

POLICY PAPER

BUCKETING DOWN: A PRINCIPLED BAIL-IN FOR LEBANON'S OVERFLOWING DEBTS

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HOW BANKING REGULATIONS CAN FAIRLY ALLOCATE LOSSES AND AVERT FUTURE CRISES





EXECUTIVE SUMMARY

Leaked details of the Lebanese government's latest financial sector rescue plan reveal a disconcerting attitude: the country's ruling elites and banking sector remain determined to avoid taking responsibility for the financial losses they caused. Instead, they have proposed that depositors shoulder nearly three times more of the total financial burden than any other stakeholder – mostly through having their savings converted from US dollars to massively devalued Lebanese Lira.

As IMF negotiations continue, Lebanese depositors must prepare to lobby for the application of international banking regulatory norms to Lebanon's crisis. These business conventions were developed in response to the 2008 Global Financial Crisis (GFC), when public funds were used to bail out private banks, sparking outrage. The regulations operate on the premise that when a bank or other company becomes insolvent, those in charge and those who took investment risks, cannot pass the losses onto innocent parties. This places investors who take higher risks (in search of higher returns) as partial insulators of safer investments if things turn sour.

This fundamental premise supports strong arguments for salvaging Lebanon's banking sector through a "bail-in," under which losses land most heavily on "insiders" – namely, the banks' shareholders. Another prominent risk-taker was Lebanon's central bank, the Banque du Liban (BDL), which oversaw the financial engineering that exacerbated the financial collapse. These parties voluntarily assumed risk in both decision-making and investing, and therefore should be held accountable for the banking crisis.

Unfortunately, Lebanon's banking regulations do not comply with international standards that would

otherwise automate a fair and orderly "bail-in" process. This vacuum has left space for politicians and banking elites to fight back against proposals that would hold them responsible for the banking crisis, and instead shunt Lebanese banks' enormous liabilities onto thousands of small and medium depositors. Lebanon's banking regulations also failed to prevent the financial crisis occurring in the first place. Notably absent are rules that properly deal with bank failures, conflicts of interest within BDL's governing bodies, banking secrecy, and disclosure practices. Over decades, these yawning regulatory gaps allowed prudent checks and balances to be disregarded, in favour of continued, unsustainable profits for banks and shareholders.

Any upcoming deal for an IMF financial rescue package will need to restructure Lebanon's broken banking sector, which will inevitably involve apportioning responsibility for meeting the sector's losses. The IMF is also likely to demand the introduction of stringent banking regulations, which will seek to reshape Lebanon's macro-economic direction and character. These high-stakes discussions will hinge on whether Lebanon's bankers and political elites will finally accept their responsibility in the economic crisis.

So far, depositors and civil society have not been given a seat at the negotiating table, despite the IMF having a self-determined responsibility to consult with the people their reforms will affect. Lebanese depositors should use these international regulatory precedents to lobby for their rights to a fair distribution of losses, and a shift towards a banking system that protects depositors, meets the needs of domestic clients, spurs local growth, and relieves the national debt burden. Failure to do so could see elites continue to evade responsibility and promote their own interests at the expense of depositors' life savings.



GLOBAL REGULATION AFTER THE GLOBAL FINANCIAL CRISIS

While Lebanon largely avoided the 2008 GFC, other countries reeled from the perilous task of allocating enormous losses from their banking sectors. In the United States and Europe, governments faced public outrage – not to mention sizeable state deficits – upon authorising “bail-outs” for banks deemed “too big to fail.” Under these arrangements, distressed banks met their liabilities with assistance from public funds; in effect, this meant that taxpayers contributed heavily to paying off the financial sector’s debts. Understandably, many American and European citizens complained that government bail-outs unfairly burdened taxpayers with the banks’ failures,¹ rather than the banks’ managers and shareholders.

Since the GFC, the international financial community responded to this growing discontent by instituting a suite of regulatory reforms, which aimed to reduce the unfairness of future banking sector collapses. First and foremost, the revised regulations of TLAC and Basel III regulations, developed by the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS) respectively promoted conditions for facilitating a “bail-in” as opposed to the reviled “bail-out.”^{2,3}

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Under a bail-in arrangement, shareholders absorb the bank’s losses to the greatest extent possible. If this does not cover all bank liabilities, some less senior bank creditors agree to absorb the remaining losses and convert their outstanding debts into equity shares, allowing the bank to recapitalise and recover. Typically, these creditors comprise investors holding a class of liabilities known as long-term subordinated debt.⁴ As such, a bail-in tries to ensure the rescue of the banking sector by the creditors and shareholders of the bank itself – as opposed to “bail-outs,” which are funded by ordinary depositors or the taxpayer. This scheme is known as Total Loss Absorption Capacity (TLAC) regulations.

