

**POLICY PAPER**

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**DRIVING DISASTER:**

**JUNE 2021**

# **LEBANON'S SHADOW FINANCIAL PLAN**

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**HOW A CLANDESTINE PLAN IS FORCING THE LEBANESE PEOPLE TO PAY FOR A BANKING CRISIS CREATED BY ELITES**



**TRIANGLE**  
POLICY | RESEARCH | MEDIA



## EXECUTIVE SUMMARY

Lebanon's economy might look like a storm-stricken boat, adrift at sea with a broken rudder, a shattered mast, and – crucially – no captain or crew. But this media-friendly narrative of chaos and inevitable decline only tells half of the story.

In fact, far more malevolent forces are setting this ship's course. In the absence of a functioning government, left unsupervised at the helm are Riad Salameh, the unelected governor of Banque Du Liban, Lebanon's central bank, and a small group representing elite economic interests. While the Lebanese people weren't looking, they hatched their own "Shadow Plan."

Unfortunately, the Shadow Plan amounts to more than simple crisis management. Rather, Lebanon's wayward captains are heading full tilt at the rocks, sheltering the richest from bearing their fair share of the financial burden. The plan shifts the system's vast losses away from banks' balance sheets, onto small and medium sized depositors, and the wider population in general.

Illegal multiple exchange rates and printing Lebanese Lira are the most obvious features of this Shadow Plan. This devastating reality is crippling the Lebanese people through inflation, imposing a forced haircut on depositors, and eviscerating their savings. Meanwhile, the same policy of increased money supply is whittling away banks' liabilities, by giving depositors their savings at rates far lower than the black market. As the banks recoup the difference, they slowly but surely reduce their share of the losses.

Still more troubling decisions lurk deeper in the shadows. To add salt to the wound, the BDL is

covertly reducing the commercial banks' exposure to unserviceable government debts, shifting future losses from their balance sheets onto its own.

Other insidious policies are enabling the banks to create capital and liquidity out of thin air by little more than accounting chicanery. Circular 567, for example, permits banks to re-evaluate their real estate portfolio to current day values as a means to bolster their capital. Measures like this have no impact on banks' real liquidity undermining the whole objective of the recapitalisation process.

The effects of this Shadow Plan are plain to see: the Lebanese Lira has lost 90 percent of its value; over half the population live below the poverty line; the economy shrank by 40 percent last year. In fact, the freefall is so severe that predictions of the future are guesswork at best. Commercial banks continue to hide behind their hands, claiming that they still have foreign currency liquidity.

The latest aspect of the Shadow Plan to be revealed is an initiative to repay depositors their savings in foreign currency up to \$25,000 per person. But the policy – which will ostensibly be unsustainably financed by the BDL's foreign reserves – amounts to little more than a bribe to placate the public temporarily. More importantly, the initiative fails to address the real losses in the financial system, meaning that depositors are unlikely to see their full deposits any time soon.

But the Shadow Plan is not a foregone conclusion. Acknowledging and understanding how this apparent policy of inaction is fuelling and shaping the ongoing crisis is the first step towards challenging it. With political will and focused pressure from civil society, not to mention the leverage of international support packages, a more equitable and sustainable alternative is possible.



## TOO GOOD TO BE TRUE

“Congratulations to Lebanon. Today, I can announce that the country has a comprehensive and historically unprecedented plan to end the period of political and economic instability which brought the country to a state of collapse.”

Caretaker Prime Minister Hassan Diab, April 30, 2020.<sup>1</sup>

Just over a year ago, the Lebanese premier Hassan Diab promised to do the impossible: solve Lebanon's economic morass with a single plan. The Financial Recovery Plan (FRP), also known as the Lazard plan or the Government Reform Plan, outlined boldly ambitious and far-reaching reforms.

Diab's optimistic tone has not aged well. But despite the past year's continued economic decline, the FRP deserves some credit for providing a blueprint for some sort of holistic reform. Many analysts welcomed the FRP as the only comprehensive policy response to the country's multiple crises to date, even if others felt it did not go far enough (See Box I).<sup>2</sup> It even had the seal of approval from Lazard, a respected financial advisory firm.

First and foremost, the plan proposed immediately scrapping the outdated Lebanese Lira peg, replacing it temporarily with a more flexible “managed float” of the exchange rate.<sup>4</sup> Until an International Monetary Foundation (IMF) deal was finalised, the plan envisaged that the BDL would spend between \$500 and \$700 million of its foreign currency reserves to stabilise the currency.<sup>5</sup> Then the injection of liquidity from international donors would have provided the necessary balance of payments support for a managed or “crawling” peg. This would sustain a transitional period until the economy was ready to move to a free floating exchange rate.

Next, the FRP would have restructured the government's debt, writing off nearly three quarters of government bonds in both local and foreign currency – in other words, a debt haircut. In most sovereign debt crises, international investors stand to lose the most when debt is cancelled. However, since Lebanon's financial crisis was largely homegrown, the vast bulk of the debt is held by the BDL and local commercial banks. Therefore, Lebanese commercial banks—who made billions of US dollars in interest on the debt prior to the crisis—would have been the ultimate losers from a comprehensive debt restructuring.

### **Box I: Flawed but functional**

*While preferable to the Shadow Plan that replaced it, the FRP was not a panacea. The plan focused largely on tackling the banking and currency crises while paying less heed to addressing inequality and the social impacts of Lebanon's various crises. The FRP's suggested austerity measures, such as cutting public wages and pensions, would have exacerbated the devastating social impacts of Lebanon's recession and currency crisis. Similarly, many tax measures recommended in the FRP were regressive, including raising electricity and gasoline prices, whilst failing to push taxation to more than 15 percent of GDP. Moreover, the plan's proposed cash assistance to help businesses during the COVID-19 pandemic amounted to a mere two percent of GDP, a fraction of the amount invested by many countries.<sup>3</sup>*



However, restructuring the total government debt would only solve part of the problem, since some 70 percent of total losses in the system are embedded within the BDL and commercial banks. The real black hole lay at the heart of the BDL. It arose not just from exposure to the sovereign debt, but also the BDL's myopic decision to fund the unsustainable currency peg.

