ASSESSMENT OF THE GAP LAW

DRAFT LAW ON FINANCIAL STABILIZATION & DEPOSIT RECOVERY

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OVERVIEW

The draft bill on "Financial Stabilization and Deposit Recovery," also known as the "Gap Law," seeks to restore financial stability and establish a mechanism for deposit recovery after six years of institutional paralysis and deliberate delays. It also introduces elements aimed at allocating losses, determining accountability, and protecting the majority of depositors. However, despite this progress, the text suffers from several inconsistencies and weaknesses that risk undermining its stated objectives.

- **The feasibility of the deposit recovery mechanism is called into question,** particularly since the proposed financing structure creates future liabilities without identifying clear sources of financing.

- This ambiguity also raises questions regarding the **fate of the gold and the level of state contribution.** In doing so, the text **opens the door to imposing undetermined additional liabilities on the Central Bank and the state,** thereby generating financial and legal risks and potentially re-creating unsustainable debt levels in the near future.

- **Critical figures are missing;** macro-fiscal and debt sustainability impact analyses have not been presented alongside the draft bill.

- The text is ambiguous with regard to the **hierarchy of claims;** while it seeks to address the case of 85% of depositors, it leaves out pension and social security funds.

- At the level of **accountability,** the text introduces improvements. While it includes a reference to the forensic audit, it does not set it as a requirement for the resolution process, and fees imposed on certain irregular transactions remain low.

Government officials announced that they will be working with the IMF, however, **the draft will need to be amended if it is to secure the IMF's endorsement** and, consequently, support from the international community.

The below presents an assessment of the most important elements of the draft bill against key principles and international standards. These **critical gaps must be addressed for the law to fulfill its objectives** of ensuring equitable recovery for depositors, enabling a sound reboot of the banking system and the economy, and restoring trust in Lebanon's financial system.

1. HIERARCHY OF CLAIMS

International standards stipulate that financial losses should first be absorbed by bank shareholders' equity, before deposits are affected. This principle, known as the « Hierarchy of Claims » ensures a fair allocation of losses and guarantees that depositors are prioritized in any proposed solution.

- **While the bill formally adopts the hierarchy of claims, the sequencing in the absorption of losses remains ambiguous, leaving room for interpretation.** It is not clear whether transactions deemed "irregular" are removed (off-balance-sheet) upfront or not, and therefore unclear whether shareholder equity would absorb losses first.

- **The timeframe for recapitalization, set at five years, is quite lengthy.** This extends the period during which certain banks are in a zombie state, and hence, risks further defaults. It also contradicts the hierarchy of claims because it allows existing shareholders to retain their economic and ownership rights —despite not having recapitalized—while the claims of depositors above USD 100,000 are effectively removed from the bank's balance sheet and compensated with long-dated instruments.

2. DEPOSIT RECOVERY MECHANISMS & FINANCING STRUCTURE

Deposit recovery mechanisms as per the latest bill are as follows:

- **The first USD 100,000 per depositor** are repaid over four years, jointly financed by banks and BDL (Banque du Liban), with BDL's contribution capped at 60%. This aims to ensure repayment to around 85% of depositors.

- **Deposits above USD 100,000** would receive their first USD 100,000 as per the above, with the remaining balance converted into long term Asset-Backed Securities (ABS) issued by BDL, with maturities ranging from 10 to 20 years, a grace period of five years, and a minimum annual amortization of 2% starting in year five[1]. ABS repayments are backed by BDL assets and revenues, and banks are responsible for 20% of such repayments.

Several issues arise with regard to the suggested recovery mechanisms, and financing structures:

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[1] This means that starting from the specified date, BDL must repay **at least 2% of the certificate's face value each year**, but may legally repay only that minimum and defer the rest of the principal until maturity.

WITH REGARD TO DEPOSITOR RECOVERY MECHANISMS:

- **Certain account categories such as the funds of various professional orders and the NSSF are not accorded seniority in the stack of claims,** whereas they should be treated as senior creditors and subsequently protected.

