

LET US (NOT) TALK ABOUT HAIRCUT

Lebanon : Bank Deposits in the Financial Turmoil

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EXECUTIVE SUMMARY

- Money is an asset, a property.
- Private property is the cornerstone of justice and democracy, and is expressly guaranteed in our Constitution.
- Lebanon's economic regime is free/liberal, as expressly stated in our Constitution.
- Dispossession (unless under strict conditions and with fair compensation) is unconstitutional, as expressly provided in our Constitution. The depositor is entitled to get its deposit back from the trusted depository. Any law that is enacted after the deposit was made, and which is hence given retroactive effect, and that allows the depository to refrain from giving back the deposit, is unconstitutional.
- The use by the State of formal mechanisms and process of law to dispossess citizens is unethical, for it constitutes use of brute-force of the law by the sovereign.
- Singling out one category of the Lebanese people - the depositors - and have them bear alone the State's losses is unfair and breaches the fundamental principle of equality of rights and duties among all citizens without distinction and preference, which is expressly guaranteed by our Constitution.
- Furthermore, making a specious distinction between "large" and "small" depositors, instead of distinguishing between "law-abiding" and "law-breaching" depositors, and giving a preferential treatment to the "small" ones, also breaches the principle of equality.
- Haircut establishes an illogical shortcut in the legal reasoning: the depositors are the creditors of the banks, and the State is the debtor of BDL and of the banks; to impose an "offset" between the unrelated State's debts and the depositors' creditor rights is simply to turn the world upside down.
- Even if, as alleged, the money in the banks is gone, wiped out by the State's losses, that does not mean that the State should be entitled to force the depositors to waive their claims against the banks, as well as the claims that they might have against BDL and the State by way of an actio pauliana ("action paulienne") or an indirect action; these claims could be submitted now or later upon better fortune. The haircut will be a forced extinction of the bank's debts towards the depositors, and a discharge, a waiver obtained forcibly by the State from the depositors who would then cease to have a title for their full claim. It is exactly as inadmissible as a haircut imposed to Eurobonds holders without their consent (CAC permitting, of course). The Russian Bonds of World War I (1914-1917) were partially repaid in ... 1996, for those who had the bonds/titles at hand. The haircut will destroy the depositors' title.
- Individual initiative is also expressly protected by our Constitution. Forcing the banks and the depositors (both from the private sector) to assume the losses of the State (public sector), will cause individual initiative to be smothered for years, and will put an end to any possibility of attracting inflows of money from investors and expatriates.

INTRODUCTION

We posit and we will show that haircut is unconstitutional, unethical and unfair.

It is even more so, when haircut is undertaken by the same political and financial apparatus that brought Lebanon to its knees through sheer corruption, squandering, and theft of public assets.

It is worth reminding that money in the banks is an asset, a property, and that all constitutional and legal provisions applicable to property apply thereto.

The State is a bad debtor, who borrowed more than it could afford and spent well beyond its means. It is not up to the honest law-abiding, tax-paying bank depositors to wipe the slate clean for the same apparatus so as to allow it to pursue the same path which will inevitably bring the country to the same place a few years from now.

It goes without saying that this is not aimed at the present Government, who inherited a dire situation and is compelled to act as a bankruptcy liquidator. But this Government should act as a trustful liquidator, abide by the rule of law, and treat all parties in strict equality.

No haircut is acceptable. Should only be considered the recovery of stolen public assets, the questioning of the culprits, the auditing of public accounts, the selling of State's assets, PPP, the assigning of future proceeds to special funds, etc. Numerous ways are available; haircut on the bank deposits of honest depositors (whatever their "size") is not one of them.

Even if, as some financial wizards say, the money in the banks is gone, wiped out by the State's losses, that does not mean that the State should be entitled to force the depositors to waive their claims against the banks, as well as the claims they might have against BDL and the State; these claims could be submitted now or later upon better fortune. The haircut will be a forced extinction of the bank's debts towards the depositors, and a discharge, a waiver obtained forcibly by the State from the depositors who would then cease to have a title for their full claim. It is exactly as inadmissible as a haircut imposed to Eurobonds holders without their consent (CAC permitting, of course); the latter are lucky to have the Courts of New York protect their rights, whereas the Lebanese depositors are left to face the Apparatus on their own, without any real recourse.