The plan faced limited options when addressing these gargantuan losses. A foreign bailout was off the cards;<sup>6</sup> since the 2008 global financial crisis, international practice has shifted away from the idea that a failed financial system should be supported by public money, especially in times of global recession such as the beginning of the COVID-19 pandemic.<sup>7</sup>

The chances of the government itself raising enough money were equally improbable. Even a functioning government would have found it impossible to raise sufficient revenue by selling its dilapidated assets. Due to the country's financial predicament, such a decision would have amounted to a pointless fire sale. Besides, the FRP rightly viewed such a policy as ethically indefensible since it would have propped up a broken system at the expense of the current population and future generations of Lebanese.

Instead, the FRP proposed a three-pronged approach to covering the losses. Firstly, a bail-in of the banking sector would draw on banks' shareholder capital and the savings of large depositors. This policy proved extremely unpopular ultimately leading to the FRP's eventual downfall (See: Passing the Buck).

In addition to the bail-in, the Lazard plan assumed that the BDL would also take on a share of the losses, by using its gold and foreign currency reserves. In

this scenario, \$3.9 billion would have remained on the BDL's books, with an aim to whittle them down over the coming years.<sup>8</sup> Finally, the plan would have attempted to claw money back from those who illegally profited from their position in government, by imposing a forensic audit of all public contracts.

Of course, the plan did not naively ignore the necessity of financing from the international community. The success of the plan was predicated on a major injection of liquidity from various donors, most notably from the IMF. An estimated \$10 billion over a five year period would have enabled the managed readjustment of the currency and stabilised the country through a period of major fiscal and macro-economic reform, as outlined in the plan.<sup>9</sup>

Diab's recovery plan was not perfect. Nonetheless, it remains a commendable attempt to create a foundational base for future reform.

## PASSING THE BUCK

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Just months after its unveiling, the plan was dead in the water. The FRP immediately drew vociferous opposition from the wealthiest and most politically connected corners of society who conspired to assassinate the programme.<sup>10</sup> The loudest voices came from those who would have been hit hardest, namely bank shareholders and large depositors.

The architects of the FRP viewed banks' shareholders either as willing accomplices to the country's precarious Ponzi scheme (See Box II) or simply blind fools. Either way, they were equally responsible for the resulting financial chaos, the plan's architects argued. The writing was on the wall. Prior to the



crisis, Lebanon had not been an investment grade country for almost a generation; a budget had not been passed in more than a decade, and endemic corruption was the defining feature of government. Whether knaves or fools, the plan held shareholders accountable for how they had invested their depositors' cash.<sup>11</sup>

### **Box II: Original sin**

*Lebanon's original sin lies in its currency peg, which artificially preserved a playboy's paradise for many years. Since the once-steady inflow of foreign currency began dwindling a decade ago, the BDL's governor Riad Salameh has pursued complex, opaque, and increasingly risky policies to attract foreign currency into the country and keep the Lebanese Lira pegged to the US dollar at 1,507.5. The peg was always fragile as long as Lebanon was reliant on imports for most of its material needs and had little in return to export. Over time this imbalance was maintained by a voracious financial sector that, at its peak in 2018, held deposits worth more than three times the country's GDP. About two-thirds of deposits were in dollars. To maintain this hugely inflated financial sector Lebanon had to attract ever larger quantities of fresh dollars into the system. "Financial engineering," for example, allowed Lebanese banks to offer exorbitant interest rates to depositors to keep the dollars flowing in. In turn, the banks would use these dollars to buy certificates of deposit from the BDL. It was only a matter of time until this flawed strategy resembling a Ponzi scheme came crashing down. For a more detailed treatment of the causes of Lebanon's ongoing economic crisis, see *Extend and Pretend*, 2019.*

Therefore, instead of a bailout of the banks, the reform plan proposed a massive bail-in of the banking sector, forcing the richest individuals to foot the bill. This measure would have largely wiped out existing shareholders, forcing them to contribute around \$20.7 billion from their own capital base. This amount would have helped write off banks' capital against their losses.

Meanwhile major depositors would have seen a progressive bail-in, in which significant portions of their deposits would be turned into shares. Those depositors could sell the shares once their banks were returned to a solid base. In this scenario, medium and small depositors would be largely unaffected. In order to aid this process, the plan demanded a forensic audit of the BDL. It also stipulated a clawback from those who had profited nefariously from public contracts.

These aspects of the plan proved deeply unpopular among banks' owners and large depositors. In a letter to Lazard, the Association of Banks in Lebanon (ABL) – which represents the interest of commercial banks – expressed its "disappointment in the government's approach" since "current shareholders will be totally wiped out and thrown out."<sup>12</sup> The ABL argued that the responsibility for the crash lay with the government and BDL for having overseen so many years of profligate and wasteful spending.<sup>13</sup> In a counterplan, the ABL rejected the need for debt and financial sector restructuring.<sup>14</sup>

These lobbying tactics were effective because wealth is highly concentrated within Lebanon's banking system. According to the IMF, the Lebanese banking system had just over 1.6 million accounts at the end of 2015, of which 16,000, or 1%, accounted for 50% of the value of deposits. Less than 0.01% of depositors, or 1,600





accounts, alone held 20% of the deposits, with an even greater concentration for dollar deposits.<sup>15</sup> With such enormous economic and political clout, banking lobbyists quickly torpedoed the deal. Soon after, the government collapsed and talks with the IMF stalled.

## THE SHADOW PLAN

A conspicuous silence followed the FRP's untimely demise. Diab's government and Lazard did not go back to the drawing board, neither was a new plan started with different consultants. One would be forgiven for thinking that the caretaker government is acting without a plan.

