The Lebanese Financial Crisis and Gap Law: A Critical Banker's View

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The Lebanese crisis is more than six years old now, and there doesn't yet seem to be an end in sight soon. Recently, a proposed Financial Gap law has been approved by the Government in December 2025 and then passed on to Parliament for ratification. The Law will not only decide the fate of deposits but the fate of the banking sector as well. In this note we will, briefly, first present a critical outline of the position of the IMF – who was kept abreast of the Law and shadowed its formulation – then provide a critical outline of the Law itself. This will be followed by some suggestions on how to improve it and the way forward – that is, saving the best for last.

To start with, the crux of the Lebanese banking crisis is the $83 billion of client deposits that banks had deposited at BDL and the latter can't pay them back because it had spent most of them on unsustainable government and monetary policies[1] (in effect, the twin deficits).

Concerning the IMF position, it is presumably a standard one, 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. It also asserts:

- Any type of haircut on depositors' accounts can't be accepted before wiping out the equity of banks.

- All customers will receive the payment back of their deposits in each bank separately, and not as amalgamated at the sector level.

- Once these two 'principles' have been applied, the IMF doesn't object to any scheme for the repayment of deposits that splits the burden on the three main parties -- Government, the Central Bank (BDL), and banks.

The IMF approach 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 victims; and, as such, it leads to the

[1] Anecdotal evidence puts the government's debt to BDL at $50 billion, including interest.

wiping out of most banks, because very few of them would find it financially feasible to recapitalize; 2) Though it allows for government support in returning back deposits, but such support is conditional on being consistent with debt sustainability. It thus doesn' t recognize the fact that it is the government maligned policies that were the ultimate culprit behind the banking crisis, and should pay for it; 3) It doesn' t ensure 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.

As to the Financial Gap Law, it was very shy as well at holding the government responsible for returning back deposits, and shifted instead the responsibility onto banks and BDL. Specifically, the Law is characterized by three important features:

- Anomalous deposits will be eliminated (doubtful deposits, deposits that represent excess interest, and deposits that were converted to USD at 1,507.5 LBP after October 2019), dropping eligible deposits from $83 billion to around $60 billion.

- Of the $60 billion, all deposits up to $100,000 will be paid over 4 years[2]. And all remaining deposits above $100,000 will get the initial

[2] This would cover 80-85% of all accounts in the banking sector.

$100,000 over 4 years; and the rest will be paid in asset-backed securities (ABS) by BDL as follows: over 10 years for deposits up to $1 million, over 15 years for deposits up to $5 million, and over 20 years for deposits above $5 million; and, for all 3 categories, 2% of the principal will be paid yearly after 5 years. It is estimated that the cost of the total $100,000 deposits will be around $22 billion, and consequently the cost of the ABS will be $38. The $22 billion cost for the $100,000 deposits will be split into 60% by BDL and 40% by banks; whereas the cost of the $38 billion for ABS will be split into 80% by BDL 20% by banks.

- An Asset Quality Review (AQR) will be undertaken on each bank before any bank equity can be acted on; however, there is a strong feeling among banks that all their equity will be zeroed-out initially, in agreement with IMF demands. However, the Law differs with the IMF in that it amalgamates the accounts of each customer under one single account.

That said, in what follows we present some important qualifications and suggestions regarding the country' s banking crisis, IMF position, and the Gap Law; noting that the Lebanese crisis is a systemic crisis, as it has encompassed the entire banking system (banks and BDL), 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 IMF' s 'hierarchy of claims' approach is 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[3]. And needless to say, this should apply to Lebanon as well, especially that the Lebanese Money and Credit Law (article 113) is very explicit about this point.

Hence, the IMF' s position should 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' and base its approach on the 'hierarchy of responsibilities' , starting with the government, then BDL, and then Lebanese banks. Moreover, the IMF' s position, by aiming at eliminating banks' equity, seems to be undermining any chance for banks' revival. Also, note that the crisis has dragged on for more than six years without any solution, during which BDL had wasted more FX reserves on subsidies and on supporting the exchange rate and the

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

government (especially during 2019-2024) while banks' equity kept on depleting to about $5 billion currently.

