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Unsustainable business model and required restructuring

April 18, 2020

Updated slides based on the original paper - February 2020 (https://lebanoneconomics.net/paper.html)

Prepared by Alia Moubayed, Gerard Zouein.

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Finding a way out of Lebanon's crisis: the case for a comprehensive and equitable approach to debt restructuring

prepared by Alia Moubayed and Gerard Zouein

February 2020

The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not represent the views of their respective employers.
This paper was finalized based on numbers published at the end of 2019, and before the outbreak of the Corona Virus. It does not reflect most recent developments and implications on the Lebanese economy

Synopsis: This paper advocates for an urgent comprehensive growth and fiscal adjustment program supported by the international donor community to deal with Lebanon's dangerous economic and financial crisis while ensuring an equitable burden sharing of the losses. At the heart of this program, a consolidated balance sheet approach is required for restructuring the country's debt (both sovereign and Banque du Liban's) and recapitalizing a right-sized banking sector while protecting small depositors. Using a model-based approach, the scenario analysis argues for taking Lebanon's debt to GDP to sustainable levels (60-80% of GDP) over the next 10 years. It stresses that the debt restructuring strategy should: 1) encompass BDL's USD liabilities; 2) design and implement a banks' recapitalization program that supports a right-sized and solid banking sector able to finance the growth recovery; and 3) ensure the cost of bank recapitalization and the burden of fiscal adjustment are equitably shared through a multipronged socio-economic policy reform framework. The paper estimates that reducing total debt to these levels by 2030 would require no less than a 60-70% principal reduction if the authorities wanted to reduce the extent of an inevitable currency devaluation, and create the fiscal space to support growth and expand social safety nets. Therein, the objective should not be to cut primary spending indiscriminately, but rather to improve its composition and efficiency. The paper warns that inaction and/or delays by using piecemeal solutions is regressive, exacting bigger losses on small depositors and the most vulnerable in society.

Note: The numbers presented in this paper are based on publicly available information as of December 2019 and estimates (e.g. the banking sector USD deposits at BDL, government arrears and contingent liabilities, etc.). As such, the analysis that follows could be subject to material changes should some of this information prove to be substantially different from what is publicly disclosed (e.g. the foreign currency liquidity at BDL). The material is used as part of various citizens' initiatives which aim to engage stakeholders inside and outside Lebanon in order to shape the priorities and direction of future economic reforms while stressing the importance of an evidence-based policy framework for dealing with the crisis. The authors welcome any comments and suggestions for improvements as the objective of this paper is to help raise awareness about Lebanon's multifaceted crisis and contribute to the public debate. They also recognize that some aspects of the analysis need further study notably in terms of the legal and regulatory feasibility of some proposals.

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نحو مخرج لأزمة لبنان المالية: لمقاربة شاملة وعادلة لإعادة هيكلة ديون لبنان

علياء المبيّض وجيرار زوين

شباط 2020

الآراء والخلاصات المعروضة في هذه الدراسة تمثّل من كتبها بصفتهم الشخصية، وهي لا تمثّل وجهة نظر أرباب عملهم أو الشركات حيث يعملون
أعدّت هذه الدراسة استنادا إلى أرقام منشورة في نهاية العام 2019 ،و قبل انتشار وباء الكورونا، وبالتالي فهي لا تأخذ بعين الاعتبار المستجدات الأخيرة وتداعياتها على الإقتصاد اللبناني منذ ذلك الحين

لمحة: تدعو هذه الدراسة إلى إطلاق برنامج طارىء وشامل للنهوض الاقتصادي والإجتماعي وللتصحيح المالي، تدعمه الجهات الدولية المانحة لمواجهة أزمة لبنان الاقتصادية والاجتماعية والمالية الخطيرة، بشكل يوزّع الأعباء بشكل عادل. وتشدّد الدراسة على ضرورة اعتماد مقاربة موحّدة لميزانيات القطاع العام ومصرف لبنان والمصارف تبنى على أساسها عملية إعادة هيكلة المديونية وإعادة رسملة القطاع المصرفي بشكل يحمي صغار المودعين. وبالاستناد إلى نموذج رقمي، تشير السيناريوهات المعروضة إلى أهمية استهداف مستوى دين عام مستدام يناهز 60-80٪ من الناتج المحلي الإجمالي بحلول العام 2030، كما وعلى ضرورة أن تتوفّر في عملية إعادة الهيكلة العناصر التالية: 1) أن تشمل مطلوبات مصرف لبنان بالعملات الأجنبية، 2) أن تترافق مع تنفيذ برنامج لإعادة رسملة المصارف يهدف إلى إعادة بناء قطاع مصرفي حجمه متّسق مع حاجات الإقتصاد التنموية، ج) أن تُوَزَّع أعباء التصحيح المالي وإعادة رسملة المصارف بشكل عادل وفق برنامج إقتصادي إجتماعي متكامل الأهداف. وتقدّر هذه الدراسة أن خفض نسبة الدين إلى هذه المستويات بحلول عام 2030 سيتطلّب اقتطاع 60-70٪ من مجمل أصل الدين العام (بالليرة وبالعملات) إذا ما أرادت السلطات التخفيف من حدّة تدهور سعر صرف الليرة اللبنانية المتوقّع والسماح بتوسيع المساحة المالية لدعم عجلة النمو وتوسيع شبكات الأمان الإجتماعي. وليس الهدف من التصحيح المالي خفض الإنفاق الأولّي بشكل عشوائي، بل تحسين كفاءته وجودة مكوّناته والحدّ من الهدر. وتحذّر الدراسة من التقاعص والتأخير في اتخاذ القرارات الصائبة. فكلفة عدم المبادرة كما الإستمرار بالتدابيرالمجتزأة، سيكون لها أثرا رجعيا إذ تحمّل أعباء كبيرة للمودعين الصغار وللفئات الأكثر تهميشاً في المجتمع.

ملاحظة: *الأرقام الملحوظة في هذه الدراسة مبنية على معلومات منشورة بنهاية العام 2019، كما وعلى بعض التقديرات (مثلا: ودائع القطاع المصرفي بالدولار لدى مصرف لبنان، المتأخّرات الحكومية، ...). بالتالي يمكن أن تتغيّر نتائج الدراسة إذا ما تبدّلت هذه الأرقام أو المعطيات بشكل كبير و(لاسيما ما يخصّ العملات الأجنبية لدى مصرف لبنان). وتجدر الإشارة إلى أنّ مواد وخلاصات هذه الدراسة عرضت ضمن مبادرات مواطنية عديدة منذ العام 2019 تهدف إلى إشراك المواطنات والمواطنين داخل وخارج لبنان في صياغة أولويات وتوجهات السياسات والإصلاحات الإقتصادية وفق أسس علمية لمعالجة الأزمة. ويرحّب فريق العمل بأيّة إقتراحات و/أو ملاحظات تساعد بتحسين هذه الدراسة وتطويرها بهدف رفع مستوى الإدراك حول الأزمة الاقتصادية المتعدّدة الأوجه والمساهمة في النقاش العام. كما يدرك فريق العمل بأنّ بعض جوانب الدراسة بحاجة إلى مزيد من البحث لاسيما في ما يتعلّق بالجوانب القانونية والتنظيمية لبعض الإقتراحات.*

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- This presentation focuses **mainly** on the need to tackle the debt overhang and BDL losses through an equitable burden sharing as a priority towards an **orderly** fiscal and exchange rate adjustment.
- It suggests **possible scenarios/options** to discuss and assesses their feasibility.
- It **DOES NOT** address all aspects of Lebanon's unfolding crisis and possible remedies (namely the details of required fiscal policy measures, the elements of a new growth and financing model for the Lebanese economy).

Outline

- Section 1: Snapshot of the current macroeconomic situation and how did we get here?
- Section 2: What happened in other crisis countries, and where is Lebanon heading?
- Section 3: Scenarios of debt restructuring and possible burden sharing
- Conclusions and Issues for further discussion

Key messages and conclusions

- **Urgency is required.** The cost of inaction is too high and will increase with time as losses accumulate endangering social stability and security.

- **Debt restructuring should be deep and comprehensive** in order to smooth the burden of required fiscal consolidation, and provide fiscal space for expanding social safety nets and support growth. Dealing with BdL (>$30bn of net negative FX position) is crucial to avoid a disorderly devaluation and to restore confidence in the LBP.

- **An equitable burden sharing is necessary** for maintaining the social peace and should underpin efforts at **recapitalizing and restructuring the banking sector**.

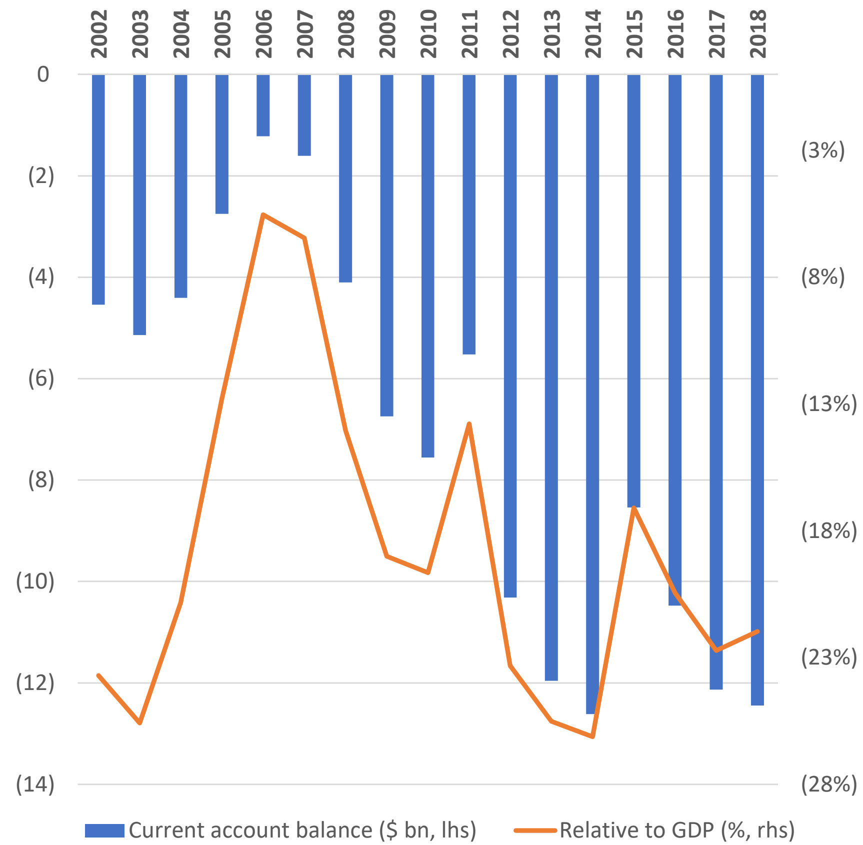
- Anchoring debt restructuring and banking sector recapitalization within a **comprehensive macro-fiscal and growth recovery program is essential.**

- The ultimate objective of the planned restructuring and recapitalization should be to **build a new economic growth model for the Lebanese economy.**

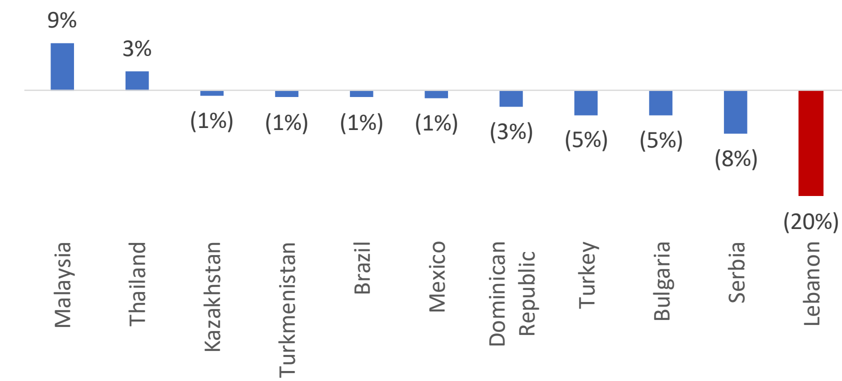
Snapshot of the current situation: How did we get here?