In this way, TLAC regulations facilitate the conditions for ensuring that more conservative investors, such as small and medium depositors, stand less exposed to a banking collapse. Subordinated debt – which provides higher returns than deposits in exchange for the lender assuming more risk – ranks lower than depositor debts upon liquidation during bankruptcy proceedings.⁵ By contrast, small-to-medium depositors receive lower yields on investment but should have a more secure position against bank failure. In the event of a restructuring, subordinated debt is converted into capital to recapitalise the bank, thus shielding ordinary depositors from damage to, or use of their, deposits to correct bank’s balance sheets.⁶ In this way, the TLAC mechanism ensures that banks have recourse to internal funding sources instead of external ones.

Post-GFC reforms have further protected depositors with clawback provisions, which impose financial accountability on key decision-makers within banks. Clawback rules compel bank management figures to pay compensation for making decisions that did not benefit the bank, even after their tenure is over. In theory,



clawback provisions should make bank leaders avoid reckless or illegal behaviour, and instead face severe financial penalties for discharging their corporate duties inadequately.⁷ In fact, effective use of clawback provisions offers an additional stream of capital to meet a bank's losses upon failure, and opens the possibility of both reducing the financial burden imposed on other debtholders, or at a later stage compensating depositors who faced haircuts as a result of a bail-in.

LEBANON'S RESISTANCE OF REGULATORY REFORM

By contrast, the Banque du Liban (BDL) did not sign up to the Basel III reforms and most other global regulatory developments following the GFC. Rather, for nearly ten years, BDL governor Riad Salameh maintained BDL's facade of prudent financial management, emboldened by Lebanon's strong performance during the 2008 international collapse. In resisting heightened regulation, BDL seemingly fell back on three arguments: i) Lebanon was not a member of the Basel Committee; ii) the country's banking sector was less sophisticated than other countries, meaning not all reforms were strictly applicable; and iii) in some respects, Lebanese banking regulations could potentially have been even more stringent than the Basel III reforms⁸.

In reality, BDL's regulations failed to stop Lebanon's banking sector from making a catalogue of poor, risky investment decisions between the GFC and October 2019, when the banking sector eventually collapsed. During this period, BDL intensified bank-lending to the Lebanese state (and to itself), which lies at the heart of the Lebanese banking crisis.^{9,10} Usually, heavy lending to the state is not a problem because of the diversification of international banks' balance sheets as well as low capital requirements

for banks' lending to the national sovereign. However, when banks become over-exposed to a single source of debt risk such as the state, their credit rating falls into the debtor's hands – to the point where the default of one can drag the other into default as well.



Lebanese banks' revenues grow off the back of the interest the state paid on sovereign bonds, while deepening banks' exposure to the Lebanese state, an entity increasingly rated a "high credit risk."



In practice, excessive state lending created opportunities for politico-banking elites to the detriment of Lebanon's financial health. Lebanese banks' revenues grow off the back of the interest the state paid on sovereign bonds, while deepening banks' exposure to the Lebanese state, an entity increasingly rated a "high credit risk."¹¹ From around 2016, as foreign currency reserves started dwindling, BDL engaged in financial engineering – a highly profitable, extremely dangerous aspect of what had become Lebanon's "regulated Ponzi scheme."¹² As some of the banks' primary shareholders were either political leaders or their cronies,^{13,14} they had growing incentives to turn a blind eye to lending to themselves and their credit unworthiness, as rolling over (public) debt brought with it more shareholder profit.

To make matters worse, Lebanon did not have post-GFC regulatory safeguards in place to facilitate an orderly, equitable bail-in when banking sector eventually collapsed. The



absence of TLAC regulations meant that Lebanon's banks, did not automatically have recourse to those creditors it needed to recover from the crisis. Indeed, a TLAC-compliant bank would have had a predetermined amount of subordinated debt in place – capital that the bank accumulated for precisely this scenario – recapitalisation.