Haircut is not a pure accounting issue to be left to cold consultants, investment bankers and financial wizards. It is an issue that goes to the core of our Constitution, of our fundamental rights, and of basic fairness and ethics. It is not about writing off some figures in a balance sheet (which, by the way, does not bring any fresh oxygen to the economy), but it is about life savings and often about life itself.

We will briefly present the Government paper prepared with Lazard Frères SAS and which provides for a haircut on bank deposits (**A**), before showing to which political and financial apparatus the unarmed depositors are opposed (**B**), and finally why a haircut on bank deposits is totally unacceptable (**C**).

A- THE GOVERNMENT PAPER PREPARED WITH LAZARD FRÈRES SAS

The whole political and financial apparatus of the Lebanese State (hereinafter, the "**Apparatus**") "discovers" today, "thanks" to godsend Lazard, that "*Lebanon is faced with an unprecedented economic crisis*" (page 1 of the **Lebanese Government's Reform Program paper** – draft of circa

April 6, 2020). Gone are the reassuring statements, made no later than the summer of 2019, on the health of the Lira and of the economy. The Apparatus considers that the USD 83 billion losses (page 19 of the Program paper) are mainly embedded with Banque du Liban (BDL), as if they are not the State's losses, but the banking sector's. And if this is the case, it would be the State's responsibility to bail out BDL, to recapitalize it, without passing the buck to the banks and/or to the depositors.

Strangely, the Program paper mentions very specific figures of losses, at a time when the Government has officially acknowledged that it does not have BDL figures : during its meeting of March 26, 2020, the Council of Ministers resolved to entrust the Minister of Finance to take with BDL the measures necessary to *“show the real reasons of the current financial and monetary situations, in addition to showing the precise figures of BDL balance sheet and profits and losses statement and the level of foreign currency reserves.”* Governing is continuity, and this Government's decision looks like an act of defiance by the current Government towards the previous ones who did not have these information. As for requesting the Minister of Finance to undertake this mission, it is also a criticism of its Ministry which was supposed, as we will see below, to control BDL, and who failed to do it properly.

The Program paper is very vague on reforms, silent on public service reduction, shallow on recovery of stolen assets and on putting an end to corruption and smuggling, which are the scourges of Lebanon. But then, the Program paper is very detailed and minute on new and increased taxes (pages 12 et seq.), prudishly calling them *“Revenue-Enhancing Measures”*, and also on getting the State's hands on the bank depositors' money, commonly known as *“haircut”* but called by the Program paper **“Transitory Exceptional Contribution** from large depositors” (pages 18 et seq.).

Of course, reforms have been promised, for two decades, since the International Conference of Paris 1 in February 2001 up to the *“Conférence Economique pour le Développement du Liban par les Réformes avec les Entreprises”* (CEDRE) in April 2018; reduction of the public sector or at least the cessation of new hiring have been on the table for years; the recovery of stolen assets has been recently in the limelight with bravado statements and empty declarations of bank secrecy lifting; to no avail.

Taxing the Lebanese people is easy; and haircutting the bank deposits is easier still. Some give it an aroma of technicality by branding it *“bail-in”* and proudly opposing it to bail-out. They applaud the fact that no bail-out means that no money will be disbursed by the State, but they keep silent about the fact that bail-in means taking (again) the Lebanese people's money, and also that bail-in applies to failed banks and not to banks' victims of a bankrupted State. A State cannot bail itself out from its own debt by forcing depositors to bail in their banks.

The Apparatus, assisted by Lazard, is now pushing on one single front: raising more taxes (and hence suffocating even more the private sector) and taking the depositors' money. They found complacent financial wizards, who display figures and charts to justify this forfeiture and try to conceal, under cold accounting justifications, an unconstitutional, unethical and unfair move.