Regarding the Gap law, we like to register two important observations. First, the deposits at BDL (of $83 billion) is a commercial, transactional matter between BDL and banks, and as such shouldn't involve the IMF, as the IMF – based on its mandate – should be strictly involved in sovereign debt restructuring and macroeconomic reform[4]. Second, even if all bank equity is eliminated (and with it banks), at $5 billion, it will only constitute a small dent in the repayments of deposits. That is why any gap Law, to be balanced, fair, and viable, has to be very explicit about the government's contribution to returning back deposits (by paying back its debt to BDL), especially as the government was ultimately the one responsible for the crisis and as it is by no means poor (only mismanaged). In turn, BDL's and banks' burden will become more tolerable.

No doubt, the gap Law is a step in the right direction after more than 6 years of policy paralysis. Clearly, however, the proposed Gap Law is not equitable to depositors, banks, and BDL. That is why we hope the Law will be adjusted in parliament before ratification, by making the government a prime contributor to the financial gap and

This is in fact the position most favored by Karin Souaid, the BDL Governor[4] by turning away from the IMF's harsh 'dictates'. As it is, any AQR will only keep no more than 6-8 banks in the market; and with the imposition of IMF 'dictates' and without government contribution, hardly any banks will be left either. In this respect, five essentials, specific points need to be taken into account so as to help mitigate the burden and enable the surviving banking system to strive and to move forward:

1) Perhaps most important, is a highly needed realization. That is, we need to realize that it is no longer valid to speak of a 'gap' at BDL because the sum of BDL's foreign assets exceed $83 billion. This can be calculated as follows: 10 billion in liquid foreign reserves; $46 billion in gold (at current price of around $5,000 per ounce); $8 billion in fixed assets[5]; $5 billion in Eurobonds (nominal value); and at least 16 billion in government debt; for a total of $85 billion. So given these available foreign currency resources, how can we not use them to pay back depositors and resuscitate the banking sector? There is no justification not to. And using these resources would not only be feasible but also the right thing to do.

[5] The value could be lower, perhaps down to $4 billion, if market conditions are not favorable

2) Then there is the issue of available liquidity. Concentrating on the $100,000 deposits, as discussed before, they are estimated at around $22 billion (paid 60% by BDL and 40% by banks). But the available liquidity in the banking system is only $15 billion ($5 billion for banks and $10 billion for BDL, though note that BDL' s $10 billion are actually banks ' own required reserves), so there will be a shortage of $7 billion. That is why an explicit contribution by the government to covering this shortage is vital (or by helping the passing of a law allowing BDL to sell part of the gold), otherwise the ability to pay back these deposits will lose credibility and the promise to meet payments will become vacuous by around the third year. Again, this is not only a realistic assessment, but also fair and just.

3) There is also the matter of large depositors. These will be paid the first $100.000, and the rest of their deposits of $38 billion will be paid back in ABS. But the crucial question is: backed by what? If the ABS are backed by an undefined amorphous entity, then the discounted present value of these securities will be negligible and large depositors will lose horrendously. However, if the ABS are backed by BDL' s gold, then their present value will be much higher and the process of meeting

these deposits will be much more credible. And, of course, this will add more fairness to the law since it will imply that large depositors receive equal treatment with Eurobond holders. As important, it will imply that BDL's gold stock should be put in the service of the law because there is no reason to keep the gold idle, admiring and extolling it as a 'fetish'. Note also that the cash flow for cashing in the ABS can be obtained from the government returning back its debt to BDL and the latter liquidating its non-essential fixed assets (like MEA, Casino du Liban, and various real estates).

4) An equally important point is the viability of the banking sector. As perhaps it is not very well known, banks have already lost $20 billion in equity. And they will also contribute their $5 billion in current equity to the repayment of the $100,000 in deposits. So they have no room to spare. And if we all agree that a restructured (smaller) banking sector is of fundamental importance to growth and welfare, then banks shouldn't carry more burden. Specifically, their 20% contribution to covering the ABS, as proposed in the law, should be phased out and the government should assume responsibility instead. This will not only mean that banks have contributed their fair share in returning back deposits – as

they have frequently promised – but will also enable banks to use their newly generated proceeds for the service of renewed financial intermediation and credit extension, and consequently economic progress.

5) Lastly, a very crucial, if not a sufficient, condition. It is that, for the law to succeed and for financial and economic stability to move forward, an environment of reform-based political stability and good governance has to be attained. Otherwise, the whole project of recovery and growth will be incomplete, if not a failure.

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