What does the IMF's Lebanon 2023 Article IV Consultation Have to Say about Financial Sector Restructuring?

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One of the more interesting parts of the recent IMF's Lebanon 2023 Article IV Consultation Report (published on June 29, 2023) is Annex IV on *Financial Sector Restructuring*. As the Lebanese crisis is primarily a banking and currency crisis, restructuring the banking sector is perhaps the most important pillar for resolving the crisis. And given how crucial this topic is, in addition to the decisive role that the IMF can play in this regard, we will concentrate in this spotlight on the report's financial sector restructuring Annex and provide a brief summary and assessment of it.

The said Annex starts, correctly, by arguing that "the losses in the commercial banks and BdL stem from four main sources: (i) the exchange rate depreciation; (ii) expected restructuring of the public debt (Eurobond holdings and LBP denominated debt, whose value has collapsed with the ongoing depreciation); (iii) non-performing loans held by commercial banks; and (iv) losses incurred by BdL".

It then zeros in on BDL losses and estimates BDL's negative equity at about $60 billion. Incidentally, we have estimated elsewhere BDL's negative equity to be around $44 billion but including gold[1]; so we are going to assume (as the Annex does not actually specify)

[1] "An Indirect Methodology to Estimate BDL's Foreign Assets and Liabilities", *Blominvest Blog, Economic Digest, March 28, 2023.*

that the $60 billion negative equity figure *excludes BDL's gold since the latter's value is close to $16 billion*. More important, it goes on to argue that "*eliminating BdL's losses and bringing BdL to zero net worth, thereby not compromising its ability to attain its policy objectives in the future and maintaining its financial independence, requires writing off a similar amount of commercial banks' claims against BdL (out of the total of $86 billion of deposits and CDs banks hold at BdL), as the sovereign is unable to recapitalize it on such a scale, given its own unsustainable debt position*"[2].

So it is clear that BDL's negative equity of $60 billion is to be covered from banks' deposits and CDs at BDL in the amount of $60 billion, or 70% of the total. But, of course, that would be detrimental to banks, and the annex acknowledges this fact by arguing that "*this large transfer of BdL losses to banks' balance sheet implies that banks will become severely undercapitalized. As current shareholders or other investors are unlikely to inject the capital needed to recapitalize the banks, rehabilitating them will require the use of internal recapitalization mechanisms*". And the internal recapitalization mechanisms are identified "as a reduction of the overall deposits by a combination of: (i) write-offs; (ii) conversion into equity or long-term bonds in banks; and (iii) lirafication of deposits at non-market rates"[3].

But in discussing these mechanisms, the Annex focuses solely on one upfront solution which "*is for a partial write down, on a bank-by-bank basis of deposits held at banks, above a minimum socially acceptable threshold, to bring banks' capital to zero. This would be done only following the bail-in of shareholders, subordinated debt,*

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[2] Currently, commercial banks' deposits and CDs held at BDL are close to $84 billion.

[3] In fact, the report's road map for banking sector rehabilitation ahead include: "writing off capital, subordinated debt instruments, and related-party deposits; internal recapitalization; protection of small FX depositors; fresh capital from current and/or new shareholders for viable banks to recapitalize and restructure these banks under credible and time-bound plans for each bank; the exit of unviable banks (by liquidation or a merger with stronger banks)".

and related deposits" . And it adds that "preliminary illustrative calculations suggest that, despite the size of the write-off, *it might be feasible to fully protect deposits up to $100,000"* [4]. As such, given that the distribution of USD accounts is as listed below:

FX Deposits by Tranches as of December 31, 2022 (Preliminary and illustrative calculations)					
Tranches	**Number of Accounts**	**Deposit Values, US$ mn**	**Percent of Accounts**	**Percent of Deposits**	**Cost of protecting up to 100K, US$ mn**
Less than US$100,000	1,246,741	16,761	88%	18%	16,761
US$100,000 to US$ 1 mn	152,527	40,795	11%	44%	15,253
US$1 mn to US$10 mn	10,790	24,416	1%	26%	1,079
More than US$10 mn	443	10,234	0.03%	11%	44
Total	**1,410,501**	**92,206**			**33,136.7**
Sources: BCC and IMF staff calculations. Data are reported on solo basis (i.e., without data of branches abroad, subsidiaries in Lebanon and subsidiaries abroad)					

It follows, then, that deposits written off would be $59 billion, which is the difference between total deposits at $92.2 billion and protected deposits at $33.2 billion. Though not mentioned explicitly, that is what actually could be implied from the analysis presented, especially given that the written off amount (59$ billion) is almost equal to BDL's negative equity of $60 billion! Most crucially, this means that it is mostly large depositors who will bear the brunt of the losses!