Current account deficit – Large, recurrent and unsustainable

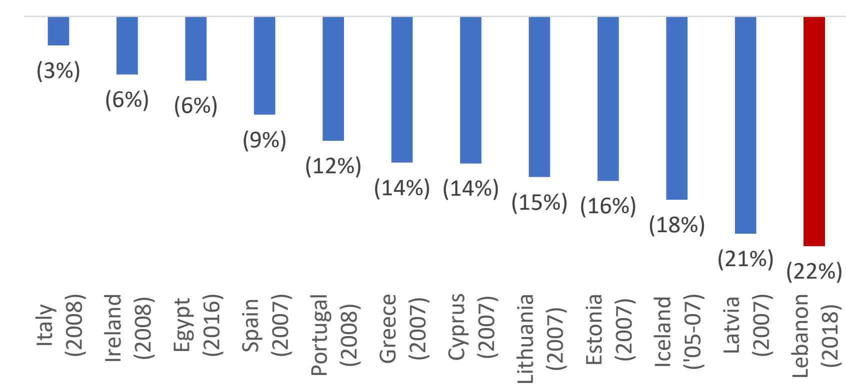
Current account deficit over time



Relative to GDP vs. other countries (cum. since 2002)*



Relative to "trouble" countries at start of crisis



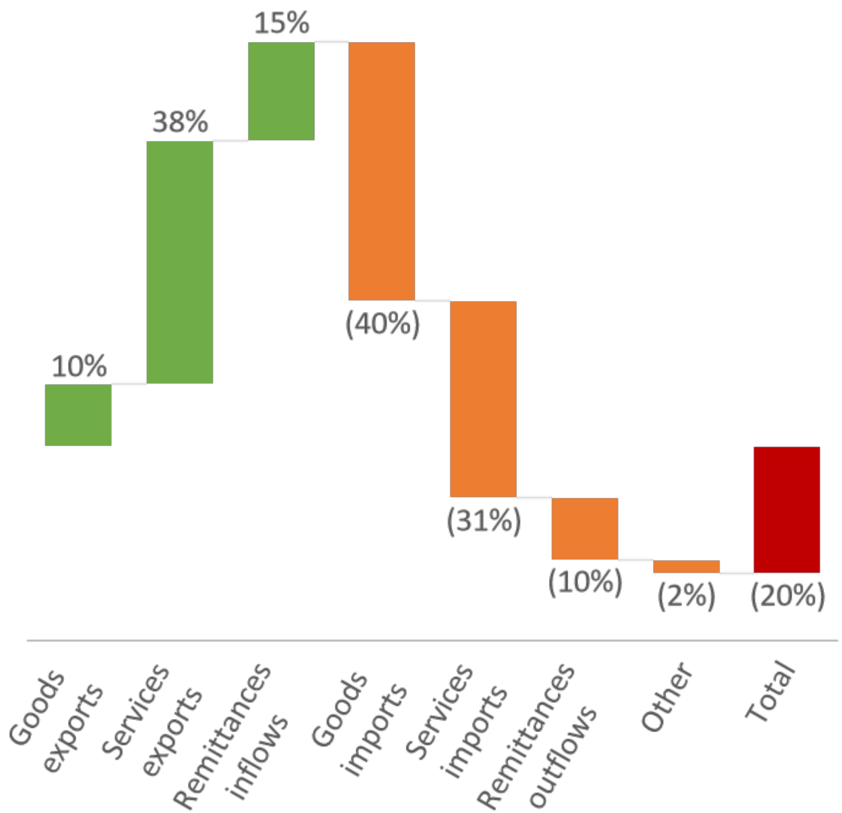
Lebanon has one of the largest current account deficits in the world and compared to any other country at the onset of its crisis.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

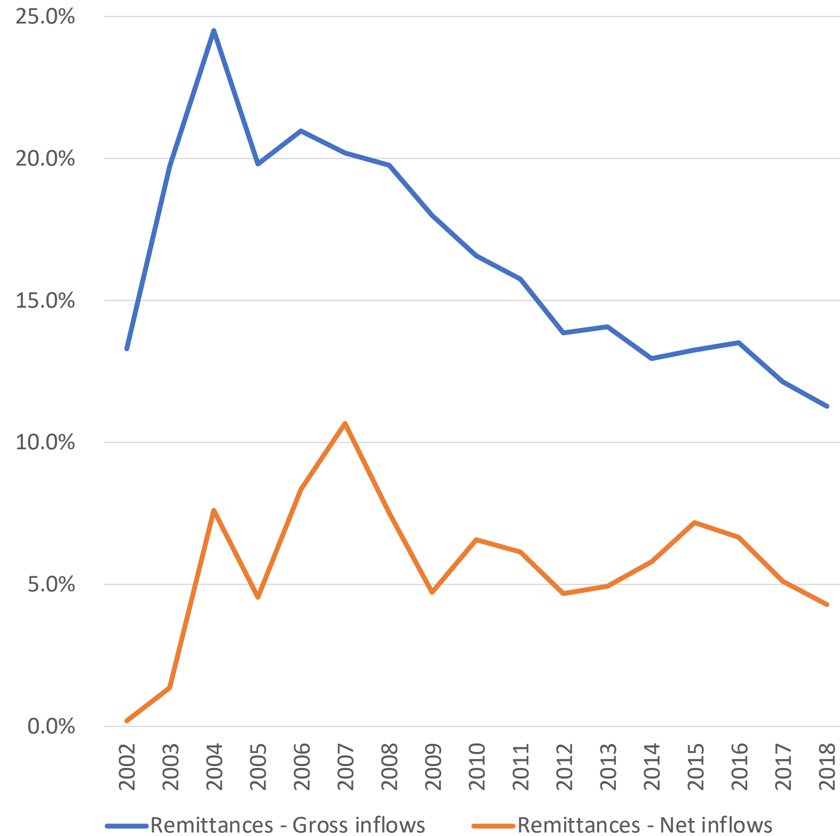
*Note: *Countries of similar GDP per capita and population >5m.*

Current account deficit – Large, recurrent and unsustainable (cont'd)

Breakdown of deficit relative to GDP (cum. since 2002)



Remittances relative to GDP over time

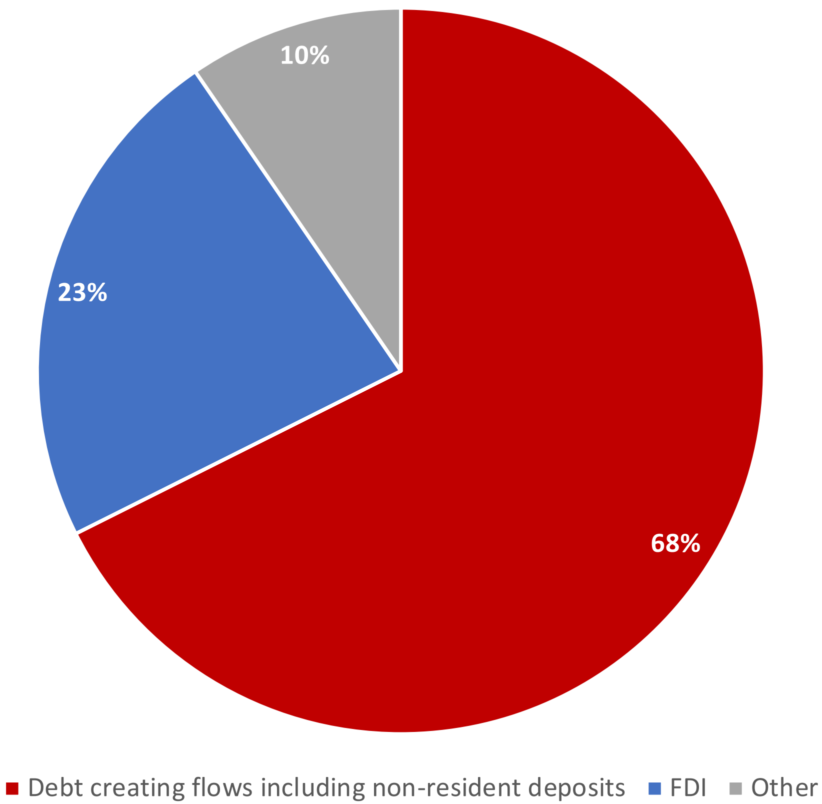


Net remittances have been deteriorating since 2015 while a fixed exchange rate allowed the Lebanese to live above their means running a large deficit in the balance of goods and services.