Let us not forget that haircut alone is just an accounting entry which does not solve the financial needs of the country, and its only result is to make depositors lose their rights on their money and their claims against the banks and against the defaulting State.

B- UNARMED DEPOSITORS AGAINST THE WHOLE APPARATUS

A brief reminder of the identity of political and financial parties to which the unarmed depositors are now opposed is necessary. The debt bubble that these parties have jointly created has burst; and, oblivious to the fact that this debt is odious, these parties are now trying to shift its unbearable burden onto the depositors.

1- The Ministry of Finance:

- has been the proud issuer of the Eurobonds year after year, with lavish road shows, prestigious teams of arrangers encompassing some of the largest banks in the world;
- has failed to collect taxes on a fair basis; and
- has refrained from fulfilling its role of controller of Banque du Liban as set in the Code of Money and Credit, either within the BDL Central Board (articles 17 et seq. of the Code), or through its Government Commissariat at BDL (articles 41 et seq.), or in the scope of the yearly mandatory presentation of BDL accounts (article 117).

2- The Parliament, save for a few of its members :

- has voted laws after laws authorizing external and internal borrowings;
- has failed for more than a decade to vote a Budget, and then approved heavily unbalanced successive Budgets (2017 to 2020 inclusive);
- has approved the public sector Law of Grid of Salaries (No.45/2017) with about 30 new or increased taxes, bringing the economy to a halt (some Parliamentarians, directly involved in the inception of this Law being more responsible than the others for presenting false figures, showing that the annual cost of the Grid was about USD 0.8 billion when it ended up costing about USD 2.5 billion; but that was the era where the billions had no value for them and could be easily borrowed or raised by more taxes);
- has never applied the constitutional rule that no Budget can be voted without the prior approval of the Discharge Bill of the previous fiscal year (article 87 of the Constitution); and
- has failed to legislate on the de facto capital control unilaterally and illegally imposed by the banks onto their depositors.

3- The Executive Power (in both its branches – articles 49 et seq. of the Constitution):

- has been a shadow power, which role has been only to rubber stamp decisions made by a few insiders and outsiders;
- has let each minister act on their own, giving a very extensive interpretation of the provisions applicable in that respect (article 66 of the Constitution) and allowing every single corruption and squandering scandal go unaccounted for; and
- has widely hired public servants for clientelism purposes, and lately in blatant breach of the freeze on hiring imposed by law (article 21 of Law No.46/2017).

4- Banque du Liban :

- has lent money **to** the public sector, in breach of the prohibition/conditions of such loans (articles 90 et seq. of the Code of Money and Credit);
- has turned a blind eye on the use of this money by some Ministries;
- has actively assisted the Ministry of Finance in marketing the subscription of the Eurobonds; and
- has used the banks' deposits in a way which remains to be qualified by experts (financial engineering, etc.).

5- The Banks, or most if not all of them :

- have breached the fiduciary duty they have towards their depositors, by lending very heavily to a debtor, the State, they knew to be illiquid and against which they knew they have no legal recourse enforcement-wise (article 860 of the Code of Civil Procedure) and who is not known (and this is euphemistical) to abide by the Conseil d'Etat decisions or arbitral awards rendered against it;
- have induced, since 2018, the depositors to block their deposits for long term periods in return for high interest rates; entered into questionable transactions with BDL by participating to the financial engineering; and
- have given preferential treatment to insiders in the scope of said engineering, or by allowing them to transfer money abroad at a time where they had imposed a very strict de facto capital control on the common depositors (since October 17, 2019 to date).