But upon closer analysis, the past year has borne witness to a number of policies, both explicit and implicit, that are shaping the trajectory of Lebanon's demise, ultimately determining who wins and who loses (See Figure I). The measures adopted in the Shadow Plan range from contentious to downright illegal. Picking apart this "Shadow Plan" requires Holmesian levels of detection.

The first clues lie in the money supply. Lebanese Lira in circulation outside the BDL – in other words printed money – increased from 6.47 trillion to 36.5 trillion Lira between October 2019 and end of March 2021.<sup>16</sup> This tsunami of cash gushing through the system is exacerbating the crash in the exchange rate and fuelling runaway inflation, both of which are crippling ordinary Lebanese citizens.

Inflated money supply is nothing new. But in the past, the BDL and banks sheltered the real economy by offering high interest rates to disincentivise withdrawing money or by letting people convert their

money from Lira to dollars at 1507.5 Lira to the dollar through the banking system. Instead of withdrawing their money and going to buy dollars, they could just do it on paper, which did not require anyone to actually supply the dollars.

But upon realising that very few dollars actually exist in the system, depositors wanted to convert their Liras to real dollars or spend it before it lost even more value. To do so, the BDL printed Lira.

## SHIFTING THE DEBT

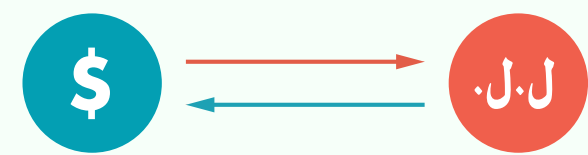
In the spring of 2020, Diab's government entered negotiations with the ABL to agree on a way to restructure domestic treasury bills – in other words, government debt in local currency. But after the FRP was blown out of the water, the talks quickly stalled.

Despite this apparent stasis, commercial banks' share of treasury bills has been decreasing since the beginning of the financial crisis proper. Some 7.64 trillion Lebanese Lira in the commercial bank's domestic treasury bills were settled between October 2019 and February 2021.<sup>17</sup>

Meanwhile, the BDL's share of treasury bills has been increasing. This is partly due to its financing of the fiscal deficit. But that does not account for the whole increase. In fact, away from the media spotlight, the BDL has been taking on government debt from commercial banks. In order to do so, the BDL has been printing Lira.<sup>18</sup>

The consequences of this policy are manifold. Firstly, when any future government returns to the negotiating table with the domestic banks its bargaining power

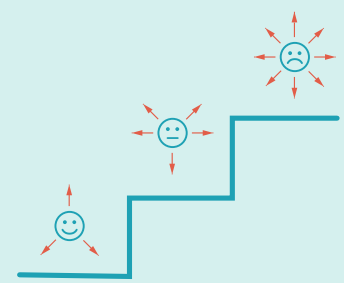
# FINANCIAL RECOVERY PLAN OR LAZARD PLAN