- **The text excludes a bail-in mechanism,** under which, deposits above a certain threshold would be converted into bank equity, allowing those depositors who absorb the losses to be compensated in case the bank recovers. The current configuration undermines deposit recovery, increases liquidity pressure, and shifts the burden of losses toward the state.

- **By adopting a per-depositor approach, the text ignores bank-by-bank differences.** The per-depositor approach risks breaching the "no creditor worse off" (NCWO) principle, which requires that no creditor or shareholder incur greater losses in resolution than under normal insolvency proceedings. By treating deposits aggregately across the banking sector, the framework ignores the difference in quality between banks' balance sheets. Bank-by-bank assessments are therefore essential to ensure consistent treatment of creditors and depositors and alignment with internationally recognized resolution standards.

WITH REGARD TO THE FINANCING STRUCTURE:

One of the main weaknesses of the bill is that it creates undefined future liabilities without clearly specifying how they will be financed. This raises serious questions about the feasibility and sustainability of the proposed financing structures.

- **ABS holders are technically compensated with long dated instruments of uncertain value.** The swap of deposits for long-term certificates creates uncertainty regarding the realizable value of claims. Large depositors are effectively given an acknowledgment of debt without clarity on who will ultimately bear the deficiency, should BDL assets and revenues prove insufficient.

- **The fate of the gold remains ambiguous,** despite the fact that the most recent issue of the bill refers to restrictions on the use of gold. The bill states "revenues from commodities and precious metals and the proceeds from the sale of assets" as potential backing for the ABS, but does not override nor amend the existing prohibition on gold disposal. It explicitly affirms Law No. 42/1986, which prohibits the disposal, sale, or pledging of BDL's gold reserves without explicit parliamentary authorization. This creates ambiguity about the actual financing mechanism and raises questions as to the intended use of gold for recovery.

- **The extent of the state's liability toward deposit recovery is also unspecified,** and may lead to future financial and legal risks. Instead of defining the extent of the state contribution, the law refers to Article 113 of the Code of Money and Credit, which opens the door to burdening the state with unsustainable obligations and debt levels, leading to later defaults.

Essentially, the text pushes unresolved losses into the future, creating contingent fiscal liabilities, and transferring significant risks onto BDL and the state. The draft bill does not set any limit to BDL's use of its assets, how much can be pledged, and what liquidity and capital buffers must remain. It also implies that the state is responsible for honoring any deficiency resulting from the banks' inability to make their share of the payments or BDL's inability to meet its capped contributions.

3. TREATMENT OF IRREGULAR TRANSACTIONS AND ACCOUNTABILITY

- **There are positive elements of accountability:** Irregular transfers, unjustified interest, preferential foreign exchange conversions, subsidized loan repayments, excessive bonuses, and suspicious accounts are subject to fines, claw-backs, revaluation, or freezing. All recovered amounts flow into the Deposit Repayment Account at BDL.

- **However, critical gaps remain: Measures are not anchored in forensic audits at both BDL and banks** which would clearly determine those who breached fiduciary duties, the regulation, and the law. While reference is made to the forensic audit in the latest draft of the law, the text does not link the audit to the resolution process or set it as a pre-requisite for accountability related measures. Moreover, fines imposed on certain irregular transactions are not sufficiently punitive.

- **In addition, the principle under which very large amounts of deposits are written off is legally fragile.** Litigation risk could compromise the entire process. Also, absent a definitive identification and quantification of « irregular transactions », the residual size of the gap at BDL would be undeterminable. The process might not result in restoring its solvency, thereby deepening the fiscal liability.

Treatment of 'irregular' transactions as stipulated by the bill:

CATEGORY	TREATMENT
(Art. 5.1) Transfers Abroad > USD 100,000 made after April 17, 2019, by major shareholders, board members, senior management, their relatives, agents, or controlled entities.	• Repatriation within 3 months of the law's effective date and subject to BDL circulars OR • If not repatriated: exceptional fine of 30% on the amount exceeding USD 100,000 • Fine proceeds transferred to the Deposit Repayment Account at BDL • Payment of the fine does not preclude judicial claims for full or partial repatriation
(Art. 5.2) Transfers Abroad > USD 100,000 executed after October 17, 2019, without valid commercial, industrial, educational, or medical justification, including PEPs as per FATF.	• Same treatment as above