6- The Constitutional Council :

It is the only constitutional organ which can boast about its record. In the absence of self referral of new laws that it considers unconstitutional, the Council has to count on one of the three Presidents (of the Republic, of the Parliament and of Council of Ministers) or on 10 parliamentarians, to be able to control the constitutionality of new laws (article 19 of Law No.250 of 1993). Fortunately, 10 parliamentarians were very often to be found among the 128 to refer laws to the Constitutional Council, and the latter ruled more often than not in favor of annulling provisions of referred laws. This happened lately in relation with the Law of Grid of Salaries (decision rendered in September 2017) and the 2018 Budget Law (decision rendered in May 2018).

It is to be hoped that 10 parliamentarians would be found to refer any haircut law to the Council, such a law being in blatant breach of various constitutional provisions as we will show in section C below.

C- HAIRCUT ON BANK DEPOSITS IS TOTALLY UNACCEPTABLE

Facing this Apparatus, which brought Lebanon to its knees, by overborrowing and squandering public money, by seeding corruption, and generalizing the unfair treatment of the citizens (leaning heavily on law-abiding citizens and turning a blind and often complacent eye on those who openly and shamelessly breach the law), there is a category of persons who are now being singled out for a new onslaught : the "*large bank depositors*" (page 19 of the Program Paper).

A very efficient campaign was launched months ago to divert attention away from the thieves of public assets, corrupt public servants, malfeasant politicians, and to direct it first towards BDL, then towards the banking sector, and finally towards the "*large bank depositors*". Anyone who lands today in Lebanon without any prior knowledge of the country, and listens to the declarations of the politicians and some financial wizards, would rightfully be entitled to think that all the economical and financial ills and woes of this country are mainly due to the "*large bank depositors*" (in addition to BDL and the banks.)

In an illogical twist of facts, the Apparatus claims that those who deposited their money in the banks, and trusted the law and the system in doing so, are the ones responsible for the bankruptcy of Lebanon, because their money was channeled by the banks towards the State through BDL. That the State has squandered this money without limit or control is now to be forgotten, if not forgiven. The very same Apparatus, who is the real culprit, is now trying to commandeer the money

of innocent bystanders, by hiding behind the stellar name of Lazard and then by unfairly using all the legal mechanisms of the State.

The Apparatus seems oblivious of, or indifferent to, the fact that the haircut is unconstitutional, unethical and unfair for 11 different reasons:

1- We will start with the general principle laid in paragraph f) (*waw*) of the Constitution's Preamble which states that the "*Economic regime is free/liberal*". To haircut all bank deposits in all banks, without consideration of the status of each bank and regardless of the financial standing, is not a move that a liberal regime would contemplate.

2- Haircut is a direct dispossession of the deposited money, which are assets, properties. Consequently, haircut breaches the same above-mentioned paragraph f) of the Preamble which also declares that "*private property*" is guaranteed; and it also breaches article 15 of the Constitution which provides that "*property is under the protection of the law, and that it cannot be taken away except for public interest reasons in cases mentioned in the law and after a fair compensation is given*". There is no Lebanese law which mentions the possibility of applying haircut on deposits, and if such a law is enacted it should give the dispossessed depositors a fair compensation. To give the depositors shares in the banks is worthless since the Program paper considers that the bank equity has been wiped out, and to give them a portion of a hypothetical Fund to be supplied by even more hypothetically recovered stolen public assets (page 20 of the Program paper) is a pitiful proposal : if such recovery were possible, no haircut would have been needed. The Apparatus has stolen public assets, has never tried to recover any of them, and is now trying to dispossess innocent depositors in exchange for the unbelievable (in the two meanings of this word) promise to compensate them by giving them a share in a Fund that will be supplied by stolen assets to be recovered, from the Apparatus, by the Apparatus itself We leave it to the reader to gauge the seriousness and credibility of this proposal. To use the full powers it is granted in the Constitution, by enacting such an unconstitutional law, exclusively in its own interest and at the expense of a portion of its own people, so as to erase its own (odious) debt, is an enormously unethical move that the State should not even begin to consider. Beyond formal legal mechanisms and process, the State should stick to basic ethics and not use the law to sweep the traces of its own misdeeds and to clear the culprits.