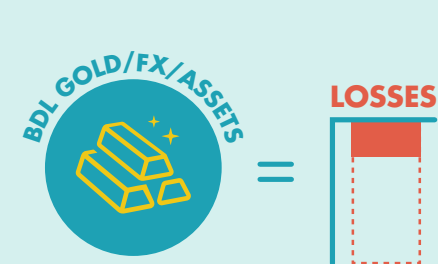
MANAGED FLOAT TO NEW EQUILIBRIUM



**\$20.7BN**  
BAIL-IN BANK SHAREHOLDERS



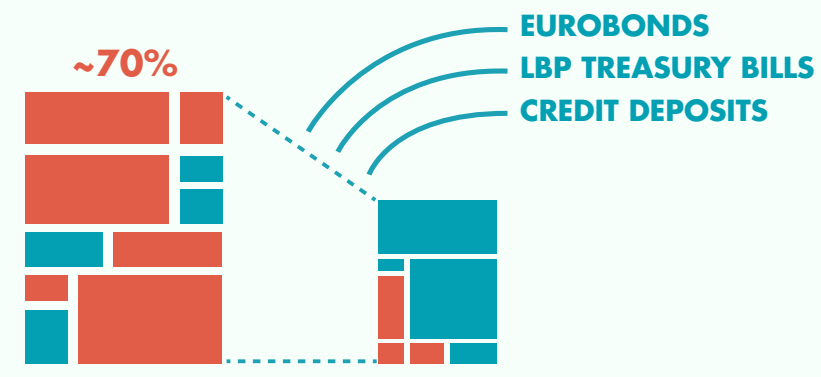
PROGRESSIVE BAIL-IN OF TOP DEPOSITORS



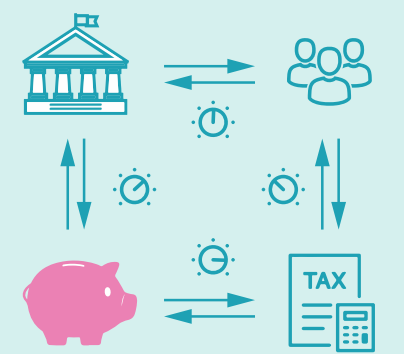
BDL GOLD, FX & ASSETS OFFSET LOSSES



SOME LOSSES REMAIN ON BDL BALANCE SHEET



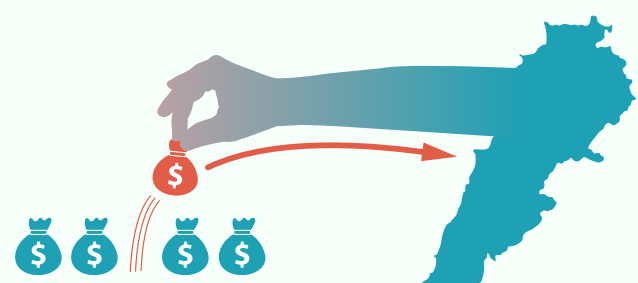
~70% FULL DEBT RESTRUCTURE



FISCAL ADJUSTMENT



MAJOR REFORM PACKAGE



CLAW BACK ILL-GOTTEN GAINS/INTEREST



CAPITAL CONTROL LAW



NEW REGULATIONS AND LAWS



NEW REGULATORY BODY



FULL AUDIT OF BDL AND BANKS



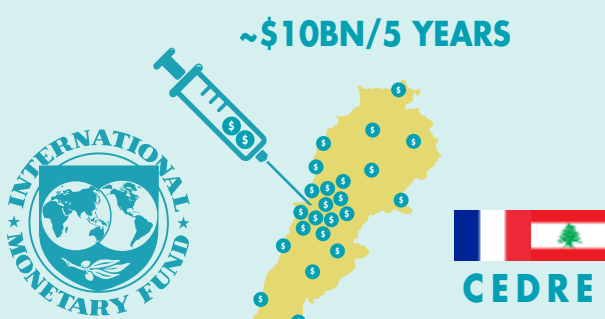
REGULATION & TRANSPARENCY



FULL RESTRUCTURE AND DOWNSIZE OF SECTOR



FINANCIAL SECTOR REFORM

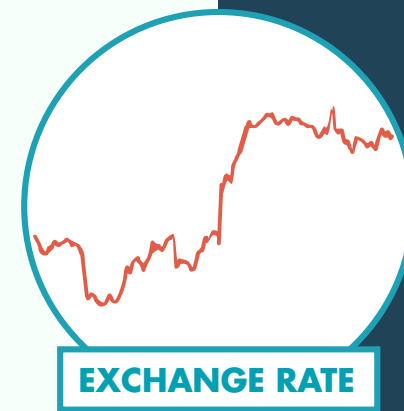


INJECTION OF USD BY THE IMF, CEDRE AND OTHER DONORS

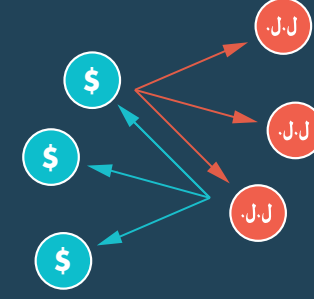


INTERNATIONAL ASSISTANCE

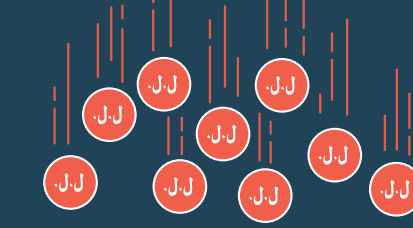
# SHADOW FINANCIAL PLAN



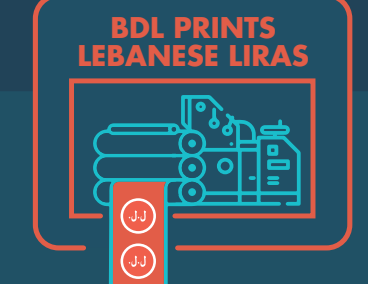
EXCHANGE RATE



MULTIPLE ILLEGAL RATES



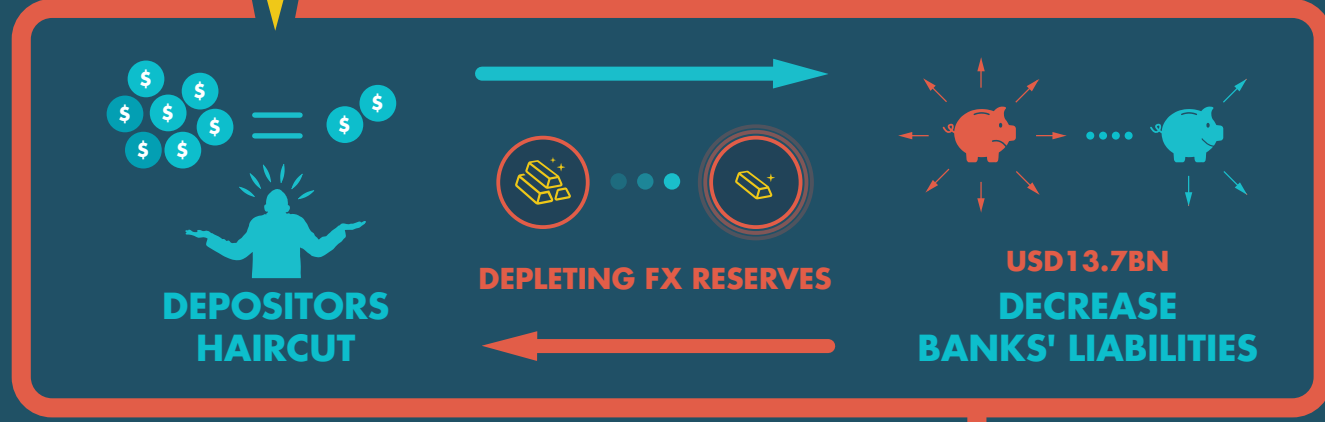
INCREASED MONEY SUPPLY



HYPERINFLATION



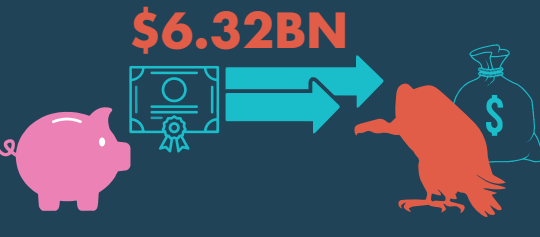
CURRENCY COLLAPSE



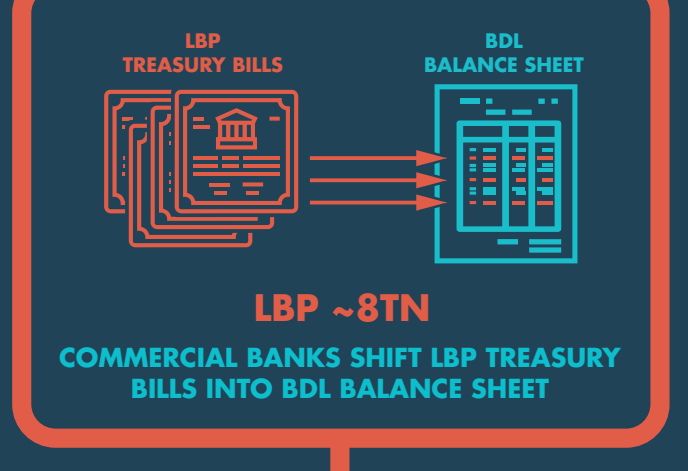
DEPOSITORS HAIRCUT

DEPLETING FX RESERVES

USD 13.7BN DECREASE BANKS' LIABILITIES



BANKS SELL EUROBONDS TO VULTURE FUNDS



LBP ~8TN COMMERCIAL BANKS SHIFT LBP TREASURY BILLS INTO BDL BALANCE SHEET