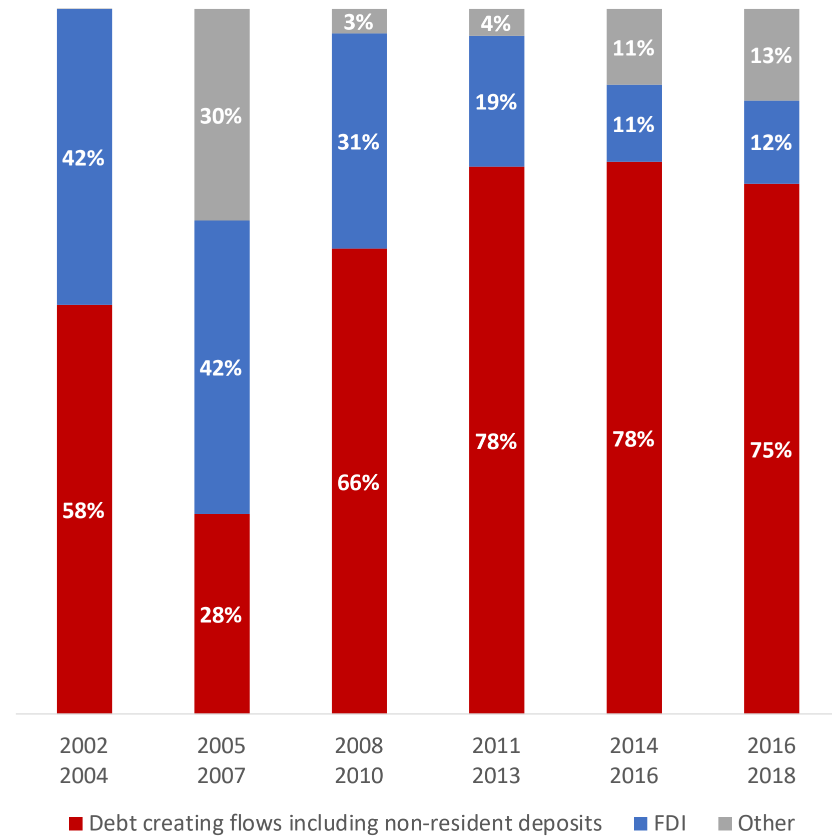
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Current account deficit – Funded through debt creating flows

Financing of the current account (cum. since 2002)*



Financing of the current account over time*

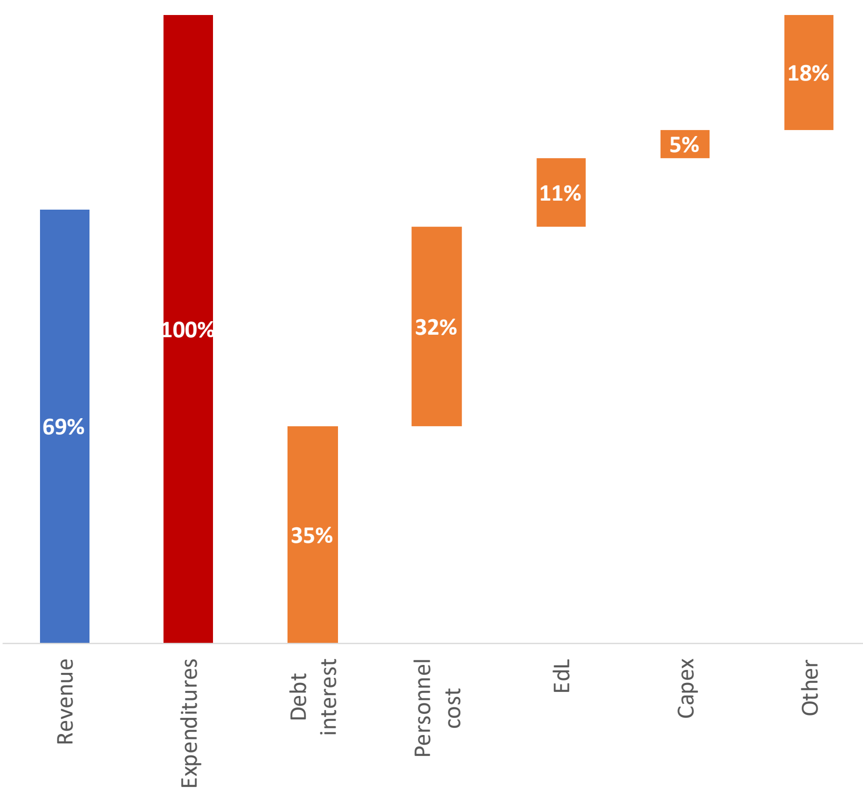


Lebanon relied on debt creating flows to finance its large current account deficits, a large part of which were non-resident deposits of foreign institutions and the diaspora. Confidence and excessive returns were key drivers.

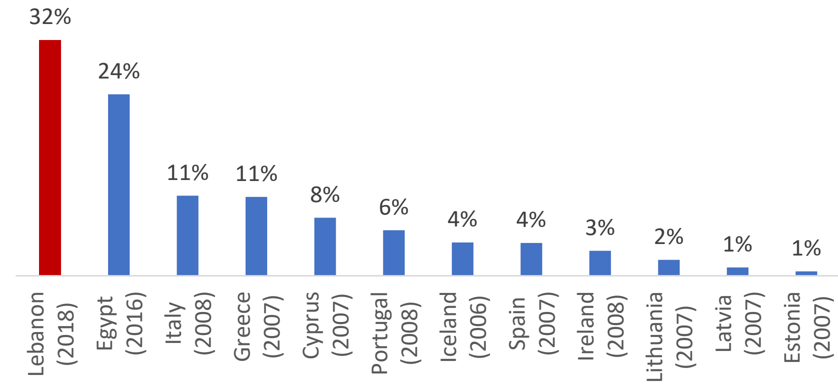
*Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban. Note: *Based on Capital & Financial Account (ex. Net errors and omissions and Reserves).*

Fiscal deficit – Large, recurrent and unsustainable with increasing budget rigidity

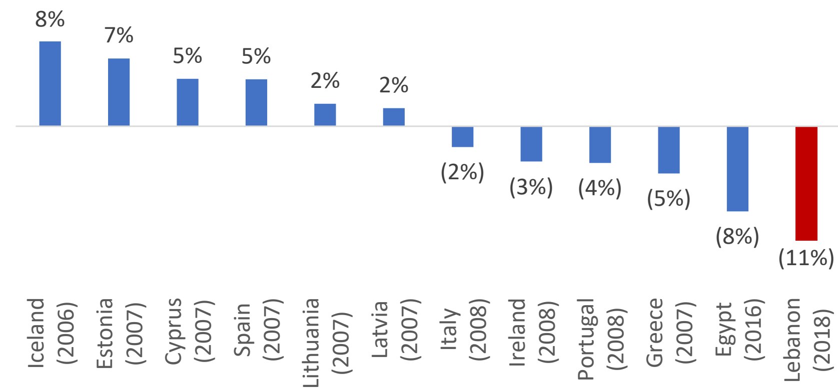
Fiscal balance (cumulative since 2002)



Interest payment as % expenditures relative to others



Fiscal balance as % of GDP relative to others

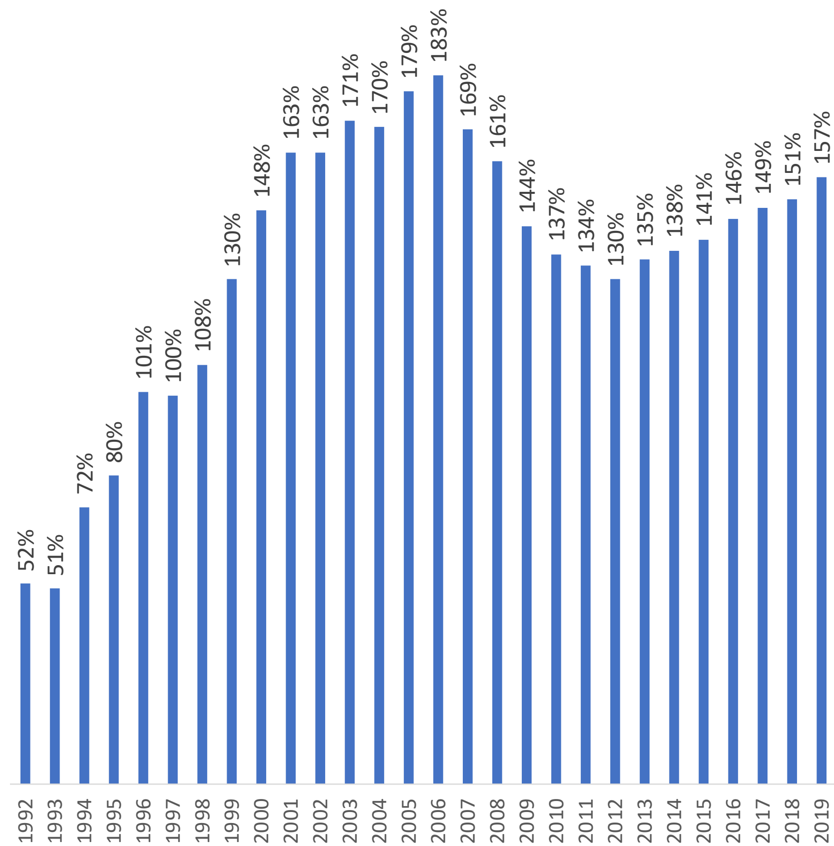


Expenditures are rigid and vulnerable to changes in interest rates and oil prices. Debt service eats ~50% of revenue, wages ~50%, and EdL ~15%, leaving no room for Capex, critical for long-term productivity and growth.

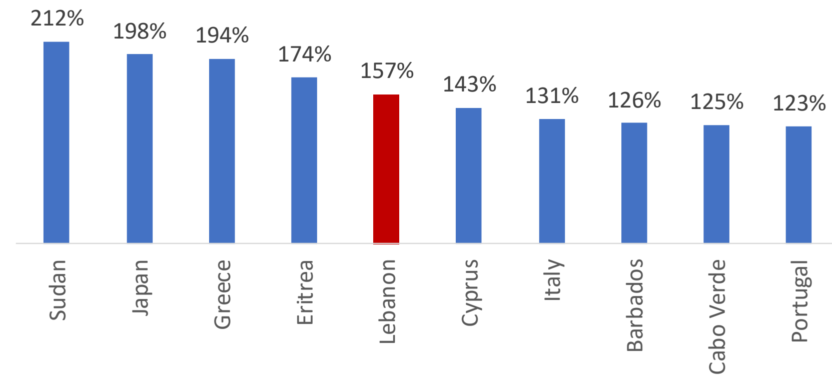
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Fiscal deficit – Large and recurrent, leading to rapid accumulation of public debt

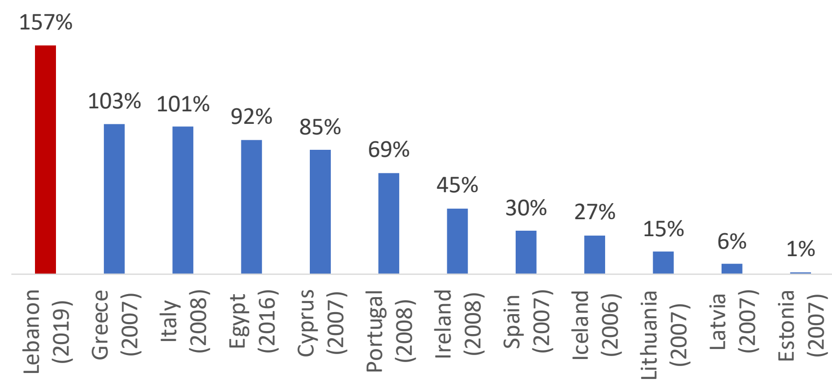
Public debt to GDP since 1992



Highest public debt to GDP in the world (2018A)



