IMF vs BDL Positions on Resolving the Financial Gap: Some Critical Thoughts

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Contact Information

Dr. Ali Bolbol

ali.bolbol@blominvestbank.com

The Lebanese crisis is six years old now, and there doesn' t seem to be an end in sight soon. One of the main reasons is the debate going on regarding the financial gap law – the law that will allocate losses and devise a scheme for the return of deposits – between the IMF and the BDL. In this note, we will very briefly outline each of the IMF and BDL positions, and then draw some critical remarks concerning what would constitute a proper resolution to the financial gap.

The IMF position is simple and straight forward and follows a standard IMF scheme in dealing with banking crises. Lebanese Banks' risky and short-sighted decisions brought them onto the abyss of the crisis; and, as such, resolution of the crisis requires following the 'hierarchy of claims' approach, whereby banks' equity and any salvageable assets will be used to payback depositors.

In the Lebanese context, the crux of the issue right now is the $83 billion in client deposits, where banks have deposited $80 billion of them at BDL and the latter can' t pay them back because it has largely spent most of them on unsustainable government and monetary policies (in effect, that is the financial gap). Given that banks have close to $4.6 billion in equity, the IMF model stipulates that banks should give these up – and since there seems to be scant assets that can be salvaged – and return them as deposits back to their clients.

Well, the IMF model in its pure, simple form as above is rather harsh for the following reasons:

1) It takes aim at wiping out banks, regardless of what that implies for the real economy
2) It returns only less than 6% of deposits
3) It doesn't allow for any BDL and/or government support in returning back deposits, though previous IMF schemes allowed for recourse and bail-out to government funds (Ireland, Greece, Iceland,..)
4) It doesn't provide horizontal equity among banks, in the sense that it treats all banks unequally the same: those who have worked hard to raise their capital with those who have squander it.

Against this IMF position, there is an alternative BDL position, which in its leaked, pure format – thus it should be considered an approximation, perhaps not totally accurate in terms of exact numbers, and subject to change; but its thrust, vision, and framework are mostly valid -- has the following outline. First, the $83 billion in deposits are whittled down to $53 billion, where the remaining $30 billion are written off because they constitute ineligible entities: excessive interest made over the 3 years prior to the crisis, doubtful or 'illegal' deposits and deposits converted from LBP to USD from October 2019 onwards. Second, of the $53 billion in eligible deposits, $21 billion will be paid back over 5 years by BDL, the government, and banks, and would capture small depositors perhaps those with deposits up to $150,000. The rest of deposits higher than this threshold, amounting to $32 billion, will be 'paid back' as perpetual asset-backed securities (and may be in combination with a bail-in). Third, the $21 billion to be paid back as cash over 5 years will probably be shared as follows: $8.8 billion by the government, $8.5 billion by

BDL, and $3.7 billion by banks. Interesting, the $8.8 billion contributed by the government actually constitutes half the debt that the government owes BDL.

There are three additional features that define the BDL leaked model:

1) The $53 billion in eligible deposits represent BDL liabilities that would become equal to BDL assets as composed of gold ($38 billion), foreign reserves ($12 billion), and other foreign assets ($3 billion)

2) The share of banks in retrieving the $21 billion in deposits is $3.7 billion, which is 80% of bank's equity[1]. So not all banks will be wiped out, and those who can pay will remain and re-capitalize – admittedly not very many -- and those who can't will be evaluated and ultimately phased out

3) Though more demanding to implement, BDL's leaked version as presented above is more balanced, as it spreads the burden of the financial gap and is not vindictive. And it allows the decent part of Lebanon's banking sector to remain and to regain confidence and growth.

We can reinforce the last notion cited above by the following critical observations regarding the country's banking crisis, noting that it is a systemic crisis, not idiosyncratic, as it encompasses the entire banking sector and then from there to the real economy:

- The fundamental point is that the Lebanese crisis is different in that it originated at BDL not at commercial banks. So, wiping out banks' equity based on the 'hierarchy of claims' approach is fundamentally wrong and unfair.

- Interestingly, in such a case, international best research and practice shows that the government has to absorb the losses, as central banks fall under its jurisdiction[2]. As important, this should then apply to Lebanon as well, especially that the Lebanese Money and Credit Law (article 13) is very explicit about this point.

[1] It is interesting that the 5 listed banks – BLOM, Audi, Byblos, BOB, and BEMO – have a combined equity close to $3.5 billion.

[2] In perhaps poetic justice, the notable research was done by the IMF: Dalton, J. and C. Dziobek. "Central Bank Losses and Experiences in Selected Countries", *IMF Working Paper, WP/05/72).*

- And that is the more so, since the majority of banks' deposits at BDL that constitute the financial gap or losses ($80 billion) was due to involuntary action dictated by BDL regulations, not undertaken voluntarily by banks.

- What most people seem also to forget, is that banks have already lost more than $16 billion in equity, falling from $21 billion in October 2019 to about $4.6 billion!. Now the IMF position is after those as well, undermining any chance for banks' revival.

- Hence, what is truly at stake is the following: do we want to rescue and revive the banking sector or do we want to eliminate it? It seems the IMF's intention is the latter: phase out the existing banking sector and start anew. But what this position seems to miss is that it will be 'throwing the baby along with the bath water' – very brutal.

We would like to end with three crucial questions. First, what is the fate of the gold reserves? In bolder terms, why not utilize part of them to help close the financial gap and return as much deposits as feasibly possible — and if not now in these dire times, then when[3]?. Second, shouldn't the IMF position be more contextual and take into account Lebanese nuances? So instead of applying a 'tunnel vision, one size fits all' approach by adjudicating the crisis based on the 'hierarchy of claims', it should be based on the 'hierarchy of responsibilities', starting with the government, then BDL, and then Lebanese banks. Third, and the hardest question of all: if the IMF insists on its model, what should the government do, go ahead with the BDL model without an IMF deal, or subscribe to the IMF model and make its banking sector disappear? Perhaps the best way out of this quandary, is to go ahead with the BDL plan, and work hard on forging a stability and security pact with Israeli, and then make the safe bet that the IMF will come through the 'back door' to sign a reform and structuring deal.

[3] It is to be noted that some of the gold will most likely be used to back BDL's-issued perpetual bonds.

For your Queries:
BLOMINVEST BANK s.a.l.

Research Department

Zaituna Bay

POBOX 11-1540 Riad El Soloh

Beirut 1107 2080 Lebanon

Research Department

Tel: +961 1 991 784

research@blominvestbank.com

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