SOVEREIGN DEBT



PUBLIC SECTOR



STATUS QUO



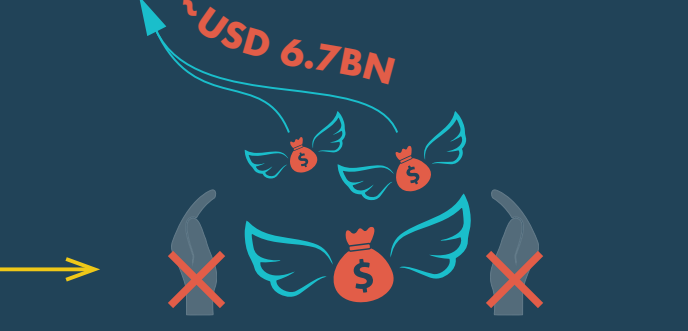
BALLOONING DEFICIT USD ~3.3BN/YEAR



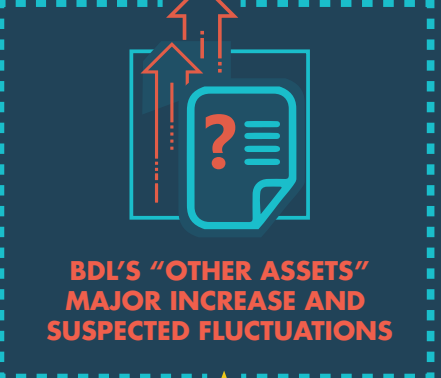
CAPITAL CONTROL



NO CAPITAL CONTROL LAW



CAPITAL FLIGHT



BDL'S "OTHER ASSETS" MAJOR INCREASE AND SUSPECTED FLUCTUATIONS



NEW REGULATIONS AND LAWS



NEW REGULATORY BODY



FULL AUDIT OF BDL AND BANKS



REGULATION & TRANSPARENCY



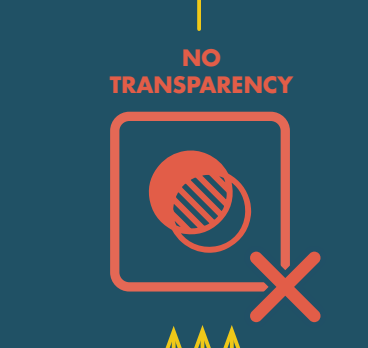
NO OVERSIGHT



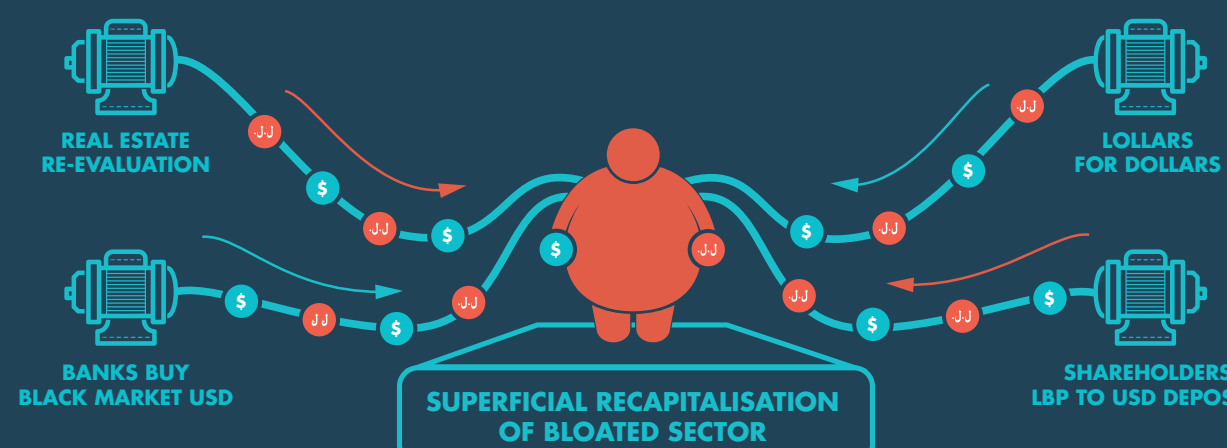
ILLEGAL CIRCULARS FROM BDL



NO AUDIT OF BDL OR BANKS



NO TRANSPARENCY



SUPERFICIAL RECAPITALISATION OF BLOATED SECTOR



INTERNATIONAL ASSISTANCE



NO ASSISTANCE

HOW TO READ THIS GRAPHIC

- CAUSAL RELATIONSHIP
- ◻ FINANCED BY PRINTING OF LBP

INJECTION OF USD BY THE IMF, CEDRE AND OTHER DONORS

Sources: Ministry of Finance, The Lebanese Government's Financial Recovery Plan, April 30, 2020; Interviews with economists; Interviews with anonymous financial sources



will have been significantly eroded. Losses from any future negotiated default will have migrated from the banks' balance sheet to the balance sheet of the BDL. This may even make restructuring of the transferred debt impossible, as the initial plan didn't include the restructuring of the debt held by the BDL, to avoid accumulating increased losses in the BDL's financial statements.