Relative to "trouble" countries at start of crisis

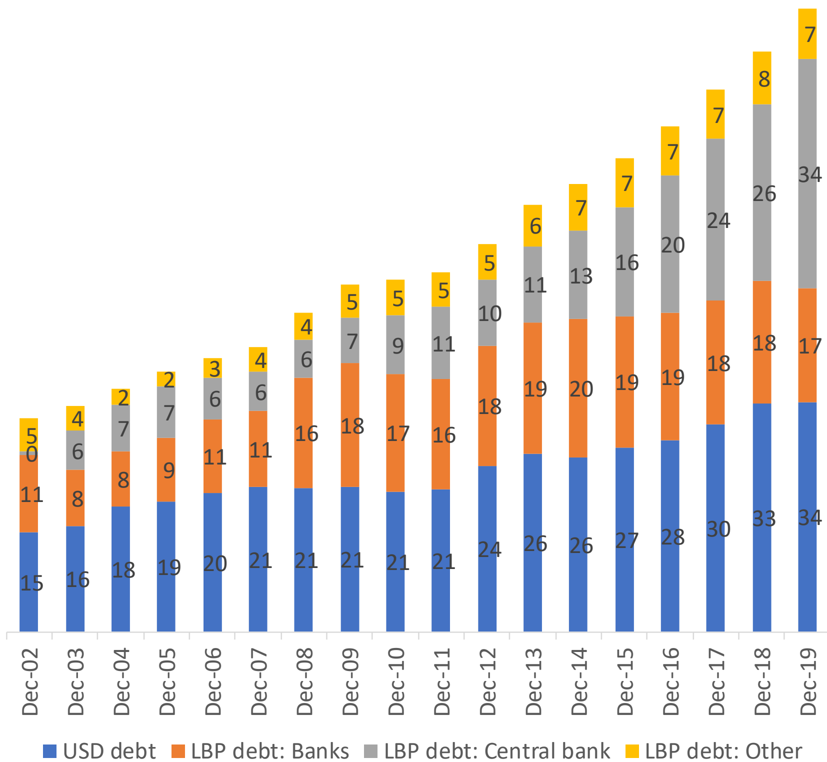


One of the worst public debt levels relative to GDP in the world. Most importantly Lebanon's current debt position is substantially worse than other "trouble" countries ahead of their crisis

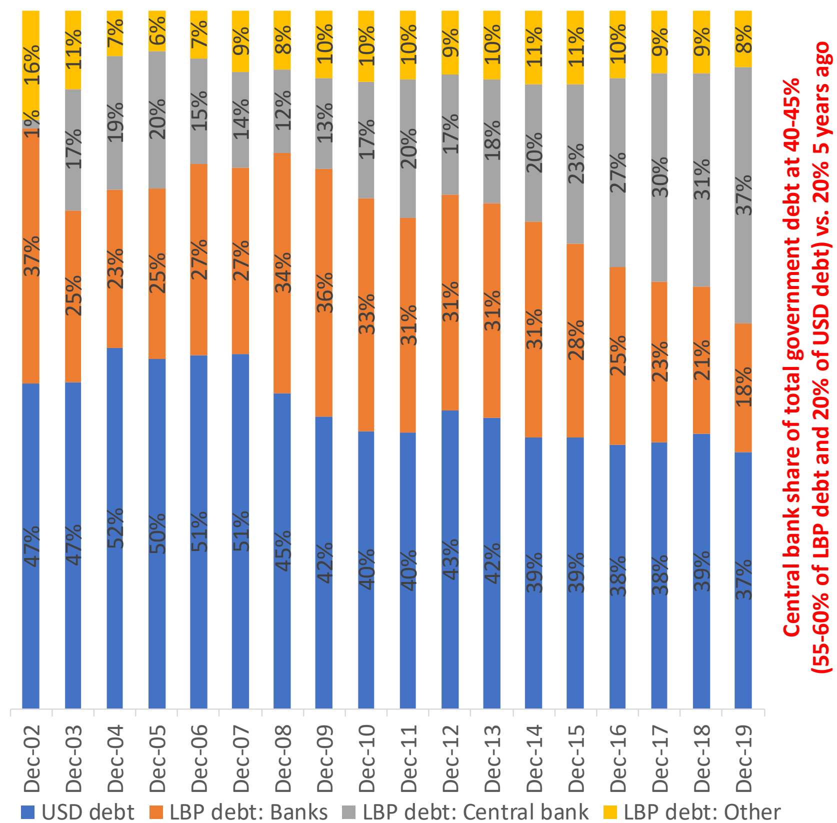
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Fiscal deficit – Increasingly funded through the central bank (debt monetisation)

Public debt evolution since 2002 ($bn)



Share of public debt (%)

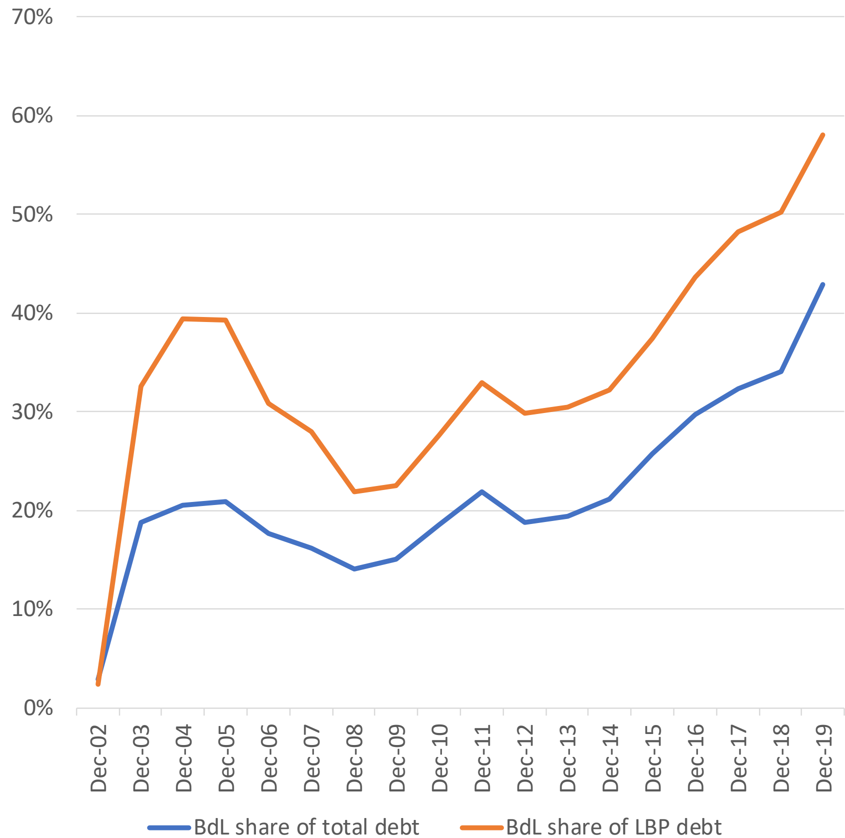


The USD share of public debt declined as government struggled to tap international market. ~50% of USD debt owned by local banks, another ~20% by BdL. The latter's share of LBP debt increased over time (debt monetization)

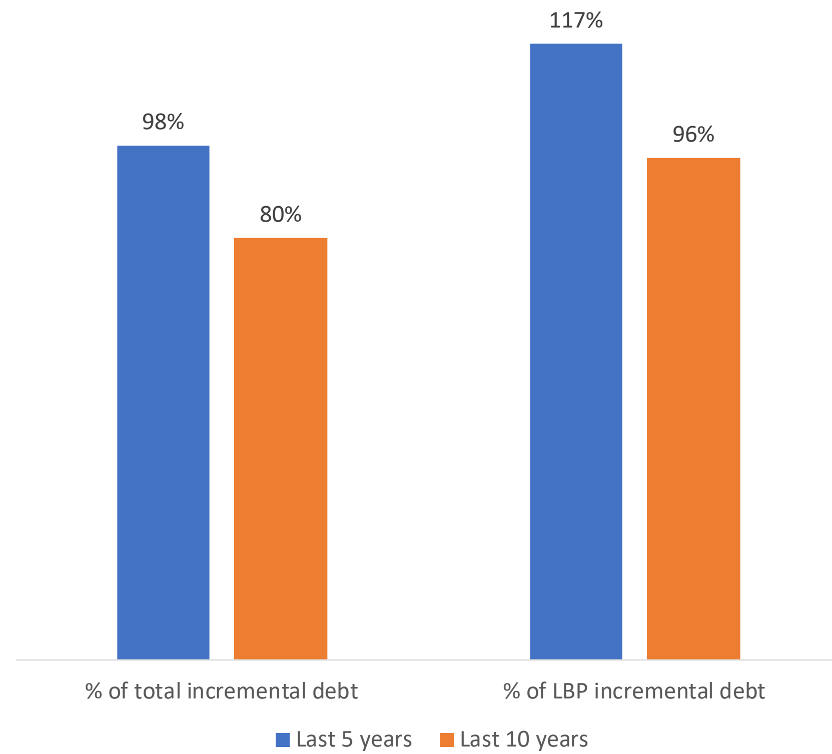
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Fiscal deficit – Banque du Liban has been the sole financier of the fiscal deficit