The Annex admits that "it has proved difficult for the government and parliament to form a consensus (let alone convince depositors and the general public) on an upfront banking strategy that writes down depositors on such a scale due to the implications for depositors" , and as a result some modifications have been proposed to mitigate the impact. Of these, it mentions *'non-eligible' deposits*, i.e. the deposits that were converted from LBP to USD accounts after October 2019, and some estimates suggest *that*

[4] It is widely acknowledged, of course, that banks' capital has been almost wiped out because of the exchange rate depreciations, non-performing loans, and default on the Eurobonds. In USD, it has currently fallen down to $3.6 billion, after it was 6 times that amount before the crisis.

the share of such deposits could be some 25 percent of total USD deposits. It also mentions *'excess' interest* -- since interest rates on deposits were excessively high during the financial engineering years, and depositors could be convinced to forego their interest earnings if principal amounts are untouched – and as such the estimate for the *interest amount over the LIBOR rate during 2015–21 is put at about $15 billion*.

Another consideration concerns protection and whether it should be done 'per depositor per system or per depositor per bank'. In this context, the Annex argues that as the "crisis is systemic, driven by failures of the government and the central bank, therefore the protection ceiling should be set per depositor throughout the banking system rather than per depositor per bank. However, some banks may have been more prudent in their investment strategies than others; thus, their depositors deserve to be treated differently. Moreover, multiple deposit accounts per depositor would be operationally difficult to evaluate, even more so under the current unhelpful bank secrecy law", and as a result "deciding which accounts, for what amount, and in which bank should be protected, will have complex implications for individual banks' viability assessments and for the recovery rates for the large depositors".

Perhaps more important, what does the annex have to say about other ways and means for filling the negative equity gap at BDL? The Annex considers quite a few options but with a somewhat critical view on most of them. These primarily are:

- *Recapitalizing BdL*: the "government would issue a marketable bond to recapitalize BdL and reduce the write-off of BdL's FX liabilities to commercial banks. In turn, banks would reduce the write-off of their customers' FX deposits. BdL's recapitalization would benefit the whole pool of depositors, and thus would be equitable. *However, such an approach could only work if the size and terms of the bond do not jeopardize the debt sustainability"*.

- *Use of state assets: the* "selling existing state assets (land and SOEs) or redirecting part of their income stream could help significantly improve the prospect of compensating depositors. However, pricing these assets accurately under the current circumstances will be near impossible and selling them would be undesirable under the current governance and transparency practices*. Moreover, such a use of state assets would complicate discussions with external creditors" .*

- *Recourse to future budget surpluses: the* "use a part of future budget surpluses to compensate depositors if certain conditions are met (e.g., growth rates and primary surpluses above those agreed upon within the IMF program framework)*. However, the introduction of state contingent payouts could complicate discussions with external creditors.... Moreover, this ultimately implies transfer of wealth from the Lebanese citizens' at large (current and future generations) to a relatively small group of depositors (potentially including non-residents and non-citizens)" .*

- *Deposit recovery fund*: the "creation of_a dedicated fund that would be funded from a number of sources (e.g., proceeds from operating and privatizing state assets, recovery of stolen assets, future oil and gas revenues, etc.). *However, a fund that explicitly or implicitly guarantees depositors constitutes a contingent claim* on government *resources, undermining the debt sustainability objectives and placing* constraints on *the fiscal policy" .*

As the analysis above shows, the Annex on *Financial Sector Restructuring* carries some weighty arguments, though it is only a few pages long. In what follows, we will present a short assessment of its major points.