The BDL is financing this operation through the printing of fresh Lebanese Lira, which is fuelling inflation and eroding the wealth and real incomes of the wider Lebanese population.

It is not just the domestic Lira-denominated treasury bills that the banks have been moving off their balance sheets. They have also been selling their Eurobonds – government debt in foreign currency – on the international markets, further whittling away their exposure to the bankrupted state. Since the beginning of the crisis the banks have sold in excess of 6 billion dollars in Eurobonds.

Selling this junk debt at rock bottom prices will negatively impact Lebanon and its people in the long run. International vulture funds who are snapping up the bonds are well versed in playing hard ball

“**While the FRP proposed a bail in of shareholders and top tier depositors to solve this problem fairly, [the BDL's] circulars managed to achieve the opposite—spreading the losses across all depositors.**”

in order to pressure distressed governments into unfavourable terms of settlement. They are also free from (the admittedly small) internal social and political responsibilities which constrain Lebanese banks and their allies. In addition, the more parties who hold Lebanon's foreign currency debt, the weaker the Lebanese government's bargaining position becomes.

## THE GAPING HOLE

Even with the debt aside, there were still not enough dollars left to meet demand. When the bottom fell out of the Lebanese financial system it left a gaping hole in the form of tens of billions of dollars that only existed on paper. The main reason for this is the billions of US dollars which disappeared into the BDL in the years prior to the crisis.<sup>19</sup> Commercial banks deposited some \$80 billion with the BDL, of which only \$15.8 billion remain, in the form of BDL's foreign currency reserves, excluding gold reserves.<sup>20</sup>

This enormous gap is the true chasm between the bank's liabilities to their depositors in foreign currencies, and the remaining liquidity in the financial system in foreign currencies. The Shadow Plan dealt with this problem through a series of discreet – and in some cases, illegal – circulars. While the FRP proposed a bail in of shareholders and top tier depositors to solve this problem fairly, these circulars managed to achieve the opposite—spreading the losses across all depositors.

The upshot of this deeply flawed decision is that Lebanese depositors are forced to withdraw their dollars at an exchange rate significantly lower than the real market rate. The percentage loss incurred by the depositor is equivalent to the difference between the

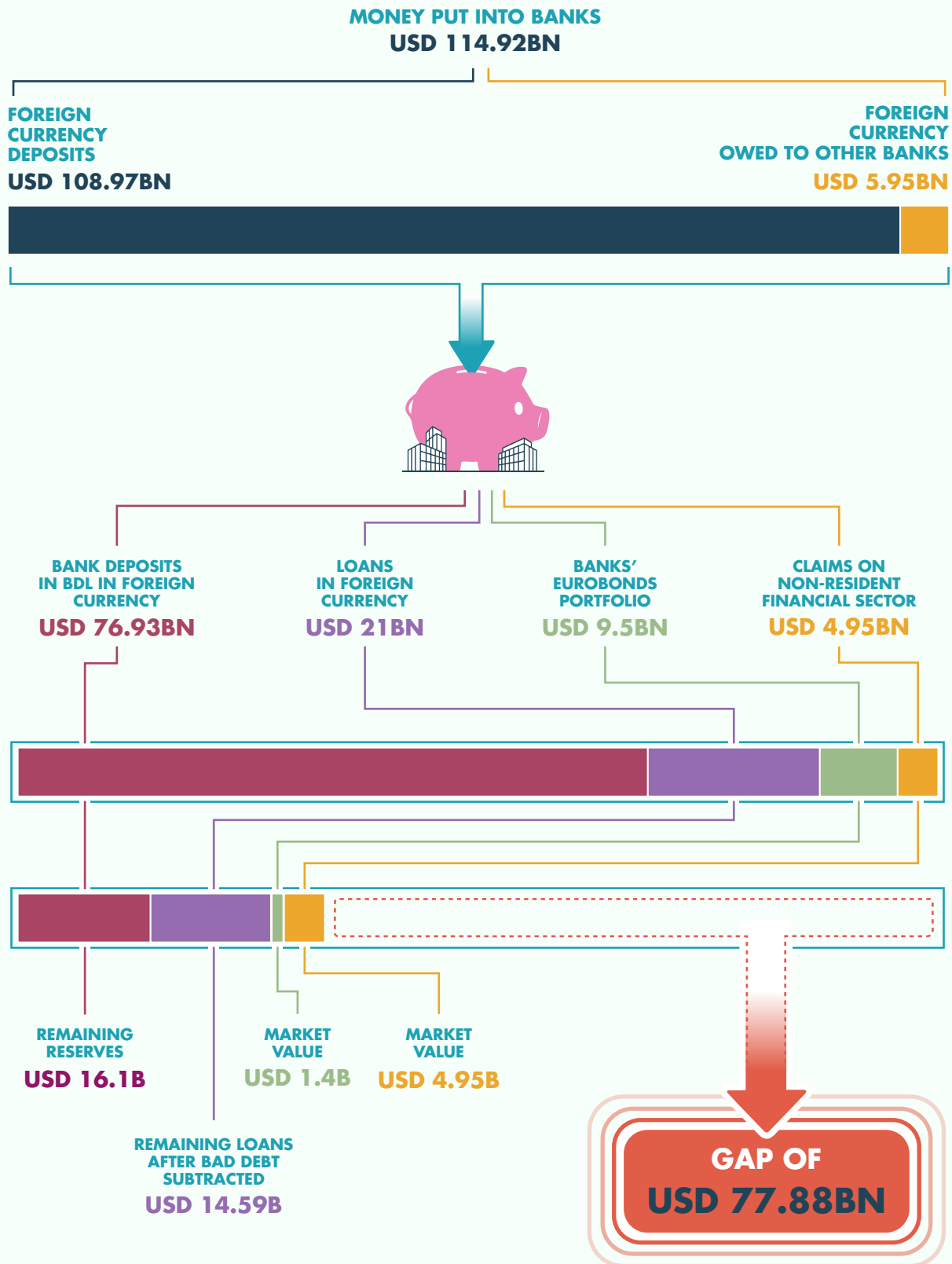




# MIND THE GAP!

## LOSSES IN LEBANON'S FINANCIAL SYSTEM

Sources: Banque du Liban, Consolidated Balance Sheet of Commercial Banks: Resident Securities Portfolio from 2017 to 2021; Interviews with anonymous financial sources.