CATEGORY	TREATMENT
(Art. 5.3) Excess interest from financial engineering. Accounts that received upfront or post-2016 interest (notably linked to financial engineering operations); applies only to balances exceeding USD 100,000 and capped at the account balance at law's effective date	• Deduction (claw-back) of excess interest from the account balance. • Banks record a reverse accounting entry on the customer's account. Corresponding reduction of banks' balances held at BDL.
(Art. 5.4) LBP-to-USD conversions or local-dollar check operations exceeding USD 100,000 where any portion was repaid in LBP at below-market rates between October 17, 2019 and the law's effective date	• Revaluation of the account balance in USD based on the following official rates per time period: Between 10/17/2019 and 12/31/2020: LBP 50,000/ USD 1 During 2021: LBP 35,000/ USD 1 During 2022: LBP 30,000/ USD 1 Between 1/1/2023 and the law's effective date: LBP 18,000/ USD 1 • The revalued amount is considered part of the depositor's total balance for repayment under the law.
(Art. 5.5) Loans and facilities exceeding USD 750,000 where any portion was repaid in LBP at below-market rates between October 17, 2019 and the law's effective date	• Exceptional fine of 30% on the repaid amount, payable in USD within 5 years • Fine paid to the Deposit Repayment Account at BDL • If unpaid, MoF enforces collection under tax recovery rules
(Art. 5.6) Bonuses and dividends paid to shareholders and senior bank employees as of 2016, and deemed excessive by independent evaluators	• Exceptional fine of 30% of the value, payable in USD within 5 years • Fine proceeds transferred to the Deposit Repayment Account • MoF enforcement if unpaid • Payment does not preclude judicial restitution claims
(Art. 5.7) Suspicious or illicit accounts suspected of false beneficial ownership or illicit source of funds under AML/CFT Law No. 44	• Referral to the Special Investigation Commission (SIC) • Accounts transferred to off-balance-sheet temporary accounts during freezing period • Corresponding off-balance-sheet transfer at BDL

4. FIGURES AND MACRO-FINANCIAL PROJECTIONS

The draft lacks an underpinning macro-financial-fiscal framework that would ensure debt sustainability, quantify the state's ultimate contribution, and provide a credible path toward restoring solvency and long-term economic growth.

The framework also lacks a system-wide assessment of foreign-currency availability, liquidity and mobilization capacity. Such a framework is necessary to validate the feasibility of the proposed deposits recovery mechanism; it assesses the liquidity that can be mobilized without compromising financial sector stability.

Data and figures are also needed regarding depositor repayment schemes, including a breakdown of deposits by size and number of accounts, the share of small deposits, the cost of their full protection, as well as the number of depositors who would actually be fully protected once account aggregation, eligibility exclusions, and adjustments for irregular or non-compliant accounts are applied.

CONCLUSION

The draft law aims to restore much needed financial stability through depositors' repayment, bank recapitalization, and balance-sheet restructuring at BDL.

However, the framework still raises significant macro-fiscal, legal, and implementation risks. The following need to be addressed to mitigate the risks of failure:

- **More clarity is required on the treatment of irregular deposits to confirm adherence to the hierarchy of claims.**

- **Repayment mechanisms should grant preferential treatment to pension and social funds.**

- **Assets used for the recovery of deposits above the USD 100,000 threshold should be ring-fenced within an independently managed Special Purpose Vehicle (SPV), with no recourse to the government.** Gold is not a productive asset in its current form; if it were to be used, it should be transferred to an SPV separate from BDL in order to generate real returns. A clearly defined share of those returns should then be earmarked specifically for deposit recovery.

- **A macro-fiscal framework, debt sustainability analysis, and liquidity diagnosis across the financial system are needed, in addition to the draft bill,** to validate the suggested deposit recovery scheme and specify state contribution levels to BDL recapitalization, among other variables.

- **A forensic audit of both the BDL and banks should be a prerequisite to the bank resolution process and an anchor to all accountability measures.** Without accountability, there can be no restoration of confidence in the financial sector.

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