Time to address Lebanon's crippling banking crisis

Lebanon has been mired in economic crisis for almost five years. A combination of acute negligence and mismanagement on the part of the government, the central bank and key institutions culminated in a series of economic and political crises that have left the banking sector on its knees and more than three-quarters of the population living in poverty.

In the following guest article for *Arab Banker*, Dr. Nasser Saidi, founder and president of Nasser Saidi & Associates, and Alia Moubayed, emerging markets economist, analyse how the crisis unfolded and chart a proposed roadmap to recovery.

October 2024 will mark five years since the advent of Lebanon's financial crisis, one of the world's deepest in modern history, according to the World Bank. Faced with persistently large twinned deficits in its budget and current accounts, and an exchange rate that has been overvalued for more than a decade, the central bank, Banque du Liban (BDL) resorted to costly 'financial engineering', excessive borrowing, effectively a disguised Ponzi scheme, to maintain an unsustainable currency peg to the US dollar.

These quasi-fiscal operations resulted in the accumulation of more than $70 bn of losses at the BDL that were disguised through creative accounting until the crisis unravelled in October 2019. The subsequent decision by banks to unilaterally declare a banking holiday in the absence of capital controls, precipitated a run on the banks, capital flight, a disorderly sovereign debt default, and a currency collapse – the worst in Lebanon's history. The subsequent prolonged period of debt and broader financial distress led to widespread protests and acute political crisis.

Since 2019, failure to restructure the banking system, and the public sector, by not undertaking structural reforms, combined with the absence of a social safety net has inflicted severe socio-economic costs. The economy contracted by a cumulative 38.0% in real terms between 2018 and 2023. Nominal GDP shrank from $52bn in 2018 to less than $20bn in 2023, and GDP per capita fell by almost one-third since 2018 to $3350.3 in 2023.

Five years after: Lebanon's polycrisis exacerbates

The decline has continued in 2024, worsened by the violence and destruction wrought by the war in the south of Lebanon. Lower real incomes and dismal growth prospects have led to a massive brain drain (10% of the population), with Lebanon increasingly dependent on expatriate remittances – now running at about 31% of GDP.

A sharp and disorderly devaluation of the national currency, combined with the prevalence of distortionary and corruption-driving multiple exchange rates, monetary financing of public sector deficits and the poorly managed removal of fuel and electricity subsidies, led to accelerated inflation. The inflation tax has averaged 127.0% over the past five years, eroding peoples' purchasing power and pushing increasing numbers into poverty – the rate of which increased from 12% in 2012 to 44% in 2022.

Public finances collapsed as revenues to GDP fell from 21% in 2018 to 6.1% in 2022, preventing the state from fulfilling its key functions of providing security, as well as basic social and infrastructure services. The government in Lebanon ceased to be able to function in any meaningful sense.

Today, Lebanon is the only emerging debt-stricken country where the crisis remains unresolved. Since January 2020, around fifteen countries have defaulted on their debt, including Ecuador and Zambia in 2020, and Sri Lanka,

Ukraine and Ghana in 2022 . All of them have either completed, or are currently finalising negotiations with their creditors based on national recovery plans to resolve the situation. They all are in discussions with key stakeholders in the private sector and civil society, reaching common ground and agreeing on a way forward to restructure debt, dealing with losses in their financial sectors and limiting the fall out on the real economy. At the same time, they have been prioritising social cohesion and protecting the most vulnerable, supported by the international community in the context of IMF programs.

In Lebanon, none of the above was done. Instead, and for the past five years, politicians have prioritised their common interests with bank shareholders above those of the rest of society, socialising the losses and privatising the gains, while actively obstructing any progress towards a much-needed IMF programme that was agreed in principle as long ago as April 2022.

The banking sector at the epicentre of the problem

Today, a major challenge hampers progress towards banks' restructuring: the distribution of the losses. Until now, the authorities have failed to recognise the losses at either the central bank or banks, or to allocate them in a way that protects smaller depositors and society at large.

Unlike other crisis-hit countries, such as Greece, Iceland and Cyprus, the BDL failed to impose a restructuring and recapitalisation of banks based on 'the waterfall of loss distribution' which would have required banks' shareholders to absorb the losses first, at the onset of the crisis.