actual USD exchange rate in the market and the 3,900 exchange rate used to withdraw money. Conversely, every time a depositor withdraws their dollars at a loss, the banks liabilities to dollar depositors decrease. Banks benefit from this process, as it reduces their accumulated losses. This explicit policy by the BDL is incrementally yet inexorably shifting the haircut from the banks onto the depositors.

Circular 151 from April 2020 effectively formalised this process, creating a false and illegal dichotomy between “old” and “new” US dollars. The circular allowed banks to pay foreign currencies deposits in Lebanese Lira, again at 3,900, despite the real black market exchange rate reaching four times this amount.<sup>21</sup> This circular was still in effect at the time of publishing when a US dollar was worth around 13,000 Lira.

This circular contradicts both the Lebanese Constitution and the Code of Money and Credit. Article 15 of the Lebanese Constitution states that all property – including savings – is protected by law. In the event that an individual’s property is expropriated for “public benefit,” the individual must be compensated with a fair compensation. Article 123 of the Code of Money and Credit states that all banks must return depositors their savings with a value equivalent to the original value. Most recently, the State Shura Council ruled Circular 151 as illegal, and demanded that depositors be reimbursed in US dollars.<sup>22</sup>

Moreover, Circular 151 did not impose official capital control laws to prevent capital flight from banks. Rather, banks were free to impose their own arbitrary capital controls. These piecemeal measures are also illegal since parliament never passed a capital control law. Multiple sources allege that powerful bank lobbyists

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***“It is no surprise that Circular 151 and the resulting arbitrary capital controls ... [are] essentially a death sentence by a million cuts for poorer Lebanese who have no choice but to withdraw money to live.”***

”

snuffed out any discussion of a legally-enforced capital control law, which would have hindered the smuggling abroad of bulk sums of dollars by influential and connected depositors. In interviews with Triangle, commercial bank representatives denied that such lobbying occurred.

It is no surprise that Circular 151 and the resulting arbitrary capital controls disproportionately impacted small and medium sized depositors. This illegal haircut is essentially a death sentence by a million cuts for poorer Lebanese who have no choice but to withdraw money to live. Meanwhile, due to the lack of a capital control law, powerful people of influence have been able to smuggle money out to the tune of some \$7 billion.<sup>23</sup> To date total dollar denominated deposits in the banking system—that is, what the banks no longer owe their depositors—have decreased by some \$13.7 billion.<sup>24,25</sup>

## **CAPITAL FROM THIN AIR**

The implementation of the Lazard Plan would have entailed a full restructuring of the banking sector with new legal powers for the government and a new banking resolution authority.



***“Following the collapse of the government and the side-lining of the Lazard plan, the BDL governor Riad Salameh directed a series of alternative recapitalisation measures, in conjunction with the banks.”***

Furthermore, it was acknowledged that a full recapitalisation of the sector would only be possible “after a well-devised consolidation aiming at restoring its solvency and viability, reinforcing its resilience and regain public confidence.” This would have necessitated a considerable downsizing of the whole financial sector; heads would have rolled, and some institutions would have folded.

However, following the collapse of the government and the side-lining of the Lazard plan, the BDL governor Riad Salameh directed a series of alternative recapitalisation measures, in conjunction with the banks.

The governor touted this alternative recapitalisation road map as a means by which the commercial banks would be able to absorb losses and restore soundness to the whole system. On face value this is laudable; however as always, the devil is in the detail. Upon closer inspection not only is the scale of recapitalisation wholly inadequate but it appears that the recapitalisation road map has actually undermined any attempt to make the shareholders bear a significant share of the losses.

The contours of the recapitalisation process were outlined in BDL Circular 154, which stipulated that the banks were supposed to increase their capital by 20 percent in order to absorb losses. Theoretically, this stipulation would have ensured

that banks brought deposits and assets from their shareholders. But instead of bringing assets which would restore the banking system’s solvency, as this measure was sold, a number of loopholes and provisions enabled banks to essentially create capital out of thin air.<sup>26</sup>

Historically, banks’ real estate assets have been recorded on their balance sheets at their historical value, that is to say the value they were purchased at. However, circular 567 permits the banks to re-evaluate their real estate portfolio to current day values as a means to bolster their capital.<sup>27</sup> A later circular (575) went further and allowed the banks to re-evaluate real estate obtained from the confiscation of bad debt collaterals – in other words, property acquired from debtors who could not meet their payments. This practice also inflated the scale of such operations.<sup>28</sup>

This re-evaluation has been conducted by the banks themselves and they have merely had to submit their findings to the anaemic Banking Control Commission of Lebanon. This amounts to little more than accounting acrobatics, which will have no impact on the banks’ liquidity undermining the whole objective of the recapitalisation process.

The circular also allows bank owners to transfer real estate owned by banks onto their balance sheets. For tax avoidance reasons many owners used to register the banks’ business premises in



the name of separate real estate companies and then rent from them. Again, this process increases capital on paper but not in the tangible real world and it has zero impact on the liquidity of the sector.