3- The Apparatus has devised a distinction between "small" and "large" depositors, giving to the former angelic features and to the latter devilish ones. The small depositors, who own bank deposits of LBP 5 million or less, can immediately retrieve all their deposits and almost double them (BDL Basic Directive No. 12215 dated April 3rd, 2020). Why was the threshold set at LBP 5 million and by whom ? Who is entitled to establish distinctions between depositors ? This is a blatant breach of paragraph c) (*jim*) of the Constitution's Preamble which provides that "*Lebanon is a democratic parliamentary republic based on ... equality of rights and duties among all citizens without distinction or preference*", as well as of Article 7 which provides that "*All Lebanese are equal before the law and enjoy equally the civil and political rights and bear the public duties and obligations without any discrimination among them*". As John Rawls put it in his seminal book "*Justice as Fairness*", equality among citizens within egalitarian economic systems is at the root of fair society. The instigators and the authors of this BDL Directive boasted that it favors 60% of the depositors, forgetful that it discriminates against the remaining 40% who are not less worthy of attention and protection. To make matters worse, they promised to issue a new BDL Directive that will give preferential treatment to "middle size depositors" (we are now waiting for the instigators and the authors to devise a new unconstitutional distinction). By dividing the depositors into small, medium and large, and by giving preferential rights to the small and medium depositors, there is a

clear unfair treatment of the unlucky large depositors who are being ostracized before being dispossessed. Equality of rights and duties is a clear constitutional principle, and it is not up to BDL to discriminate between depositors. The distinction should have been made, for instance, between law-abiding depositors and law-breaching ones. Are the large depositors, who have earned money through hard work or by selling family assets to be able to raise their children or to cover their medical expenses, less worthy than thieves or gamblers or drug dealers who have squandered all their ill gotten money and kept only LBP 5 million in the bank ?

4- More importantly, and still based on paragraph c) (*jim*) of the Constitution's Preamble and the principle of "*equality of rights and duties among all citizens without distinction or preference*", the haircut establishes a negative discrimination between bank depositors and the remainder of the population. The State has borrowed about USD 100 billion, and has (theoretically) used them in the public interest of all the Lebanese population and not in the interest of the depositors alone. Consequently, any losses incurred by the State should be borne equally by the entire population and not by the depositors alone. Why distinguish between citizens who deposited their money in the banks and citizens who invested the same amount in an asset for instance ? Both (hopefully) paid their taxes, and both are Lebanese with the same rights and duties.

5- The often made allegation to justify a haircut, that the depositors have earned high interest, has no value for two reasons. First, the interest rates were well known to the Apparatus and were the fair price to pay by an unworthy and risky debtor. Second, by taxing the interest year after year, by raising twice the tax rate, and by easily collecting the related taxes, the Apparatus accepted this interest and created vested rights. Making a haircut, even on earned taxes and not on the principal, is to enact a retroactive (tax) law, and that goes against basic legal principles.

6- Haircut establishes an illogical shortcut in the legal reasoning. The bank depositor is the creditor of the bank; the bank is the creditor of BDL (and also of the State, through Eurobonds to which it subscribed); and BDL is the creditor of the State. Then, the State declares that it cannot reimburse its debt, and that triggers a chain effect : BDL cannot reimburse the bank, and the bank cannot give the money back to the depositor. If the rule of law applies, the defaulting debtor (i.e. the State), who is illiquid but still solvent, should use its (current and future) assets to pay back (even if partially) its creditors/lenders. In this case, that means that some kind of sale of State's assets should be contemplated (even if this is not enough to cover the losses). If the State decides to cancel its debt towards BDL and towards the banks by haircutting the deposits, then only the sole real creditors in the chain, i.e. the depositors, are illegally and unfairly dispossessed. It is as if the State imposes an offset ("*compensation*") between different parties having different contractual relations and without counterpart, since the State is a net debtor and the depositor is a net creditor; this is a legal heresy (article 328 of the Code of Obligations and Contracts).