BdL share of government debt over time



BdL share of incremental government LBP debt

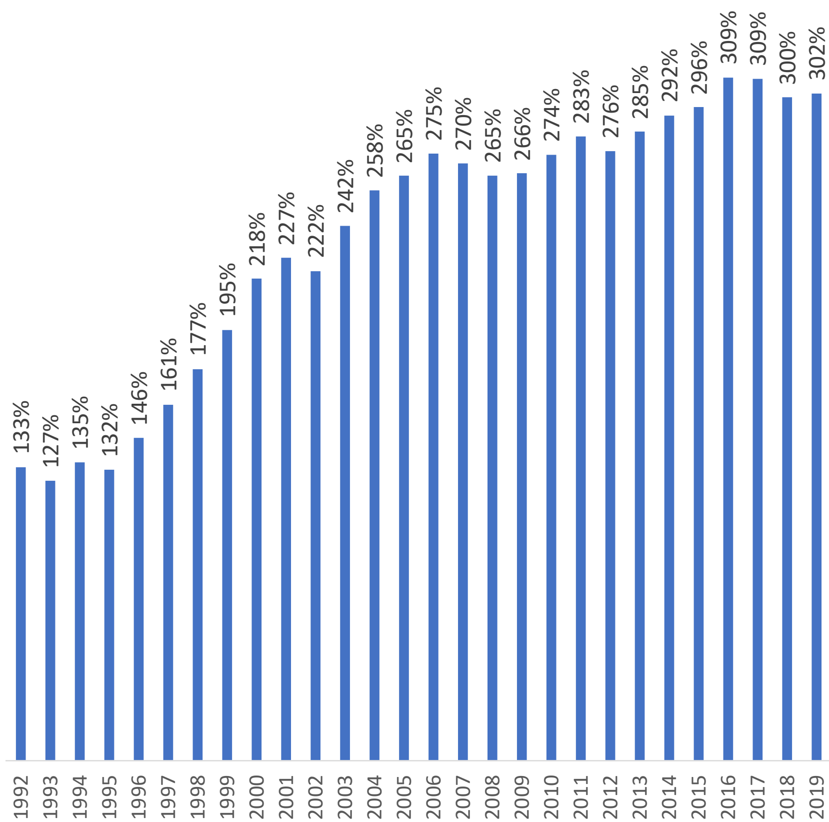


BdL funded most the incremental LBP government borrowing over the last 10 yrs (debt monetization)

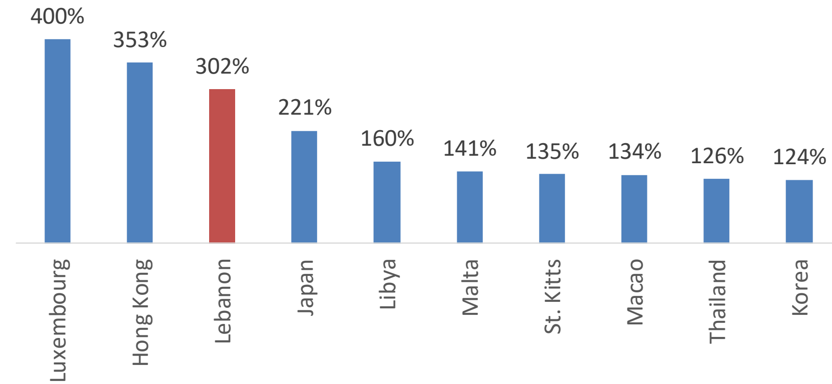
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Current account & fiscal deficits were funded by deposits into the banking sector

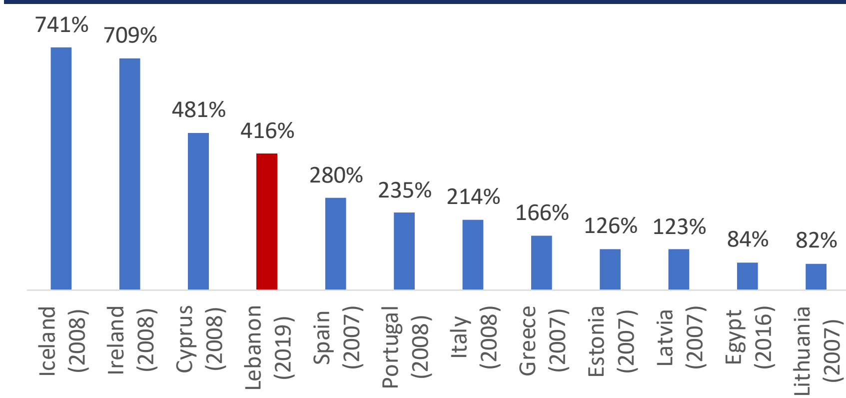
Lebanese banking sector total deposits as % of GDP



World's highest banks deposit to GDP (2018A)



Total banks assets to GDP vs "trouble" countries

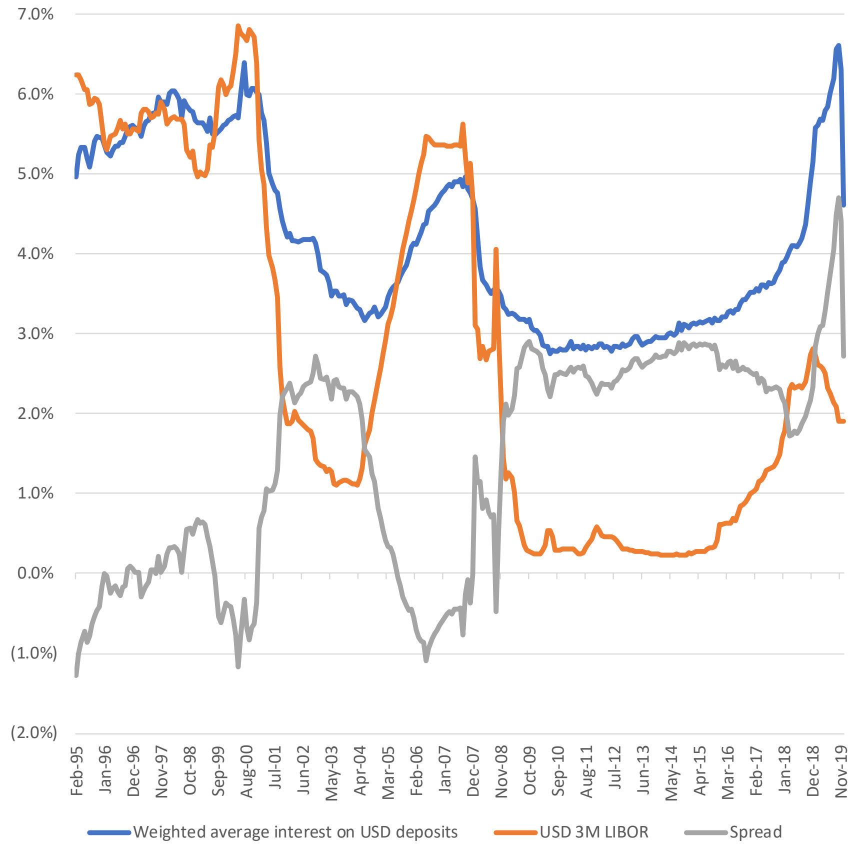


Strong deposit inflows, lured by excessive returns post 2015 led to an outsized banking sector relative to GDP.

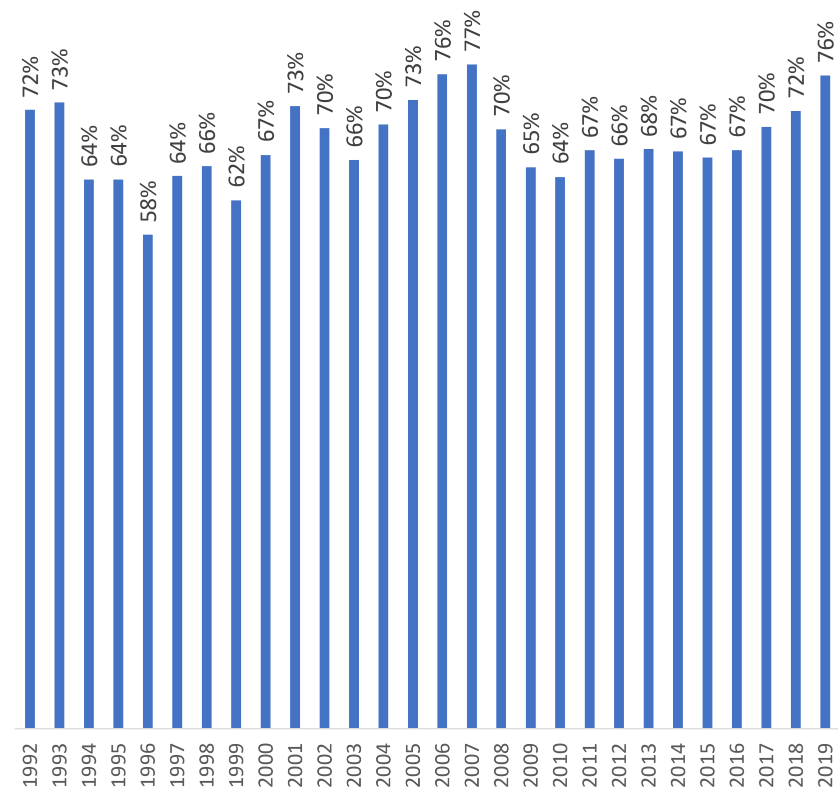
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban, OECD, individual countries central banks.

Deposits inflows were driven by attractive interest rates differentials

Lebanese banks rates on USD deposits vs 3M Libor (%)



Dollar deposits relative to total deposits (%)

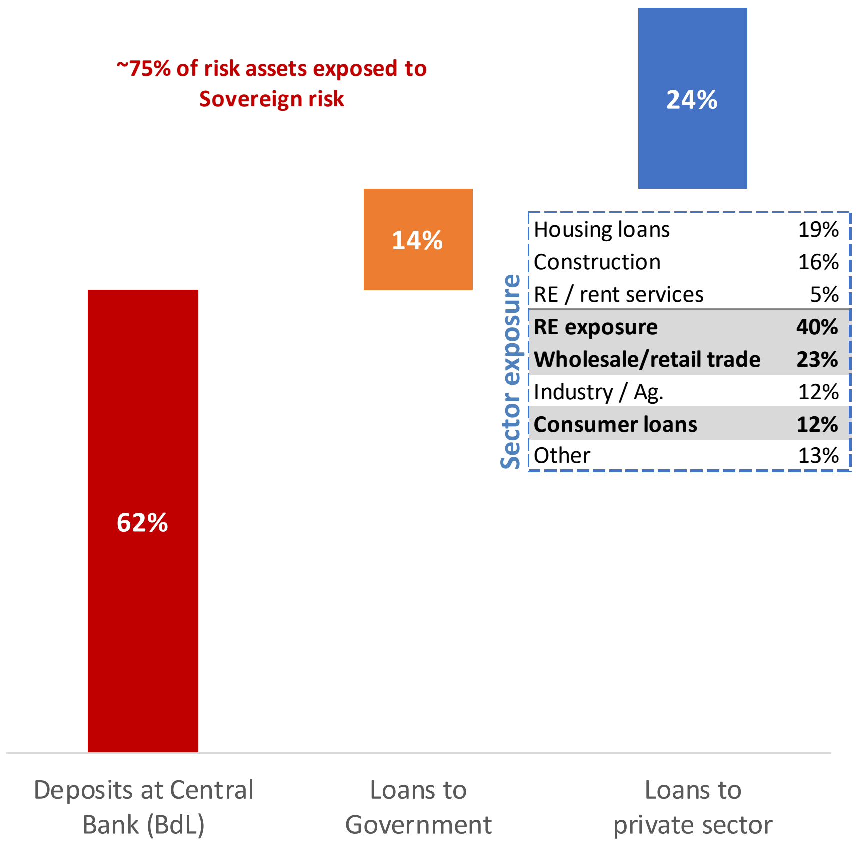


Inflows driven by attractive interest rates differentials (~250bps premium to LIBOR), compounded by a sizeable diaspora, kept deposit dollarization elevated (70% of deposits in $).

