meeting its specific objective.</p> <p>The governance bodies, their powers, responsibilities and limitations will be clearly defined in the Bank's Charter and its supporting policy papers.</p> <p>The Bank's management information system will allow a timely and comprehensive controlling and pro-active management of evolving operational and counterpart risks.</p> <p>The Bank will be subject to the supervision of the Central Bank of Syria and strictly abide by the banking laws and prudential regulation</p>
<b>Co-operation Potential with Donors</b>	The Bank will further qualify as a local partner organisation for donor funded financial and technical promotion programmes. It will execute the donor programmes either directly or act as an "apex-institution" for partnering banks.
<b>Accounting</b>	International Accounting Standards will be adopted from the outset.
<b>Target Groups</b>	<p>A. Individuals or SMEs wishing to invest in a new company</p> <p>B. SMEs wishing to expand or modernise their fixed assets</p> <p>C. Local banks eligible and interested in channelling refinance facilities of the Development Bank to above individuals and SMEs</p> <p>SMEs are defined as formal and informal enterprises employing up to 50 workers. Enterprises with up to 5 workers are considered micro.</p> <p>All sectors are eligible excluding oil/gas, arms/ammunition and drugs as well as any activity involving child labour or female exploitation. Investments involving environment risks will be subject to a particular assessment.</p>
<b>Financial Services</b>	<ul style="list-style-type: none"> <li>Extend loans and guarantees directly through own branch network.</li> <li>Provide target group oriented refinance facilities to partnering banks.</li> </ul>





- Open and manage bank accounts.
- Collect savings for time deposits.
- Effect transfers.
- Receive payment documents for collection.
- Issue debt securities.
- Issue stocks, bonds and other types of securities, such as convertibles as and when permitted by the Capital Market Authority.
- Conduct dealing operations with government and other securities.

The details of the financial services and, in particular, the loans and refinances (amount, interest rate, term, grace period, collaterals, prudential limits) will need to be designed in more depths.

**Sustainability**

Whilst profit maximisation is not the prime objective of the Bank, yet it will pursue operational and also financial self-sufficiency and hence will operate according to market oriented business principles.

**No Subsidised Lending Policy**

In its capacity as a first tier financial institution, the Bank's policy on interests and other fees will be guided by prevailing market conditions. The Bank will tailor its fees to the individual risk profile of the borrower.

The Bank will not abuse its privileged status to crowd out other banks. Instead, the Bank - through its direct lending performance - will motivate the partnering banks to expand into SME finance by means of their own resources, i.e. over and above the refinance facilities received.

**Initial Capital Requirement**

In view of the substantial demand potential, it is recommended to consider an initial equity capital of the Development Bank equal to double the minimum capitalisation requirement as stipulated by the Central Bank of Syria, equivalent to SYP 3 billion.

Accumulated profits will not be distributed but added to the equity funds.

**Funding**

Funding should mostly be long-term in order to avoid term mismatches with the mid- to long-term loans.

Funding sources will predominantly be: Government loans, donor refinanced SME promotion programmes, market placement of own debt securities as well as Interbank loans.

The ratio of equity funds to other liabilities will not exceed 1:3. Hence the initial cash flow projection of the Bank would foresee a development of the total balance sheet in the first – e.g. 3 to 5 years – up to SYP 12 billion.

**A Note to Foreign Exchange Risk Hedging:**

Most likely, donor contributions will be denominated in foreign currency. The Bank will, hence, assume foreign currency liabilities but will not enjoy equivalent foreign currency earnings. Correspondingly the currency risks would be rolled over unhedged to the participating Syrian banks, if the Bank on-lent the donor contribution in foreign currency as well. Unfortunately, to date the Syrian financial sector does not



allow offsetting forward Foreign Exchange exposure, since markets for typical hedging instruments such as currency forwards, swaps and options, are currently unavailable.

This is where – with the support of a funding donor – at least a partial hedge against unexpected devaluations of the Syrian Pound should be provided to the Bank & partnering banks. Based on positive experience in Turkey, the BAI Team recommends either creating an additional “*top-up fund*” or earmarking part of an anticipated foreign currency facility as an “*exchange risk cover fund*”. Such a hedging mechanism basically aims at covering only those exchange rate losses that exceed priced-in market expectations. The size of such a fund should be a function of the anticipated frequency and magnitude of exchange rate shocks and thus is highly subjective in nature. In our judgement, the fund should at the very least amount to 20% of the facility amount in order to provide a meaningful cover range for the Bank & partnering banks.