In Lebanon, however, bank balance sheets rely primarily on shareholders and depositors, making a clean bail-in – one that does not involve ordinary depositors – highly unlikely. Indeed, from October 2019, BDL swiftly directed the banks to begin discussing the imposition of “haircuts” on ordinary depositors, under which they would need to write off large swathes of savings to reduce the debt burden. To make matters worse, clawback provisions – which aim to impose accountability and financial responsibility on negligent bank management – are unheard of in Lebanon. Far from key decision-makers having their money reclaimed to meet banking losses, Salameh conceded that connected depositors had transferred more than \$1 billion between 17 October 2019 and 30 January 2020 – despite illegal capital controls preventing ordinary depositors from accessing their savings.¹⁵ Other insiders, who sat on BDL committees, have placed the amount of capital flight closer to \$6 billion.¹⁶

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Box I: Double Hatting

BDL's governance structure has inbuilt measures for oversight of BDL policies and accounts. Their effectiveness has however been thoroughly compromised by undue political influence, conflicts of interest among committee members, and gaps that allow the governor to dominate decision making.

For instance, the two main regulatory bodies embedded within BDL – the Central Council (BDLCC) and the Banking Control Commission of Lebanon (BCCL) – include delegates from the Ministries of Economy and Finance as well as other political appointees. The ministerial representatives provide direct, systemic political influence over BDL's regulatory bodies. In other countries, the national reserve bank often maintains staff who are independent from the government. In Lebanon, concerns of undue influence grow even stronger given the extensive conflicts of interest between Lebanon's political and banking elites.

Further, the BDL governor heads the three BDL oversight bodies, being the Higher Banking Commission, the Special Investigation Commission, and the Capital Markets Authority (CMA). This makes the governor a man of many hats, with his deputies potentially relegated to performing tasks of the governor's own choosing.

Double hatting – where chairs of boards also serve as an institution's general manager (CEO) – extends throughout Lebanon's banking sector. Prohibited by the BCBS,¹⁷ this practice minimises internal accountability procedures and contributed to some extent to the GFC. A confidential banking source told Triangle that, in some cases, auditors have even reviewed Lebanese banks in which their relatives owned shares – one glaring example of a blatant, unchecked conflict of interest. In 2021, A former member of the BCCL stated that such conflicts of interest within the CMA influenced banks' deceptive transfer of deposits into around US\$4 billion of preferred shareholdings¹⁸.



WHO WILL FOOT THE BILL? ASSIGNING LEBANON'S BANKING LOSSES

With insufficient regulation in place, Lebanon has played host to a bitter dispute over how to allocate the banking sector's losses. In 2020, accounting firm Lazard authored the former Diab government's "Financial Rescue Plan," which included "bail-in" as one of the main recovery options for the financial sector.¹⁹ In lieu of subordinated debt, the Lazard plan relies heavily on the concept of a 'haircut' i.e., a reduction in the market value of deposits, applicable to the largest 2% of depositors (aligning with the then-government's promise of protecting 98% of depositors). This contradicts the fundamental purpose of bail-ins, which is to protect senior debt-holders – especially depositors. As such, the Lazard approach substitutes subordinated debt with depositor debt, and becomes akin to a bail-out, with the Lebanese public funding the rescue operation through their deposits instead of through taxation.

The Lazard plan was immediately opposed by business and political elites – many of whom had profited from the banks' risky lending through exorbitant interest rates on their large deposits. In its May 2020 response proposal, the Association of Banks in Lebanon (ABL) suggested covering the sector's losses through a de facto fire sale of state assets – which would be transferred to the banks. The ABL proposal offered little detail on how remaining losses would be recouped.²⁰

To agree upon a compromise distribution of losses as part of an IMF rescue package, the Lebanese government will need to decide on which party will act in the place of subordinated debt. In these negotiations, the guiding principle should be to allocate losses in a bail-in plan that complies as closely as possible with a TLAC-structured distribution of losses. Then, as necessary, the arrangement should dis-