7- If to compensate for the haircut, depositors are given shares in the bank in a wizardly devised bail-in, that would also constitute an unfair dispossession of the banks' shareholders, since the latter are also not responsible for the State's default and losses. Furthermore, to impose a bail-in on all banks, regardless of the specific situation of each, of its exposure to the State's debts and losses, and of the quality of its management, would be an equally unfair treatment of the banks and their shareholders as the one discussed above for the depositors. By the same token, it would be reasonable to give to the banks shares in BDL after its recapitalization by its sole shareholder, the State.

8- The bank which receives money from the depositor is bound to give back the same amount to the depositor (article 307 of the Code of Commerce). The depositor is entitled to get its deposit

back from the trusted depository. A haircut law, which is enacted after the deposit was made and which is hence given retroactive effect, gives the depository bank the unconstitutional order not to give back the deposit to its depositor (in order to wipe out losses totally unrelated to the depositor ... and to the bank).

9- Even if, as alleged, the money in the banks is gone, wiped out (indirectly so, since there is no legal link between the deposits and the State's debts and losses) by the State's losses, that does not mean that the State should be entitled to force the depositors to waive their claims against the banks, and also the claims that they might have against BDL and against the State by way of an indirect action (article 276 of the Code of Obligations and Contract) or of an *actio pauliana* ("action paulienne" – article 278 of the Code). These claims could be submitted now or later upon better fortune. The haircut will be a forced extinction of the bank's debts towards the depositors without satisfaction/repayment of the latter (article 290, para.3 of the Code of Obligations and Contracts). It will be a discharge, a waiver obtained forcibly by the State from the depositors who would then cease to have a title for their full claim. It is exactly as inadmissible as a haircut imposed to Eurobonds holders without their consent (CAC permitting, of course); the latter are lucky to have the Courts of New York protect their rights, whereas the Lebanese depositors are left to face alone the Apparatus without any real recourse. The Russian Bonds of World War I (1914-1917) were partially repaid in ... 1996, for those who had the bonds/titles at hand. The haircut will destroy the depositors' title and hope. We are told that the State's, BDL's and the banks' vaults are empty today. But come better days, the depositors should have their title at hand to claim their full dues. Rather than canceling/extinguishing the depositors' rights on part of their deposits, the State should make sure that they keep their rights thereon, without a set maturity and linked to better fortune of the State, of BDL and/or of the banks ("*clause de retour à meilleure fortune*") and senior to dividends and all other non-current payments.

10- The more vexing issue is that, after the haircut is undertaken, and the bank depositors are dispossessed without a fair compensation, the balance of their deposits will stay under capital control, will still be under forced conversion in Lira, and will remain at risk of new Apparatus illegal moves and new taxes, of bank bankruptcy, and of new State default (Argentina is now defaulting for the ninth time).

11- The Apparatus and some consultants are now singing in unison against the "rent economy", for whatever it means in such an under industrialized country with such small agricultural surfaces. They seem to forget that modern Lebanon has been built in (large) part by its bankers, its service providers, and more generally by a liberal and merchant private sector, who are the main taxpayers, and thanks to whom (unfortunately) the Apparatus has been able to reach this abysmal level of debt and losses. And they also seem to forget that they have killed the "*individual initiative*", mentioned in paragraph f) (*waw*) of the Constitution's Preamble, by over taxation and heavy bureaucracy. The haircut will not only pauperize the depositors, but will also crush the banking system, built by 50 years of hard work and unrelenting effort, putting an end to any possible inflows of money from investors and expatriates. By forcing the banks and the depositors (all from the private sector) to take on the losses of the State (public sector), the individual initiative is smothered for years, killing any hope of economic recovery.

The discussion about haircut eclipses the sole real issue: The Apparatus has stolen and squandered the money borrowed abroad and in Lebanon, and the culprits should be held responsible. It is not (only) about recovering stolen public assets (which could be considered an

arduous and time consuming task, and a hopeless one if entrusted to the Apparatus itself) as much as it is about accountability, real reforms, and building back the lost trust in the State.

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