In order to make the most economical use of the limited exchange risk cover resources, it is suggested that the donor organisation – which will contribute funds to the Bank – uses voluntary transactions in conventional financial instruments to manage the exposure of the Bank and partnering banks rather than an administrative claims process. By “making markets” for the Bank and partnering banks in standard EUR/SYP options or forwards, the donor would be in a position to manage closely the incentive component in its trades and ultimately phase out the support, once conditions stabilise to the extent that the on-lending banks can find efficiently priced hedging instruments in the regular inter-bank market.

*Pre-requisites:* The central pre-requisite for such a market-based Foreign Exchange risk cover mechanism is a credible daily reference rate in the Foreign Exchange spot market for the Syrian Pound against the EUR. Such a rate must be objectively determined and published. It must also represent an actual conversion opportunity for the Bank and partnering banks, at which they could expect to buy or sell EUR for Syrian Pounds without obtaining discretionary authorisation from the GoS or the Central Bank of Syria.

*Recommendation:* Syria is rapidly moving away from administrative exchange rates towards establishing a unified exchange rate regime determined largely by market forces in the sense of a “managed float”. This should create appropriate conditions for the operation of an “exchange risk cover fund” by the time the Bank would be operational.

## **Action Plan for Phase II:**

Phase II will focus on carefully planning the establishment of the Bank along the Phases 1 – 4 as described below.

Phase 1: Take a strategic decision on whether to follow the BAI Team's recommendation to merger an exiting Public Bank to the Syria SME Bank or whether to establish a new financial institution.



### ***In case of transforming an existing bank:***

- Phase 2: *Financial Rehabilitation:* carry out loan assessment; clean up the loan portfolio and other doubtful receivables within the DDI-context. Re-capitalise the bank.
- Phase 3: *Institutional Consolidation:* close strategically unnecessary branches, liquidate idle assets, reduce or even stop inefficient or loss-making services, and consider retrenchment requirements and alternatives.
- Phase 4: *Institutional Transformation:* enact a special law for the Bank, establish transparent corporate governance, organisation, system and procedures, modernise IT/MIS. Establish a Board of Directors and hire professional management and other key staff, develop and implement training curricula for all staff members, especially those involved in direct lending or bank refinancing.

The design and preparation for implementing the option of the “Syria SME Bank” with its ultimate structure as suggested above will follow the tasks defined by the Terms of Reference of the EIB, namely:

- Preparation of a Transformation Plan.
- Proposed changes in the Statutes and Policy Statement.
- Proposed changes in the Organisation and Management.
- Proposed changes in key Policy Documents and other Operating Manuals.
- Preparation of the Operational Business Plan, including a Financial Model.
- Timing for the Transformation (Critical Path Analysis).

In case a decision would be taken in favour of establishing a new financial institution instead of transforming an existing bank, then the design and preparation of the Syria SME Bank will take place through following steps:

- Proposal of the Statutes and Policy Statement.
- Proposal of the Organisation and Management.
- Proposal of key Policy Documents and other Operating Manuals.
- Preparation of the Operational Business Plan, including a Financial Model.
- Timing for the Transformation (Critical Path Analysis).

In both cases – and contrary to the Terms of Reference - a prospectus will not be needed, given that the GoS will continue to be the exclusive owner of the Bank. However, once the Bank is eligible to issue debt securities, the drafting of a respective prospectus will be necessary. For this purpose the additional services of an arranging financial institution will be required.



## 7.3.2 Export Credit Insurance

### 7.3.2.1 Introduction

There are many examples of export credit insurance companies around the World, which can serve as examples for a Syrian company. Indeed, there are many in North Africa and the Middle East.

#### The National Credit Insurers in North Africa and the Middle East

Name of National Insurer	Country of Exporter	Location of Buyers
CAGEX	Algeria	World-wide
Export Credit Guarantee of Egypt	Egypt	World-wide
Jordan Loan Guarantee Corp. Ltd	Jordan	World-wide
Compagnie Libanaise pour la Protection du Credit	Lebanon	World-wide
SMAEX	Morocco	World-wide
Export Credit Guarantee Agency	Oman	World-wide

Firstly, it is important to clarify what risks are internationally accepted for credit insurance. Listed below are the categories of risk to which a commercial entity is exposed when doing business both at home and in other countries.

#### Trade Credit Risks involving non-payment, insolvency and buyer default

- Pre-sale (from confirmed order to acceptance of the goods) credit periods of not more than 360 days<sup>50</sup>.
- Post-sale credit periods of generally up to 180 days, but not normally more than 2 years<sup>51</sup>.