Finally, senior sources within the banking sector confirmed to Triangle that certain banks have been allowing shareholders to deposit Lebanese Lira, which are then converted into USD deposits in “old money” accounts, at the old official exchange rate of 1,507.5. These deposits are used to bolster the banks’ capital on paper.

However, this is merely another accounting trick, yielding no actual injection of dollars into the system. Unsurprisingly, banks’ shareholders – who made this decision – benefit in two ways: benefiting from an extremely favourable exchange rate on their Lebanese currency and also artificially inflating the foreign currency contribution to the bank and their own capital base.

Collectively these manoeuvres constitute a recapitalisation process that is based on little more than sleight of hand and accounting wizardry. In any future settlement the banks’ owners can write off the inflated part of their capital, to account for some of the losses, without making any actual sacrifices. The banks win, people lose, again.

## SLIPPERY LIQUID

Lebanon has a liquidity issue as illustrated in the BDL’s net reserves position - meaning the difference between its liabilities and assets - which is now negative to the tune of some \$60 billion.<sup>29</sup>

This problem was supposed to be addressed through another part of the recapitalization process, according to Circular 154 from August 2020.<sup>30</sup> This required Lebanese banks to deposit “available liquidity” in correspondent banks – accounts abroad within financial institutions acting on behalf of Lebanese banks. That is to say that dollar deposits should be created in correspondent accounts in order to increase real liquidity. The amount of liquidity deposited should be equal to 3 percent of the total foreign currency deposits in each bank.

To bring in this liquidity, the BDL asked the banks to “encourage” clients who transferred abroad more than \$500,000 since July 2017 to bring back at least 15 percent and then freeze that money in Lebanon for five years. This would increase to 30 percent for politically exposed people and the shareholders of the banks.

But the ambiguously-worded circular has no legal authority to impose any actual liability on the de-

***“Collectively [the BDL’s] manoeuvres constitute a recapitalisation process that is based on little more than sleight of hand and accounting wizardry.”***





positors who performed the transfers, due to the absence of any capital control law. This strange requirement for banks to “encourage” clients had no teeth and was a mere deflection, disguising the actual sources the banks are depending on to bring in this liquidity.

Banks have also been selling their fixed assets abroad, such as branches in foreign countries, and they are using the proceeds to credit their accounts with their corresponding banks. These fixed assets would have been used more beneficially in any future settlement. By transforming them into liquid assets held in foreign banks they can be easily syphoned outside of the system due to the absence of a capital control law.

The end result of these processes has not been to bring liquidity back into the Lebanese banking system but rather to credit balances in the banks' accounts outside the country.

## WHAT NEXT?

The original (and illegal) sin of creating a false dichotomy between what constitutes ‘fresh’ and ‘old’ money lies at the heart of an intricately constructed plan which serves to protect a narrow swathe of the Lebanese people from taking on their fair share. Dealing in such financial double speak—that a one currency can have more than one price in another—is not only ludicrous, it is criminal.

Lebanon's ruling class of bankers and politicians, who see themselves as ingenious financial engineers, have become nothing less than monetary butchers who continue to refuse

to take their fair share of losses, intentionally devalue the national currency, and with it the hopes and dreams of the Lebanese. As they have hacked away at the savings, livelihoods and future of Lebanon, it's likely they are now attempting to placate the masses by introducing a new form of illegal capital controls, capping the amount the Lebanese can withdraw at, if the BDL governor is to be believed, somewhere around \$25,000.<sup>31</sup> The greatest irony in all of this is that the most likely source of these funds is the required reserves of the central bank, the last bit of reserves the country has before it can officially declare its bankruptcy.

One would be forgiven for thinking that this would be the final stroke in the shadow plan that has caused so much grief and hardship to Lebanon and its people. Having moved capital offshore, bankers and politicians (often one and the same) are primed for the moment Lebanon can officially declare bankruptcy and finally come to the table willing to accept any form of settlement.

Public assets, long sought after by the banks as payment for the public debt, will likely be swept up by those who had the fortune and connections

“**Dealing in such financial double speak—that a one currency can have more than one price in another—is not only ludicrous, it is criminal.**”



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***"Opposition groups and activists should campaign for an independent judiciary which can effectively and impartially uphold Lebanese law, including the Lebanese Constitution and the Code of Money and Credit."***

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not to have their money confiscated by illegal capital controls. In the absence of effective regulators, what are now inefficient public monopolies will likely become private ones, entrenching the clientelism and power of the moneyed classes in Lebanon even further.

After everything that has happened, a few extra thousand dollars or so in the pockets of Lebanese, coupled with fatigue from the crisis, could mean people will be open to dealing with the \$77 billion gaping hole in the banking sector at some other time, or even never. But the Lebanese should refuse—every dollar they get under state-sanctioned bribery will likely be lost to hyperinflation as lira's become even less valuable and economic hardship continues.

Instead, some 20 months into a financial crisis, it is high time to start a real reform process by first bringing the current plan out of the shadows. The first and most important step of this process is for opposition groups and the Lebanese public at large to acknowledge a difficult reality: that the Shadow Plan is an official policy directed through the BDL by Lebanon's elites, who span the upper echelons of politics and banking.

Next, opposition groups and activists should campaign for an independent judiciary which can effectively and impartially uphold Lebanese law, including the Lebanese Constitution and the Code of Money and Credit. Only a fully independent judiciary can hold accountable those who steered Lebanon's economy further into ruin and ensure that such a tragedy never occurs again.

Simultaneously, activists, policy makers, and think tanks must bring greater attention to the FRP's weaknesses, rather than upholding it as a panacea for Lebanon's problems. Most importantly, a sufficient social safety net to protect the most vulnerable from austerity measures should be front and centre in policy making, not an afterthought.

When the Lebanese go to the polls in just under a year, they would do well to remember who stole their savings. Only by ensuring that this truth is not lost will enable the Lebanese to shape their future.

#### EDITOR'S NOTE

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