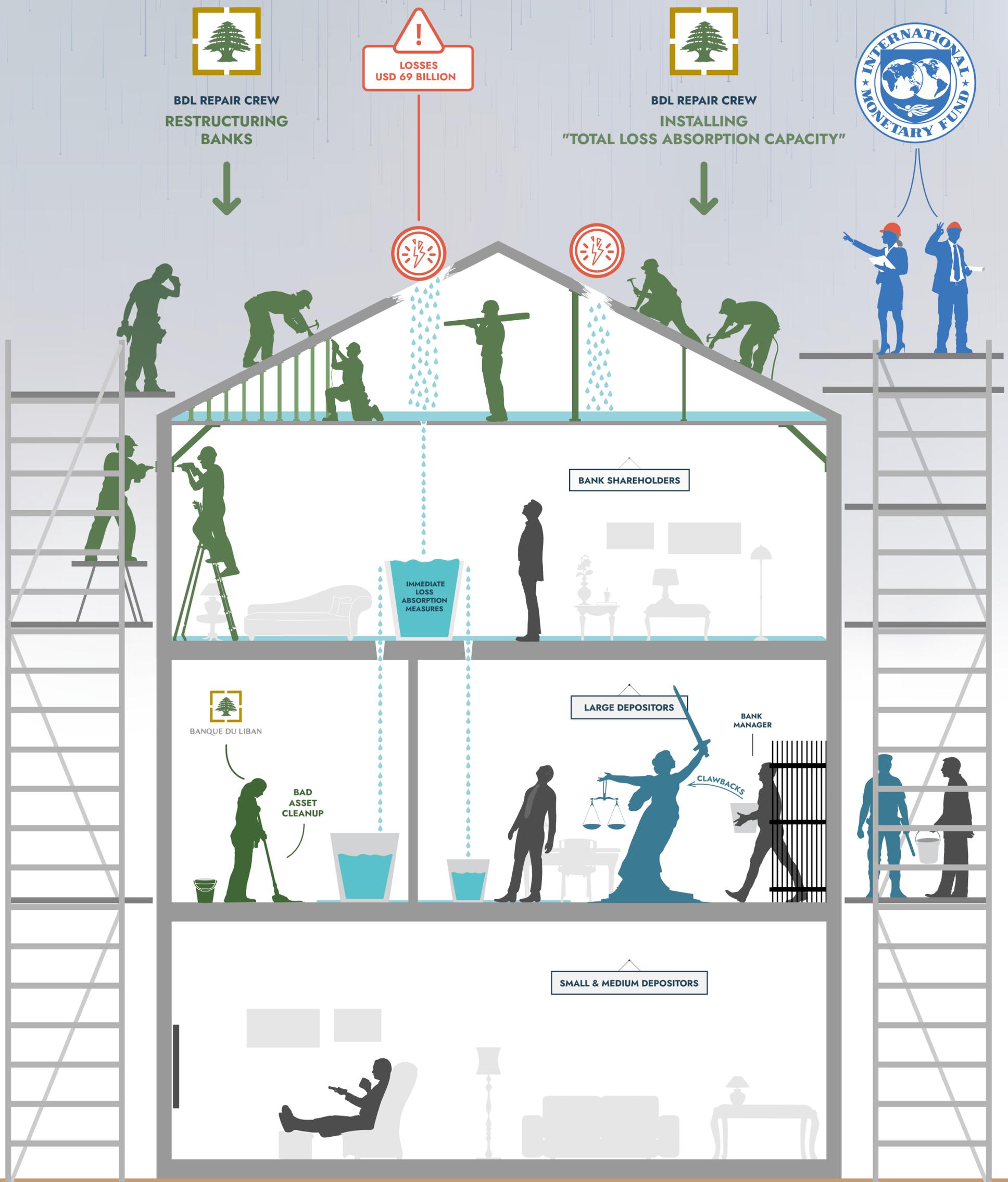
tribute further losses proportionately to the level of risk that each investor took on. In the Lebanese case, this means following international standards for shareholder accountability in failed banks and imposing accountability for the decisions that led to the banking crisis – while also acknowledging that ordinary depositors will inevitably assume some of the debt burden.

First, as business owners, bank shareholders should not be treated any different than the shareholders of a TLAC-compliant international bank. This means that shareholders must foot the bill during downturns; in Lebanon's banking crisis, this will likely lead to a 100% wipe-out of their shareholdings.* In 2021, existing bank shareholders and preferred shareholders' capital was valued at 31 trillion Lebanese Lira²¹ (approximately US\$20.6 billion at the exchange rate of 1500).

There is no escaping the fact however that shareholders' stakes will be insufficient to absorb all losses, and further readjustments will be necessary. Failed and weak banks will have to be merged, and their bad assets transferred to BDL's balance sheets.

* *Within Lebanon's banks there are clear differences between banks' major shareholders many of whom are politically exposed, and "preferred shareholders". The latter would normally be considered as part of the liability structure of a bank, however in Lebanon many of these parties are financially un-savvy depositors who were duped into converting their deposits and lifelong savings into preferred shares with the promise of a "secured financial return". Under a bail-in, these parties would have to incur a loss, however it is strongly plausible that banks broke the law in convincing depositors into agreeing to these conversions (see Azar G, 2021). As such, compensation mechanisms can be designed to allow those parties to recoup some of their losses.*

SIMULATING TOTAL LOSS ABSORPTION CAPACITY IN LEBANON'S BANKING LOSSES





Given the lack of sufficient subordinated debt in the system, the **second** tier of loss responsibility will comprise a balancing act between BDL and large depositors. BDL's mopping up of the on-paper losses will have to be significant enough so that a haircut on large depositors alone will suffice to cover the remainder of losses.