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

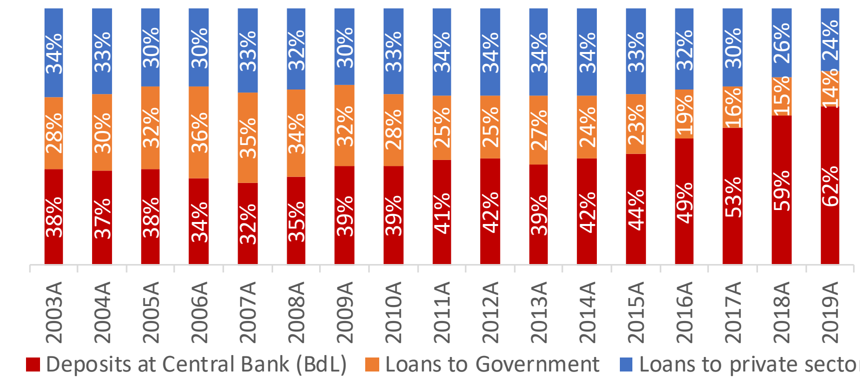
Business model significantly weakened banks and put depositors’ money at risk

Banks risk assets composition (%)

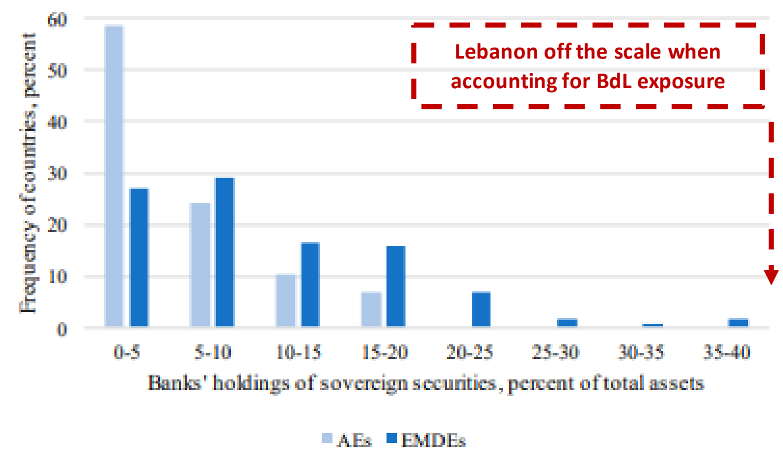


Housing loans	19%
Construction	16%
RE / rent services	5%
RE exposure	**40%**
Wholesale/retail trade	**23%**
Industry / Ag.	12%
Consumer loans	**12%**
Other	13%

Banks risk exposure evolution over time (%)



Relative to other countries

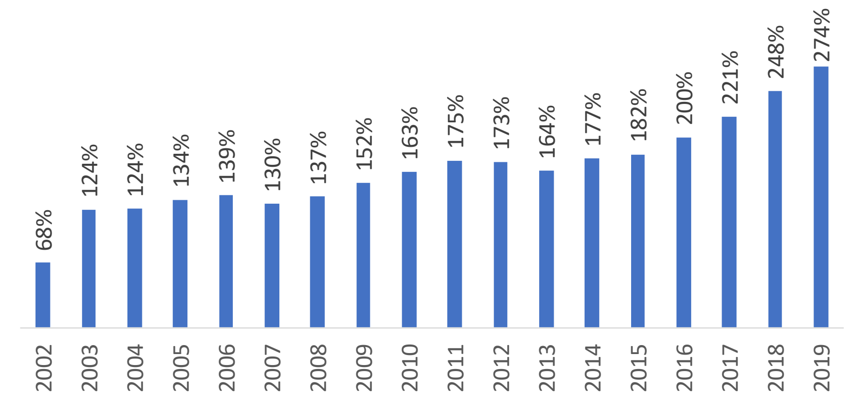


The banks’ business model relied on lending to government and shifted to BdL as sovereign creditworthiness deteriorated. Banks became “brokerage houses” undermining their “underwriting expertise” to some extent.

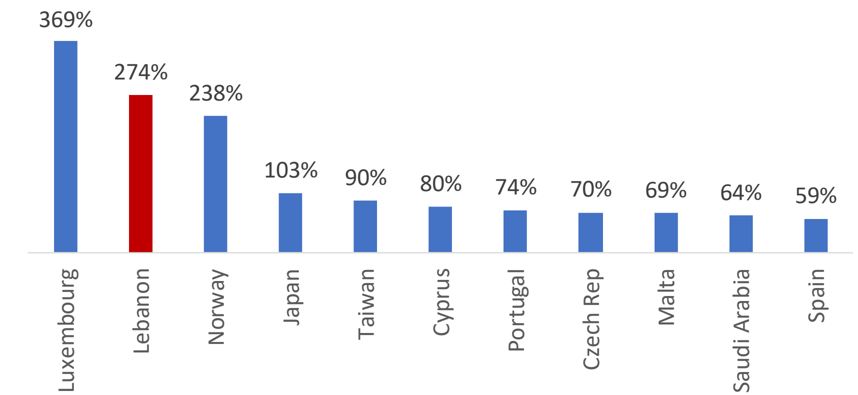
Source: IMF, World Bank, Lebanon’s Ministry of Finance, Banque du Liban.

Banque du Liban balance sheet increased significantly over time

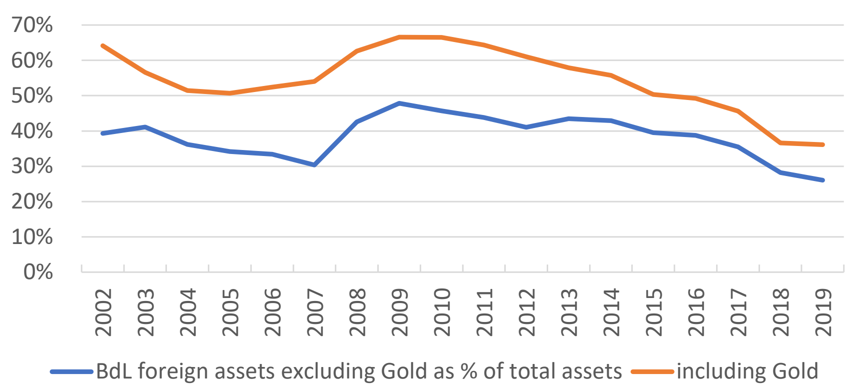
BdL total assets relative to GDP*



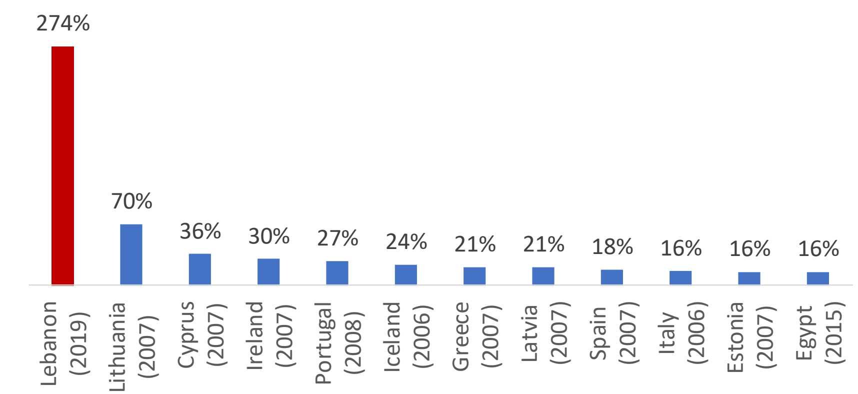
World's largest CB balance sheet size relative to GDP*



BdL foreign assets relative to total assets*



Relative to "trouble" countries at start of crisis*



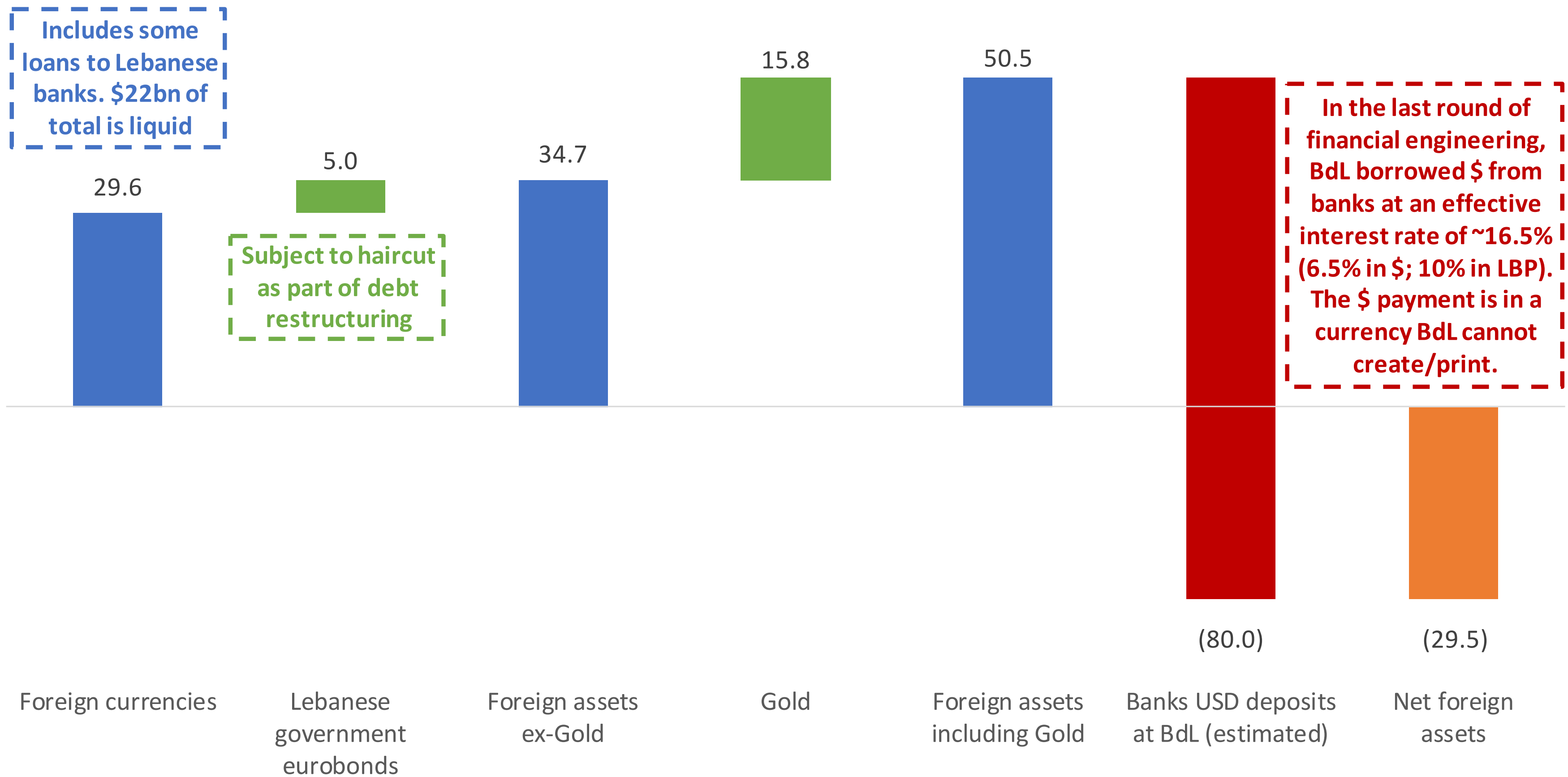
BdL is one of the largest central banks in the world relative to the size of the economy. Size of BdL's balance sheet and its deteriorating FX position will hinder its ability to intervene in a debt restructuring / bank bail-out scenario