Faced with losses that were too big to be absorbed by the banks' existing equity (estimated at approximately $21 bn at the time), the BDL did not work towards mobilising other sources of external capital either from existing shareholders, strategic investors, or the sale of banks assets, nor did it consider turning to depositors' savings as a potential source of capital through a bail-in. Instead, the BDL, in collusion with the Association of Banks in Lebanon, rewarded the latter's bad governance and mismanagement by deliberate 'Lirafication' – the effective conversion of foreign currency deposits into Lebanese Liras – of more than $20 bn of deposits, a massive, unvoted-for wealth tax.

Accordingly, the size of the banking sector shrank, and its structure dramatically changed, while a massive transfer of wealth took place. Total assets declined from $262.8bn at the end of October 2019, to $104.3bn at the end of May 2024. Total private sector deposits fell from $168.3bn to $90.9bn during the same period (Figure 1).

Importantly the sharp devaluation in the Lebanese Lira eroded the value of any such deposits from the equivalent of $44.7bn at the end of 2019, to a mere $0.6 bn at the end of May 2024. In parallel, frozen foreign currency (FC) deposits fell from $123.7bn to $90.3bn due to capital flight and a *de facto* haircut through forced Lirafication causing a massive multi-generational destruction of wealth.

Concomitantly, with the implicit acquiescence of the BDL and the Banking Control Commission (BCC) – banks allowed borrowers to repay their FC-denominated loans using both their lira and frozen FC deposits ('lollars')

Privileged private sector corporates rapidly deleveraged, in a chaotic process causing a huge wealth transfer from depositors to borrowers. In the absence of any clear and coherent policy framework, the deleveraging process did nothing to support economic recovery and credit to GDP fell from more than 102.2% of GDP in 2019 to around 37% in May 2024 (Figure 1).

Failure to restructure left banks in a zombie state, fuelling dollarisation, as well as the cash and informal economy and raising risks to the sector. Today, banks are unable to fulfil their normal functions of financial intermediation, but are increasingly exposed to the risks of an expanding cash economy and thriving illicit activities (such as smuggling and illicit trade).

Ironically, some of these activities are being facilitated by the BDL's own regulations, notably Circular 165, through which the BDL allegedly aims at 'bringing back the liquidity into the banking system'.

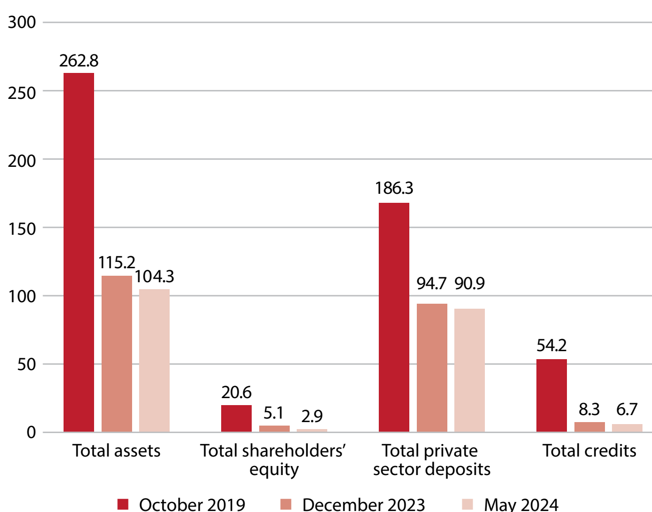
The size of the dollarised cash economy is estimated to have increased from 26.2% in 2021 to around 46% of GDP in 2022, heightening the risks of money laundering, corruption and growing informality, while also facilitating tax evasion.

In 2023, the Financial Action Task Force (FATF), an international financial crimes watchdog, highlighted six key areas where Lebanon is only 'partially compliant' with internationally accepted rules on anti-money laundering and counter-terrorist financing (AML/CFT). Deficiencies in combating money laundering, in transparency and beneficial ownership of legal arrangements, concerns about some designated non-financial businesses and professions, and a weak system of mutual legal assistance (freezing and confiscation) raise the likelihood of a grey-listing in 2024. A grey-listing would pressure politicians into adopting and implementing a reform roadmap to avoid a black-listing, sanctions and Lebanon's increasing international financial exclusion.