Large depositors' contribution to covering the losses – the haircut – will come by converting a part of their deposits into preferential shares in restructured banks. At the same time, this share conversion will form the primary component of their compensation, as they will receive preferential dividend payments once the banks start making profits. Secondary forms of compensation – primarily clawbacks – should be pursued through legal processes.

Box II: Consolidation and downsizing

By 2019, Lebanon had a remarkable 63 banks servicing a country of just 6 million inhabitants. As part of any financial rescue package, the IMF will almost certainly demand the merger of Lebanese banks which are unable to recover by themselves (consolidation). After that, the sector restructuring will need to rid the resulting banks' balance-sheets of the "bad assets" or loss-making loans (downsizing). These assets should then be transferred to BDL's balance sheet, subject to banks becoming subject to a suite of regulatory reform requirements.

Consolidation and downsizing will increase the likelihood of depositors recuperating some of their savings over a shorter period, as new banks would start operating from a clean slate. The two processes will also ensure that Lebanese banks face consequences for their past failures, in exchange for receiving a fresh start. In this way, consolidation and downsizing – like proposals to wipe out bank shareholder debt – can help allay concerns that the banks have been let off the hook.

Clawbacks will need to be applied retrospectively against decision makers who set up financial engineering (FE), bank management figures that facilitated participation in FE, and bankers who broke the law in applying capital controls. The money recouped from this process should then be allocated to the largest depositors to compensate as much as possible for the haircut on their deposits.

While clawbacks do not exist in Lebanese banking regulation as yet, the IMF could insist that they are conducted as a part of its rescue package and incorporated in future regulations under an independent clawback authority. This would ensure that the success of these measures is not dependent on the compromised judicial system prevailing over politics.

The parameters of the haircut assigned to large depositors, as well as the appropriate compensation/clawback mechanisms require negotiation within the context of an optimisation problem that will need to be solved empirically as part of a holistic proposal (see Annex 1). The eventual outcome of these calculations should involve the BDL, shareholders, large depositors, and bank managers to an extent that protects the deposits of ordinary small and medium depositors under a threshold in line with international best practice.

RECOMMENDATIONS

At best, the proposed compromise will buy time for Lebanon. The country will remain exposed to other banking crises unless reforms go further than allocating current losses fairly. In tandem with these important outcomes, Lebanese banking needs fundamental institutional changes to reduce the likelihood and impact of future downturns.



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ALLOCATING TODAY'S LOSSES

As part of the IMF negotiations, Lebanon's government should present the TLAC-structured distribution of losses as a principled solution to the current banking crisis. This compromise proposal apportions liability in line with accountability and / or assumed risk, while also acknowledging that even large depositors will inevitably forego some savings to salvage the banking sector. These unfortunate parties should receive due compensation further down the line.

IMMEDIATE REGULATORY CHANGES

Beyond the current crisis, **Lebanon's banking sector must formally implement bail-in (TLAC) and clawback provisions in line with BCBS rules.** This would diversify the sector's liability structure and enable it to trigger a proper bail-in (if needed) in line with the main objective of protecting the rights of all depositors.

In the realm of governance, BDL's commissions need to be rid of any political bias. This removal of bias needs to start from the top. While Lebanon is rich with talented individuals who could take on the mantle of central bank governor, in the current climate appointing a foreigner as central bank governor would send a strong signal to the international community that Lebanon is serious about reforms. This practice occurs in various other international jurisdictions and

should also be subject to a non-extendable time frame to signal a full break with the past.

While there is no escaping the need for a political appointment for members of the central commission, **BDL's oversight bodies must be independent, not politically exposed, and required to report to parliamentary scrutiny.** Parliament, while far from perfect in the current clientelist context, is a much more open and publicly accessible arena than BDL's committees, and individual MPs and committees can scrutinise and/or address regulatory updates on the public record.