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

*Note: *Excluding the impact of BdL financial engineering on balance sheet.*

Banque du Liban net foreign reserves were brought into negative territory

BdL negative net foreign currency position ($ bn) – April 2020



BdL net foreign currency position (including gold) have been negative for many years, and estimated at ~60% of GDP (excluding haircuts on Lebanese government Eurobonds).

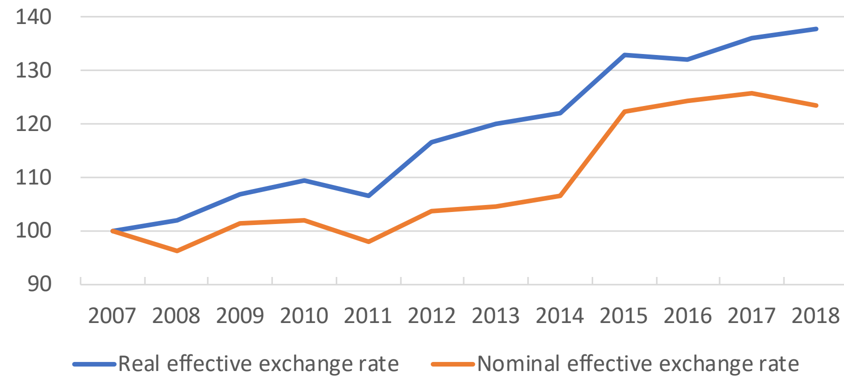
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

The currency overvaluation

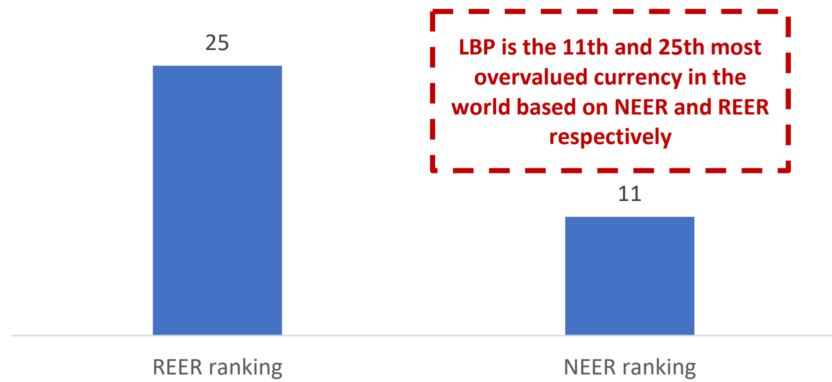
IMF view of the currency

*“The IMF’s EBA-light methodology suggests that **the real effective exchange rate is significantly overvalued.** The very high negative net foreign asset position, with high levels of short-term debt suggests that the external sustainability approach is the most relevant measure for Lebanon. It suggests a **50 percent overvaluation** if net foreign assets were to be stabilized at the 2018 level of -128 percent of GDP. In turn, the exchange rate is **overvalued by 66 percent** if the net foreign assets were to be brought down to -100 percent of GDP by 2024. The current account approach suggests a **real exchange rate gap of 63 percent in 2018 (compared to 45 percent estimated in 2017)**. As in previous years, the IREER approach suggests a much smaller REER gap of 9.1 percent. The REER has appreciated over 30 percent since the lows in 2008. The appreciation trends are consistent with the higher domestic inflation rates in Lebanon in the past year and appreciation of the nominal effective exchange rate.”*

Real / Nominal effective exchange rate (2007-2018)



Most overvalued FX ranking: Lebanon in top decile



The cost of the currency peg has been exorbitant, including high interest rates paid by BdL and an erosion of export competitiveness as the real effective exchange rate has significantly appreciated since 2007

Source: IMF, World Bank, Lebanon’s Ministry of Finance, Banque du Liban, Bruegel.

Lebanon Inc consolidated foreign currency balance sheet

Government ($ bn)	
USD assets	
Asset sale	?
Other	?
Total foreign currency assets	**?**
USD liabilities	
Eurobond: Banks	12
Eurobond: Banque du Liban	5
Eurobond: Non-domestic held	13
Total foreign currency liabilities	**30**
Net foreign currency position	**(30)**

Banque du Liban ($ bn)	
USD assets	
Government Eurobond	5
Loans to Banks	8
Foreign currencies	22
Gold	16
Total foreign currency assets	**50**
USD liabilities	
Banks holdings at Banque du Liban	80
Other	?
Total foreign currency liabilities	**80**
Net foreign currency position	**(30)**

Banks ($ bn)	
USD assets	
Government Eurobond	12
Holdings at Banque du Liban	80
Private sector USD loans	31
Other foreign assets	11
Total foreign currency assets	**133**
USD liabilities	
Loans from Banque du Liban	8
Customers USD deposits	117
Other foreign liabilities	9
Total foreign currency liabilities	**134**
Net foreign currency position	**(1)**

Consolidated foreign currency balance sheet ($ bn)

Assets ($ bn)	Current
BdL: Foreign currencies - End of period	22
BdL: Gold	16
BdL: Total foreign currency assets	37
Government (including asset sale)	0
Banks: Private sector USD loans	31
Banks: Other foreign currency assets	11
Banks: Total foreign currency assets	42
Lebanon Inc: Foreign currency assets	**79**

Liabilities and Equity ($ bn)	
Government: Non-domestic held Eurobonds	13
Banks: USD deposits	117
Banks: Other foreign liabilities	9
Banks: Total	126
Lebanon Inc: Foreign currency liabilities	**139**
Lebanon Inc: Equity = Net foreign currency position	**(60)**

Negative net foreign currency position

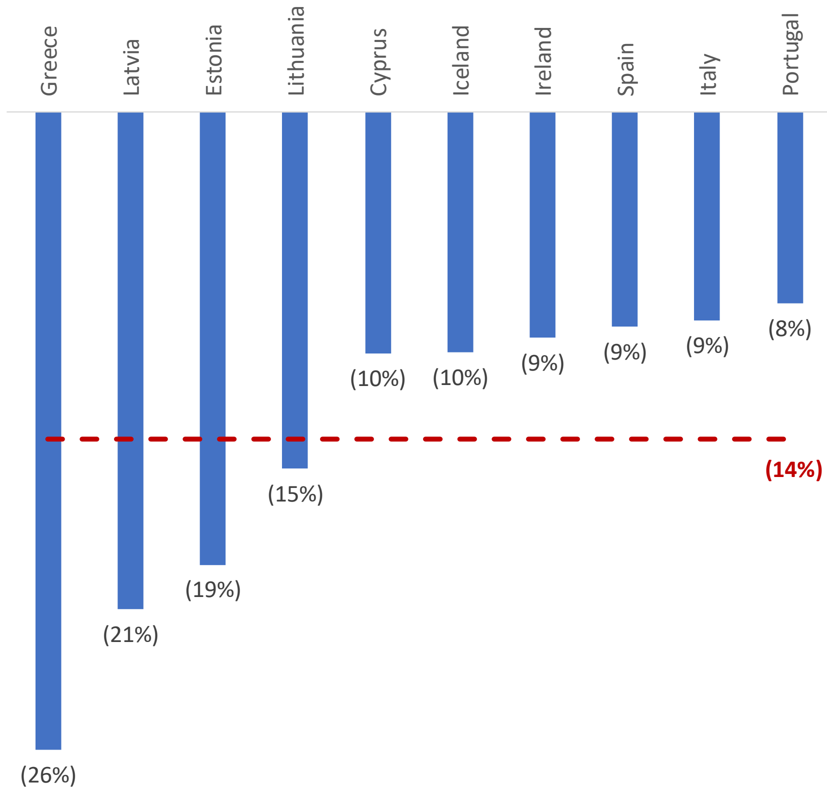
Lebanon Inc net foreign currency position is negative and estimated at 115% of 2019 GDP (including gold). This position will deteriorate with time and should be addressed when looking at the different proposed solutions

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban. Feb-2020 data for consolidated banks balance sheet; 15-Apr-2020 data for BdL.

