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

THE PROBLEM

As disputes over allocating Lebanon's banking sector losses play out between the IMF, government, and financial elites, uncertainty and suffering continues for Lebanon's small and medium depositors. These everyday customers face the prospect of losing most of their deposits' value to rescue Lebanon's failed banks.

In other countries, post-GFC regulations require that banks must hold insulating liabilities that shield a company's low-risk creditors – such as depositors and everyday clients – in cases of bankruptcy or inescapable debt. Usually, these safeguards come in the form of subordinated debt, which offer investors higher returns but expose their capital to being wiped out in an insolvency scenario.

These regulations effectively automate a "bail-in" process, whereby shareholders and subordinated debtholders bear the brunt of a bank's failure. The "bail-in" process deliberately protects low-risk creditors, as well as ordinary taxpayers, who may lose money under the reviled "bail-out" solution to a banking collapse. Therefore, bail-ins aim to ensure responsibility for failed business was taken by those who knowingly took risky business and investment decisions.

Lebanon, however, failed to introduce these post-GFC regulations – known as "Total Loss Absorption Capacity" (TLAC) –making loss allocation under the current banking crisis much less clear-cut. The regulatory vacuum has left open an opportunity for bankers and politicians to shift responsibility for the estimated $69 billion in losses onto depositors and public assets, instead of bank shareholders and other investors who profited from their risky lending practices.

To make matters worse, BDL has also failed to introduce "clawback" provisions, which allow courts to recover bonuses and other entitlements from bank management who presided over poor financial decisions.

COMPROMISED OVERSIGHT

It is likely that the BDL did not introduce the post-GFC banking regulations for several, often interrelated reasons. First, BDL relied heavily on Lebanon's relatively strong performance during the GFC as a basis for resisting further reforms, insisting that Lebanese banking regulations were already adequate. Indeed, BDL continued to champion the notion that Lebanon's banking sector followed conservative, prudent financial policies, making additional regulation unnecessary.

Second, Lebanon's banking sector has compromised internal governance structures, which multiplied existing conflicts of interest between Lebanon's banks and the nation's political elites, which hold both direct and indirect interests in the sector. Indeed, the entrenched conflicts of interest within the management of both BDL and commercial banks transgressed another international regulatory standard – the prohibition of double-hatting in management and oversight positions.

BDL's internal oversight bodies are also compromised, both by political appointees sitting on key bodies, andby the predominance of the central bank governor over the Higher Banking Commission, the Special Investigation Commission, and the Capital Markets Authority (CMA).

WITH NO TLAC, WHO FOOTS THE BILLS?

Without a guiding regulatory structure, the distribution of losses in Lebanon's banking sector has become a matter of political contestation and financial manipulation. In the

absence of subordinated debt, the government and the IMF need to agree upon a plan that allocates losses across bank shareholders, depositors, and the BDL.

Bank shareholders have the primary responsibility for bank failures, but so far resisted assuming this liability. Even with a 100% wipe-out of bank shareholders, however, BDL will need to take on a significant portion of the losses on its balance sheets. Even after BDL assumes specified debts, the nation's large depositors will also need to face a haircut on their savings. In the case of depositors, it would be equitable to provide compensation for their contribution to the "bail-in" with shareholdings and clawbacks from financial decision makers over time.

CLEANING THE STATE

The process of filling Lebanon's banking losses with adequate stakeholder contributions has become a political negotiation requiring coordinated positions from organizations defending depositors rights.

Among the major steps up for negotiation with the IMF and Lebanese government are the consolidation of Lebanese banks; Lebanon's adoption of preventative and remedial regulatory measures – including TLAC and more rigorous independence for the oversight of BDL – as well as parliamentary oversight of BDL; and limits on concentrated lending to the state.

Organisations defending depositors' interests should coordinate on the following fundamentals:

1. Refusing any distribution of losses through a bail-in which does not fall in line with international financial regulatory standards devised post-GFC regulations, specifically TLAC.

2. Acknowledging Lebanon's lack of subordinated debt, international financial regulatory standards of a bail-in need to be simulated whereby:

a. Current shareholders maintain the complete financial burden and are wiped out.

b. Large to medium-sized depositors receive D-E swaps in the banks and recourse to the outcomes of clawback measures.

c. Small depositors are completely protected and compensated in the currency of their holdings.

3. Future banking sector regulations – specifically around bank liability structures – are organized so:

a. Subordinated debt is mandatory and adequate to stave off a future downfall in the banking sector.

b. Minimum deposit insurance is in line with international standards and protected against exchange rate fluctuations.

c. Clawback provisions are monitored and implemented if necessary through an independent body with judicial powers.

d. Aggregated commercial bank bad assets taken on by BDL need recompensating through BDL profits from its asset holdings over time (e.g. real estate, MEA, Casino du Liban).

e. There is no legal amnesty for bank shareholders and managers who contravened laws before a Financial Rescue Plan.

POINTS FOR DISCUSSION:

1. Should we let shareholders keep their banks if they return assets? Would this encourage them to bring assets back?

2. What level should minimum deposit insurance be instituted at, given the US benchmark is USD250,000?

3. What should be done with the assets parked at the BDL?

SIMULATING TOTAL LOSS ABSORPTION CAPACITY IN LEBANON'S BANKING LOSSES