A Reform Roadmap: reform or die

Before any other measures can be taken, the country must urgently address the perils of zombie banks – they are a compelling reason why the sector must rapidly proceed with a comprehensive restructuring. Lebanon needs between five to 10 years to restore banks' viability and their ability to efficiently allocate resources to support the recovery. This requires action on three fronts: (i) devising a restructuring plan based on bank recapitalisation, starting with shareholders and a bail-in of large depositors in order to maximise deposit recovery; (ii) restoring trust in the BDL and the banks by

Figure 1: Lebanon – Key banking indicators 2019–24 ($ bn)



Source : Banque du Liban, IMF

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stressing accountability and bolstering independence of the regulatory framework; and (iii) accelerating structural reforms to propel growth and rebuild national wealth.

Work had progressed on a revised bank resolution law, to address some of these issues related to loss absorption, but it was sabotaged recently by politicians. This revised version, establishing an independent Bank Resolution Authority, should be expanded and resubmitted to parliament.

However, even before any of this work can be done, it will be critical to pass amendments to the Bank Secrecy Law. These would enable deficiencies highlighted by the IMF to be identified, combat pervasive tax evasion, facilitate the effective implementation of AML/CFT regulations and identify the stock of deposits that could be eligible for consideration, while increasing their potential recovery rate.

Credible monetary reform requires a strong, professional, and politically independent central bank. Monetary policy should be directed at controlling inflation, accompanied by a flexible exchange rate regime. There is a need to radically reform the BDL's governance by limiting the governor and vice-governors' terms to four years, renewable only once and without cumulation of functions.

The BCC, the Special Investigation Commission and the Capital Markets Authority, should be independently governed institutions. Moreover, the BDL's Central Council, which sets monetary, exchange rate and credit policies, must play a dominant role in decision-making. This should not be confined to the central bank governor only, as was the case during former BDL governor Riad Salameh's mandate. In addition, reinstating transparency and disclosure at the BDL will be critical. It will need to publish audited financial statements and accounts, minutes of central council meetings and provide reports on its performance to the council of ministers and parliament. Without rebuilding and modernising the regulatory and legal framework, there can be no prospects for restoring trust in the banking system.

The next area to address is, macroeconomic stabilisation and growth – which will require urgent fiscal reform, public sector restructuring and structural reforms. We need to see the introduction of a fiscal rule, which would enable Lebanon to achieve a sizeable primary fiscal surplus and put public debt on a downward and sustainable path.

Addressing tax evasion and the 'underground economy', reviewing the size of government subsidies (via smart, targeted cash subsides or direct transfers to households) and implementing the government procurement law, will all support the nation's fiscal performance.

A pension system and social protection reform, including social safety nets, is critical, considering rising poverty and inequality levels in the country. Structural reform is essential for the public electricity, water and telecom sectors, and more widely, for other state-owned enterprises and government-related entities (SOEs and GREs). A potential solution would be to establish an independent, national wealth fund (like Singapore's Temasek) to professionally manage all SOEs and GREs in addition to future oil and gas revenues. Privatisation is not a viable option without fundamental structural reform and good governance of SOEs and GREs. Eventually, moving to a digital government would increase transparency and accountability, while also helping to combat corruption.

Lebanon should build on the lessons learned over the last five years of crisis to move forward. The institutional failure of the BDL, BCC, successive governments and parliament, coupled with a lack of judiciary independence, has caused, perpetuated, and deepened the polycrisis.

The bottom line is that the country cannot recover from its polycrisis without fundamental political reform to instil economic and judicial good governance, rule of law and accountability. Political reform remains unlikely in a polarised domestic landscape dominated by regional geopolitical issues, the war in Gaza and a political class benefiting from the large informal, cash-based economy and the cushion of remittances.

Having said that, the only way forward for the next five years must begin with the election of a new president who garners enough support and is capable of managing the worsening crisis, and the nomination of a new prime minister prepared to focus on the restructuring agenda (debt, financial sector, and the public sector) and negotiate an IMF programme as soon as possible.

This programme should help downsize the public sector and recapitalise banks while reducing their numbers, and quick-start negotiations with international bondholders to reach a restructuring deal and regain their trust. In parallel to re-integrating international financial markets, Lebanon will need to re-establish good and friendly relationships with the GCC and embrace deepening its trade and investment with them. ■