#### Political Risks

- Risks to foreign contracts: Frustration, repudiation, and embargo due to political influence.
- Risks to revenue: Inconvertibility, inability to transfer funds, trade disruption, force majeure (including War).
- Risks to finance: Unfair calling of On-Demand Bonds.

<sup>50</sup> The insurance normally does not cover failure on the part of the exporter to produce the goods on time or to an agreed specification.

<sup>51</sup> Except for major capital items which are rarely provided by developing countries.



Normally, trade credit risks (and to the extent that they exist, political risks) which are on buyers from OECD countries and for under two years can be reinsured on the international reinsurance market and so, generally, can be undertaken by private insurance companies for their own account. It may also be possible for exports to many other countries and for tenors over two years to be reinsured. This includes sometimes, the political risk. However, because of the uncertainty, governments generally will accept the trade credit risks on non-OECD countries and on all political risks.

Attradius, a large Dutch/UK based insurer in recent years paid out on average about 48% of its premium income in respect of net claims<sup>52</sup>, 25% went in operating costs, leaving 27% as underwriting profit. It is interesting to note that ECGA of Oman claims that their annual average pay out in recent years was lower at 40% of its premium income. In addition, both premium income and the equity supporting the insurance policies can be invested, thereby increasing income. Hence, it would seem that export credit insurance can be profitable.

Normally, an export credit insurer classifies countries according to five categories; A, B, C, D, and E, as follows:

- “A” grade would generally be the OECD countries,
- “B” grade would include Bahrain, Hong Kong, Kuwait and the UAE,
- “C” grade would include Egypt, India, Morocco, Saudi Arabia and Tunisia,
- “D” grade would include Bangladesh, Lebanon, and Vietnam,
- “E” grade would be the excluded countries, such as Iraq, North Korea, and Zaire.

The credit insurer will obviously continually amend the countries within each country grading as different economic or political circumstances arise.

The countries comprising the Arab region would generally fall into the B, C, and D grades with approximately 50% being classed as B and C countries.

The period of credit for the majority of the commodities traded within the Arab region will range from a sight letter of credit up to 360 days and, sometimes, 720 days credit. However, the greatest concentration will involve credit terms of between 120 and 180 days.

ECGA of Oman has been using a premium-rating matrix, which indicates the following rates for exports to:

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<sup>52</sup> Attradius operate on a three-year cycle, they close a year's accounts only after three years have elapsed. The pay out mentioned in the text was an average for closed years. The three following years, which were still open, showed an average underwriting profit of 37%. Of course, this return will probably diminish before closure as additional claims are received.



1. Grade B countries for credit periods of up to 180 days are subject to a premium rate of 0.80% on the value of the exported item(s),
2. Grade C countries for credit periods of up to 180 days are subject to a premium rate of 1.10% on the value of the exported item(s) and,
3. Grade D countries for credit periods of up to 180 days are subject to a premium rate of 2.25% on the value of the exported items.

Unlike Syria, Oman exports very little to OCED countries, but a rate of about 0.6% on the value of the exported items would seem reasonable.

It is also important to note that unlike many forms of general insurance, credit insurance is an optional insurance and has to compete with other financially-based products, such as forfaiting and factoring, etc. As a result of this situation, credit insurance is only normally utilised for up to a maximum of 20% to 25% of the exports from any country.

However, these percentages will also reflect the fact that many countries have multinationals carrying out a sizeable proportion of the trade. These companies are not major users of export credit insurance as they are normally exporting to their subsidiaries; rather they use domestic credit insurance within the country of import. Also, export credit insurance is not so often used in the trading of oil and gas. This implies that the proportion of total Syrian exports which is likely to be covered by credit insurance will be less than 20%, but of non-oil and gas exports the proportion is likely to be higher.

In addition to the above, a new credit insurer must also acknowledge that during the “start-up” period, there are costs incurred which only yield benefits in the long-term, such as those associated with marketing and selling, and establishing a credit rating and performance criteria. This means that it is not unusual for a new export credit insurer only to underwrite relatively low percentages of available exports within the first few years of operations.

### **7.3.2.2 The Design Framework**

#### **a. The target customer group**

With regard to export credit insurance in Syria, the target customer group would be all non-oil and gas exporters from Syria, including construction companies. The marketing emphasis that should be used is the potential enhancement to the exporters’ sales package resulting from the ability to offer credit terms. Buyers and potential buyers of Syrian goods could also be approached to inform them that they might be able to obtain credit terms when buying Syrian exports.