First, the Annex considers BDL's negative equity gap at $60 billion as the appropriate and operational financial gap to adopt, stemming from its conviction that BDL's viability is the gateway to financial sector rejuvenation in Lebanon. Alternatively, *one could equally*

argue that the financial gap is better expressed as the difference between what BDL owes banks in deposits (and CDS) and its ready foreign assets, which put the gap at about $75 billion, as most of these deposits were largely placed at BDL as a result of BDL rules and regulations. This follows from the belief that it is banks' recovery and getting back what it is rightly theirs that ensure future financial sector viability. And that is especially the case *as the crisis had originated mostly with BDL, not with the banks.*

Second, the seeming process of 'kicking the can down the road' by shifting responsibility from BDL to banks to ultimately large depositors is neither fair nor efficient -- although to be honest the Annex doesn't *explicitly* endorse shifting the ultimate burden to large depositors . As such, it is unfair because it does not agree with the fundamental concept of horizontal equity as it denies big depositors what rightly belongs to them; and it is inefficient because it penalizes (the success of) big savers who are usually the *prime investors* in the country.

Third, the framework of 'per depositor per bank' that the annex alludes to is the more appropriate and just framework to deal with concerning the protected limit of $100,000 and the 'non-eligible' accounts. This is because banks differ in terms of their financial position and in terms of the nature of their deposits as to whether they are mostly retail or high net worth[5]. The framework should also involve *clear and enforceable 'eligibility criteria' in relation to 'non-eligible' and multiple accounts especially in relation to dates and amounts*. And, though complex and time consuming, it should involve preparing and evaluating the accounts of individual banks separately and each on its own.

Fourth, the Annex is critical of the use of state or public resources to close the gap at BDL and to fund the return of large deposits. And it does that by offering mostly three justifications for not to use state

[5] In addition to accounts held by pension funds, insurers, and other public interest institutions

resources: it would jeopardize debt sustainability, it would complicate negotiations with external creditors, and it would discriminate against future generations. Let us pick up each justification in order:

The foreign debt of marketable Eurobonds stood at $31 billion before default. Currently, $5 billion is held by BDL and $4 billion by Lebanese banks, so this leaves $22 billion in the hands of foreign creditors. Given that the IMF estimates Lebanon's GDP in 2022 at $22 billion, then the external debt-to-GDP ratio is 100%[6]. And given that, as is widely acknowledged[7], debt is considered sustainable at a ratio of 90%, then Lebanon's debt is not far from being sustainable, and there is no need for excessive worry about unsustainability, especially that one of the main purposes of an IMF program is to *enhance sustainability further*.

What matters for foreign creditors in debt negotiations is the *willingness and ability to pay by the indebted country, and these are first and foremost determined by economic growth*. And economic growth in turn depends crucially on a *well-functioning banking sector and the confidence of big savers and investors.* So how can a bank restructuring plan that guarantees both fail to impress foreign creditors?

Current depositors, small and large, are part of the people and their rights and welfare deserve to be ensured by the use of public resources. As such, the idea of denying them that, on the grounds that the use of these resources hurts future generations, is against the concept of inter-generational equity. Besides, the economic prospects of future generations will definitely be increased if the current generation has enough resources to save and invest for a better future.

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[6] Domestic debt has mostly depreciated in value because of the exchange rate losses; it currently stands at about $1 billion only.

[7] Reinhart, C. and Rogoff, K. 2011. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton University Press.

Additionally, there are two important reasons why the use of public resources is efficient and just for financial restructuring. First, it is widely known that the gap at BDL was used for public policy and expenditures – as support to the exchange rate peg, subsidies to basic commodities, and transfers to EDL – so not holding the government responsible for the gap is like giving it a license to be spendthrift and corrupt; in addition, there is a governance failure involved, in that moral hazard implies that the government will always get away with its wasteful spending. Second, the use of state resources to pay for the financial gap will transfer these resources to the private sector – private depositors, privatized companies, etc… -- which is superior from a governance point of view, as it will put the management of the county' s resources in more efficient and growth-enhancing hands.

Lastly, it is granted that the IMF' s *Article IV Consultation Report*, including the Annex on *Financial Sector Restructuring,* is a well-articulated analysis of the crisis facing Lebanon. But if Lebanon ever becomes a normal country with an elected president and a well-functioning government, and if it ever elects to have a much-needed IMF reform program, the IMF has to think sometimes 'outside the box' as the Lebanese crisis is complex and perhaps unique, and nowhere is this more so than in the treatment of financial sector restructuring. In fairness, and notwithstanding its criticism, the report nevertheless conveys the impression of flexibility as to the potential use of these resources, thereby raising the hope of an eventual, if gradual, return of most deposits and a sound, but fair, financial restructuring process.

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