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

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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 standard, and follows an international paradigm in dealing with banking crises. It argues that Lebanese Banks' risky and short-sighted decisions had brought them onto the abyss of the crisis; and, as such, resolution of the crisis requires following the 'hierarchy of claims' approach, whereby it is banks' equity that will be primarily used to pay back liabilities, mainly deposits.

To elaborate, the crux of the Lebanese banking crisis is the $83 billion of client deposits, where $80 billion of them had been deposited at BDL and the latter can't pay them back because it had spent most of them on unsustainable government and monetary policies (in effect, that is the financial gap). Accordingly, the IMF approach, in its simple, raw, and figures-less form, is structured as follows :

- As per international standards, they can't accept any type of haircut on depositors' accounts before wiping out the equity of banks.

- Any customer will receive the payment back of his/her deposit in each bank separately (and not at the sector level)

- Once these two pillars have been applied, the IMF doesn't object to any scheme for the repayment of deposits and for the repartition of the burden of this scheme between the three main parties (Government, BDL, and banks).

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

1) It recognizes that banks are the culprit behind the crisis, not its victim; and, as such, it leads to the wiping out of most banks, because very few of them would find it financially – and, more importantly, morally – feasible to recapitalize.

2) Though it allows for government support in returning back deposits (like the $16.5 billion the government owes BDL), but that is conditional on government assistance being consistent with debt sustainability. However, debt sustainability is an inexact art form in the best of times, as it is very sensitive to the values of the variables determining it[1], in addition to the fact that there is no consensus on what constitutes sustainable debt. Let alone, most important, the fact that it is government maligned policies that are the ultimate culprit behind the banking crisis, not banks

3) It doesn't recognize horizontal equity among banks, in the sense that it treats all banks unequally the same: those who have worked hard to raise and protect their capital with those who have managed to lose or squander it.

Against this IMF position, there is an alternative BDL position, which in its leaked format has the following outline (and since it is a leak, 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). First, the $83 billion in deposits are whittled down

[1] The variables are: GDP growth rate, interest rate, and the primary deficit.

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 or 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 to 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, with the latter composed of gold ($38 billion), foreign reserves ($12 billion), and other foreign assets ($3 billion). As important, it also implies a deposits haircut of $30 billion

2) The share of banks in retrieving the $21 billion in deposits is $3.7 billion, which is 75% of bank's equity. 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 among BDL, government, and the banks; and it is not vindictive. As such, it allows for a 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 has encompassed the entire banking sector and then from there to the real and monetary 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 – and that is a principal matter.

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

- And that is the more so since the majority of banks' deposits at BDL that constitute the financial gap ($80 billion) was due to involuntary action dictated by BDL, not undertaken voluntarily by banks. Surely, some of it was tempted by the high interest rates incentivized by BDL, but most of it was a result of BDL regulatory controls.

- 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 $4.9 billion (not counting the capital injection of $4 billion in 2020-21)!. Now the IMF position seems to be after those as well, undermining any chance for banks' revival. Also, note that the crisis has dragged on for six years without any solution – and that was no fault of the banks – during which BDL had wasted more FX reserves on subsidies and on supporting the exchange rate (2019-2023) while banks' equity kept on depleting.

- 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 (directly or indirectly) aims at the latter: phase out much of 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' – tough and perhaps brutal.

[2] See: Dalton, J. and C. Dziobek. "Central Bank Losses and Experiences in Selected Countries", IMF Working Paper, WP/05/72).

We would like to end with three crucial questions:

First, 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', the IMF should be thinking 'outside the box' of international standards and base its approach on the 'hierarchy of responsibilities', starting with the government, then BDL, and then Lebanese banks.

Second, 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]

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 allow most of its banking sector to 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 Israel, and then bet that the IMF would return through the 'back door' to sign a reform and structural adjustment deal – but that is a big bet, no doubt!

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

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