Parliament must also fully repeal banking secrecy laws and ensure that an independent forensic audit takes place of all relevant BDL and bank accounts. Having earned a bad reputation globally, banking secrecy has become more detrimental than beneficial as it promotes the feeling that illegal accounts can be concealed²² and limits trust in the banking sector. As the world moves more in the direction of international openness and cooperation through transparency²³, there are now many ways to circumvent such secrecy barriers where the political muscle prevails. Lebanon should join the rest of the world and at last repeal all banking secrecy laws, paving the way for a more open and productive banking sector.



Depositor insurance is an essential safety-net for small deposits yet – in Lebanon – the current level of coverage provided (75 million LBP) is far too low.

Equal to US\$50,000 under the official exchange rate, depositor insurance was worth around US\$3,750 at the time of publication. Higher insurance floors would have reduced the rate of panic withdrawals during the crisis. In the United States, deposits are insured for up to \$250,000 in savings; Lebanese regulations should require similar safeguards in future.

In addition, banks should only be allowed to conduct independently reviewed asset revaluations, if they are to use the latter as an additional component of capital.

BDL, hoping to increase banks' capital by 20% during the crisis, allowed the banks to revalue their fixed assets (i.e., real estate) assets and account for the difference as an additional capital instrument without any rational basis for it. While perfectly legitimate as a regulatory measure²⁴, the revaluation needs to follow prudent calculations, and align with the actual property price movements.

SUSTAINABLE BANKING FOR LEBANON

Resetting Lebanon's long-term economic trajectory requires resolving its sovereign-bank nexus, which ties the banking sector's creditworthiness to the state's credit rating. The BCBS has not yet published its position on the treatment of sovereign exposures, however Lebanon can lead by limiting exposures to a single debt source and developing a waterfall scheme whereby additional capital should be held against low-rated sovereigns.

Lebanon will need to prove its credibility to the IMF to receive help in recovering from the current crisis. The IMF should require Lebanon adheres to

TLAC requirements, and that other BCBS regulations linked to liquidity^{25, 26, 27, 28} to bring the country's banking sector into line with global best practice. Specifically, Lebanon needs to make the changes long suggested by the IMF²⁹ on the application of the Liquidity Coverage Ratio (LCR) and correct deviations from BCBS³⁰ related to the capital treatment of FX denominated sovereign debt. These could have helped flag the liquidity needs and improper risk assessments of the banking sector.

Even though banks in Lebanon have compulsory disclosures mandated by the central bank, they seem to obfuscate much of the content which these disclosures were aimed at in the first place. Transparency must become a pillar of the industry, meaning disclosure requirements must meet the same rigour and composition as the BCBS Pillar III³¹ disclosures while also requiring audited financial statements by external firms.

As poorer countries rely on international donors to help them recover from banking crises, international regulators can play a big part in applying internationally agreed rules to poorer countries, even if they were not signatories to international agreements. The BCBS should hence expand its oversight of regulatory implementation, known as Regulatory Consistency Assessment Programme (RCAP), from the member countries to all countries in order to expose any flaws early on and play a part in protecting vulnerable depositors.

EDITOR'S NOTE

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Annex 1: The Compensation and Haircut Optimisation Problem

The 'haircut' is calculated for each large depositor on a pro-rata basis:

$$\mathbf{Bail-in = Total Losses - Total Bail-in Eligible Instruments - Central Bank Deficit}$$

$$\mathbf{Equation 1: Haircut (\theta) = Bail-in / Total Large Deposits}$$

The depositor's share of the newly restructured bank is:

$$\mathbf{Equation 2: New share value = Original deposit \times (1 - Haircut) / Total New Assets}$$

These depositors-turned-shareholders are then given priority under the new capital structure of the restructured bank (akin to preferred share owners) and receive a pre-agreed proportion, δ , of the bank's future profits in the form of dividends as well as being given the first right to sell back their shares at an improved valuation, λ , once the market recovers. They would also be given priority to receive other forms of compensation through a proportion, γ , of clawback measures. The values of δ and γ would be decided by the new shareholders based on the strategic preferences of each restructured bank while λ would be based on expected market projections.

Excluding discounting, the relationship between the haircut and various forms of compensation is presented below. Note that, all forms of compensation would automatically seize once the haircut amount has been offset. At that point the preferred shareholder can decide to revert to a normal shareholder or convert their shares into a depositor account at market value.

$$\theta \times Original\ Deposit = \lambda \times New\ share + \delta \times Future\ profits + \gamma \times Clawback; (2)$$

Combining equations 1 & 2, we get the following empirical model:

$$\mathbf{Bail-in \times Original\ Deposit / Total\ Large\ Deposits = \lambda \times New\ share + \delta \times Future\ profits + \gamma \times Clawback}$$



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