**b. The products to offer**

The products to be offered are:

- A combined policy offering commercial and political risk cover
- A guarantee to cover the issuance of bid bonds
- A guarantee to cover the issuance of performance bonds
- A policy to cover the unfair retention of bid or performance bonds

Policies will normally cover up to a maximum of 85% of the risk in the expectation that the exporter will bear 15% of the risk.

**c. Whether to establish a new institution or expand an existing institution(s)**

Ideally, the export credit insurer should be a private sector company, preferably with an equity participation from the State Insurance Company, that would underwrite all marketable<sup>53</sup> risks. The Government should be prepared to offer to accept for its own account all non-marketable risks (at appropriate rates that would aim for the account to break-even at worst over the long-term), and, as an incentive to attract a private venture to insure marketable risks on their own account to offer to appoint such a company to manage the state account in return for a fee. The private venture could be a new company, or a window in, or a subsidiary of an existing general insurer.

If no private enterprise were prepared to set up as an export credit insurer, the Government could set up a wholly-owned agency, such as has been done in Algeria, Jordan, Morocco, Oman, and Tunisia. Only in the Lebanon is the insurer a private company.

**d. An outline of the recommended institution**

In conclusion, it is therefore recommended the following:

<b>Term Sheet for the Recommended "Export Credit Insurance Company"</b>	
<b>Overall Objective</b>	Increase the value of non-oil exports from Syria.
<b>Specific Objective</b>	Enhance the selling ability of Syrian exporters by enabling them to offer credit terms and to use the insurance policy as collateral to obtain bank finance.
<b>Legal Status</b>	<ol style="list-style-type: none"> <li>1. Independent export credit insurance company issuing policies for its own account that it is able to reinsure abroad the.</li> <li>2. An export credit insurance window established by the Syrian Government to insure risks that cannot be reinsured on world markets and</li> </ol>

<sup>53</sup> Marketable risks are commercial and political risks on public and non-public debtors at terms of up to two years on buyers in all EU and OECD countries (if not EU members). Non-marketable risks are those that do not fall within the definition of marketable risks.



**Term Sheet for the Recommended "Export Credit Insurance Company"**

managed for a fee by the independent export credit insurance company.

**Governance**

1. The export credit insurance company will be registered by the shareholders and be subject to the supervision of the Syrian Insurance Board. It will have an institutional capability and capacity sufficient for meeting its specific objective.

The governance bodies, their powers, responsibilities and limitations will be clearly defined in the Company's Charter and its supporting policy papers.

The Company's management information system will allow a timely and comprehensive control and pro-active management of evolving operational and counterpart risks.

2. The insurance window opened by the Syrian Government will have a predetermined risk ceiling and an independent board to monitor the performance of the window and to set prudential limits and risk premium rates.

The day-to-day management of the window will be undertaken by the Company for an annual fee.

**Institutional Status**

The Export Credit Insurance Company will be licensed as an insurance company

The insurance window will be a budget line in the accounts of the Government, but with an independent board to oversee the commitment of funds and the risks being undertaken, and to set risk premium rates with a view to the promotion of exports.

**Co-operation Potential with Donors**

The insurance company will seek membership of:

- The Prague Club of new export credit agencies, with a view to eventually joining the Berne Union.
- ICISA, the International Credit Insurance & Surety Association.

These associations circulate credit risk information amongst their members. Representatives of the independent board would attend meetings of these associations.

The insurance company will also seek to establish an association with a major export credit agency or group of agencies, which will provide it with technical support and credit risk information on buyers world-wide.

**Accounting**

International Accounting Standards will be adopted from the outset. The accounts will be subject to independent audit. The Company will maintain totally separate books for its "Own" account and its "State Account" activities.

**Profit Centre System**

"Own Account" and "State Account" activities will be treated as separate Profit Centres.

**Staffing /**

The Company will ensure that key positions will be held by sufficiently qualified professionals. The marketing team may be recruited from existing trade promotion activities since a good knowledge of the potential of





**Term Sheet for the Recommended "Export Credit Insurance Company"**

**Salary Scheme**

individual Syrian exports is essential. The underwriters must be experienced in export credit insurance and it may be possible to retain one or two Syrians working in the Inter Arab Investment Guarantee Corporation (IAIGC) in Kuwait or the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC) in Saudi Arabia. However, in the first few years, it may be necessary to fill key posts with non-Syrians.

The salary scheme will be competitive and reflect the special qualifications of the staff required. The bonus policy will equally emphasise the Company's dual goals of a growth and quality orientated insurance portfolio development.

**Branching Policy**

The key to a successful export credit insurance company is its ability to market its products successfully and to provide "hand-holding" for clients. In order to achieve this, the company needs to establish marketing capabilities in the major cities. This could be achieved, at least in part, by retaining (and training) freelancers who would operate as brokers or agents.

**Target Groups**

- A. Existing exporters
- B. Potential exporters who may not have exported previously
- C. Banks which may have clients that are exporting or have the potential to export
- D. Potential buyers of Syrian exports

In fact, all exports are eligible, excluding oil/gas, arms/ammunition and drugs, as well as any activity involving child labour or female exploitation.

Because the company will have access to databases of buyers world-wide, the marketing teams of the company will be in a good position to advise about exporting and provide names of potential buyers

**Sustainability**

If the Company were to be owned by:

- Other insurers, then its export development orientated sales emphasis might introduce its owners to many potential clients for other insurance products.
- Banks, then its export development orientated sales emphasis might result in increased lending. It could also bring the banks closer to their customers
- The Government, then its development role would be more important than its revenue generating capability.

Hence, whilst profit maximisation need not be the prime objective of the Company, it should pursue operational and financial self-sufficiency and operate according to market orientated business principles.

**No Subsidised Underwriting Policy**

There would be little advantage to exporters in the Company receiving an underwriting subsidy. However, it could receive a subsidy for its marketing efforts.

**Exports Supported**

Conservatively, 20% of non-oil exports could be supported by the insurance.



**Term Sheet for the Recommended "Export Credit Insurance Company"**

At present, non-oil exports amount to more than EUR 1 billion per annum. On this basis exports worth EUR 200 million per annum would be supported.

An obvious objective is to increase non-oil and gas exports significantly over the foreseeable future. If such a prospect is achieved, the amount of insured exports could rise commensurately.

**Initial Capital Requirement**

The initial capital cost would depend largely on the value of exports underwritten, but could be in the region of € 15 million.

**Revenues**

Income would come from three sources:

- The investment of the equity capital;
- Premium income;
- The management fee relating to the Government's account.

**Action Plan for Phase II:**

If the GoS accepts the recommendation to introduce export credit insurance in Syria, how this is accomplished will need to be carefully considered and planned.

Phase II will focus specifically on this issue as described below in Phases 1 - 4. Whether a new enterprise is to be established or a window set up in an existing enterprise, such as the Syrian Insurance Company, would depend upon the reaction of the insurers, banks and others to the proposal.

The implementation would take place in four, partly overlapping phases:

Phase 1: *Selection of a partner from amongst the established credit insurers:* establishment of a reinsurance treaty either through the partner or with a selection of reinsurers. Approaches would be made to the IAIGC and the ICIEC as to whether they would co-operate with regional exports, either as a reinsurer or co-insurer. Arrange with the partners for access to databases of buyers world-wide, and the provision of documented procedures (tailor-made for Syria) and the training of key personnel.

Phase 2: *Establishment of systems and procedures:* in close co-ordination with the reinsurers and co-insurers, prepare systems and procedures for use in the insurance activity; send key staff for training with the reinsurers/co-insurers; design a promotional strategy and programme; train a marketing/customer support team.

Phase 3: *Establish a database of exporters and potential exporters and intermediaries who support exporters and develop a marketing programme:* Hold seminars in commercial and industrial locations to solicit interest in export credit insurance and acquaint intermediaries with the concept and value of export credit insurance.



Phase 4: *Start active marketing of export credit insurance:* Including taking exporters abroad to meet buyers and inviting chambers of commerce abroad to visit Syria together with potential buyers. Working with exporters to include credit offers to enhance their sales package and orientate trade negotiations away from price discounts and towards credit terms.

The design, and preparations for implementing the option of Export Credit Insurance with its ultimate structure, as suggested above, will follow the tasks defined by the Terms of Reference, namely:

- Prepare a Development Plan.
- Propose new Statutes and Policy Statements.
- Prepare the Operational Business Plan, including a Financial Model.
- Propose the Organisation and Management.
- Propose new key Policy Documents and other Operating Manuals.
- Propose the timing for the Development (Critical Path Analysis).

As mentioned in the Terms of Reference, a prospectus will be needed in order to help those who may consider investing in an export credit insurance company. However, once the company has been established, additional equity or a bond issue may be required to support further underwriting. The company could issue debt securities and, to this end, the drafting of a respective prospectus would be necessary. For this purpose, the additional services of an arranging financial institution will be required.