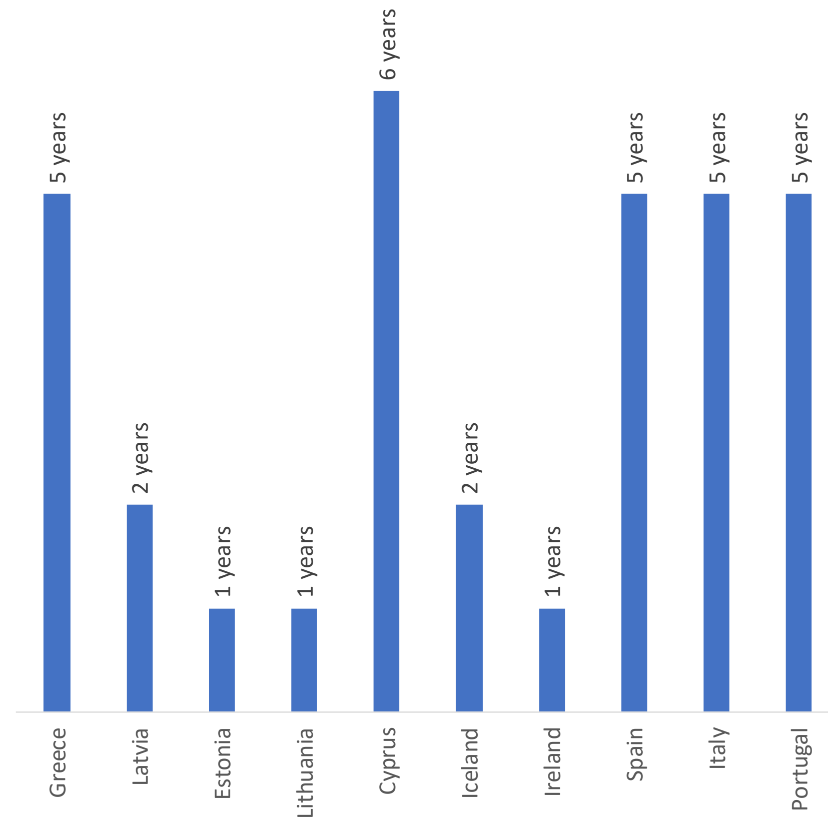
Snapshot of where are we heading: Lessons from crisis countries

Contraction in real GDP of select "crisis countries"

Cumulative contraction in real GDP of select countries



Years from peak to trough GDP

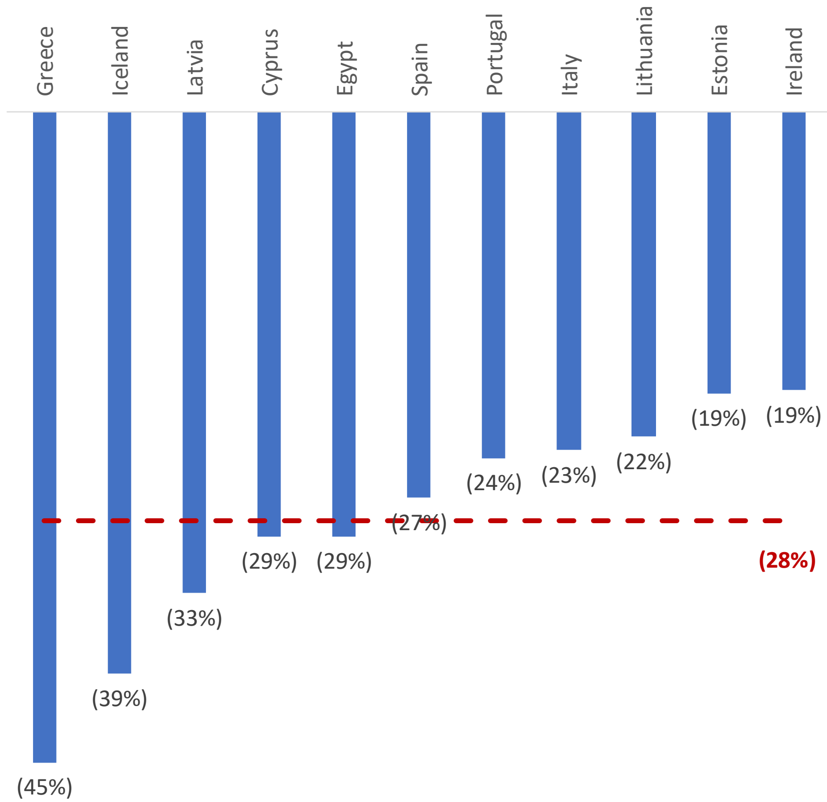


Past experience in other crisis countries suggests a real GDP contraction of 15-25% over next few years (even more due to COVID-19). Recovery speed depends on policy makers' actions including structural reforms and depth of debt restructuring.

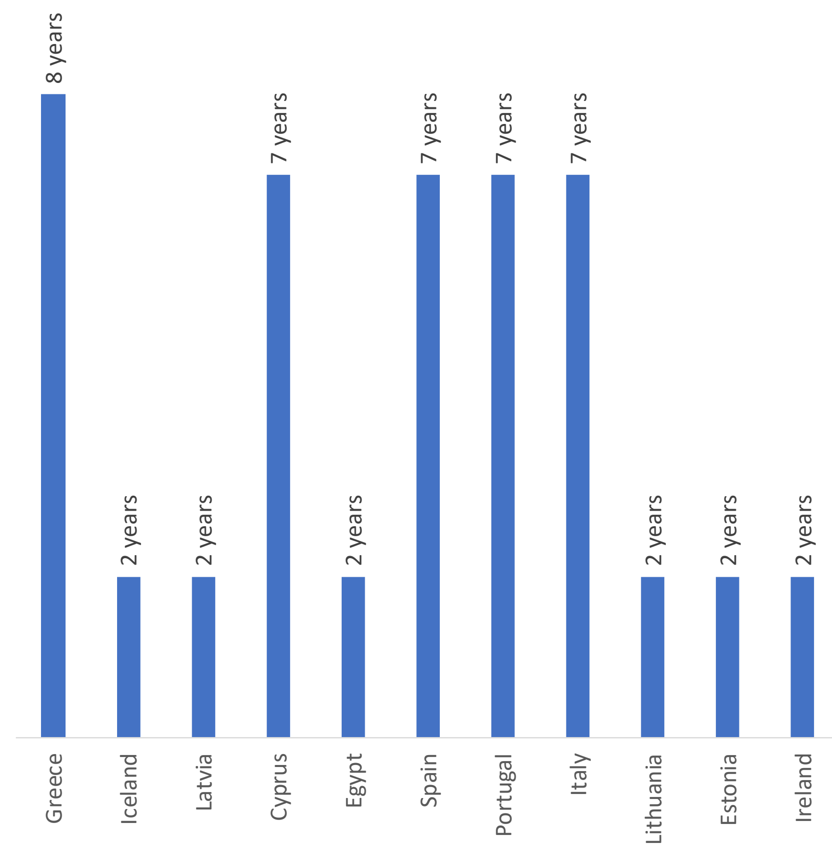
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Contraction in nominal GDP of select "crisis countries"

Cumulative contraction in $ GDP of select countries



Years from peak to trough GDP

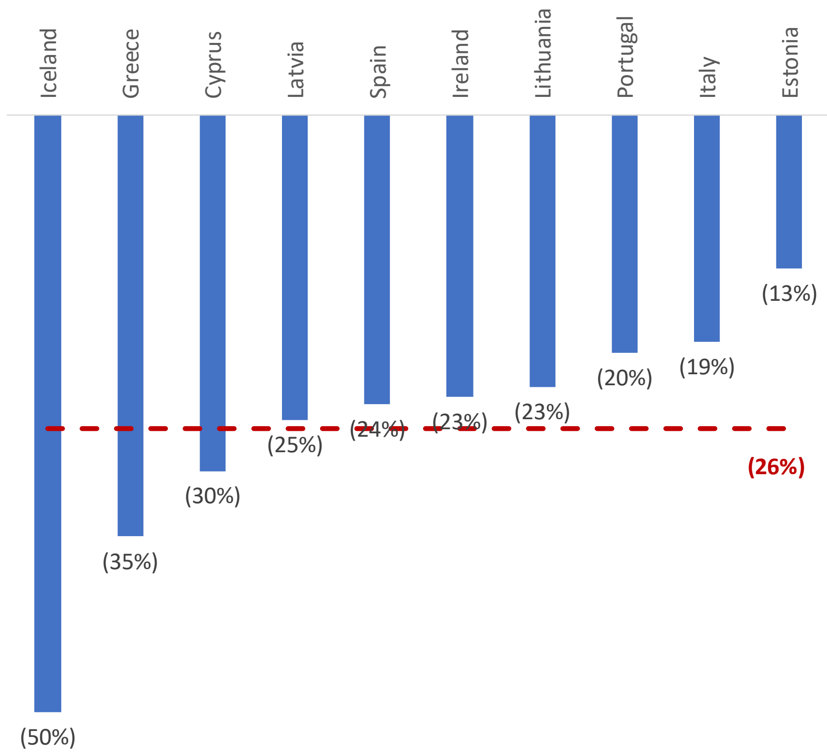


Sharp real GDP contraction and exchange rate overvaluation will likely result in more than 25-35% reduction in $ nominal GDP over next few years.

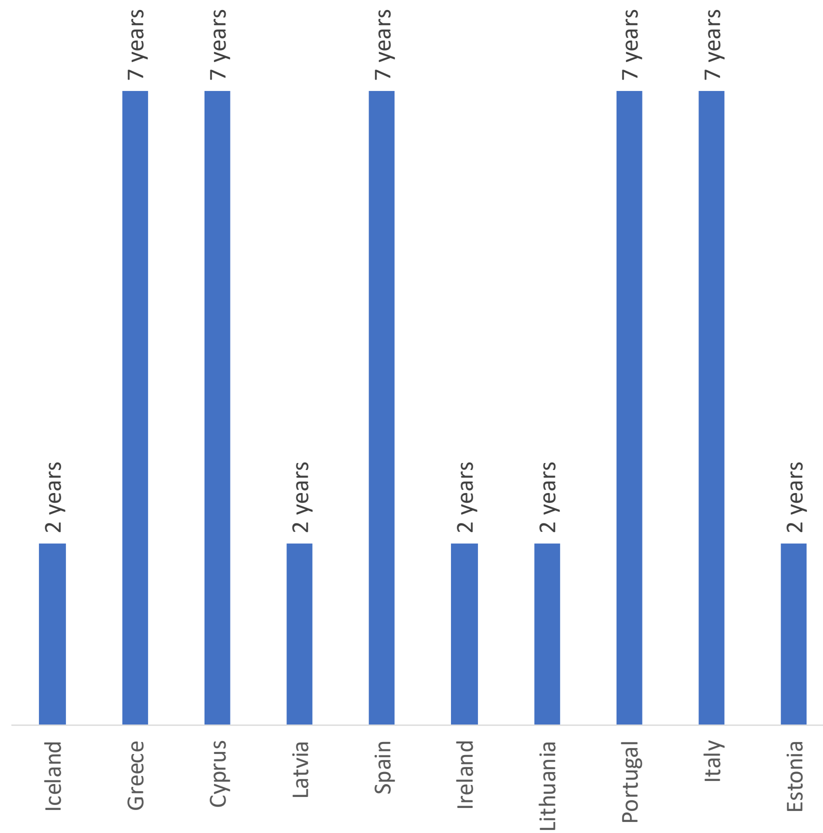
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Change in government revenues of select “crisis countries”

Cumulative contraction of government revenues in $



Years from peak to trough government revenues

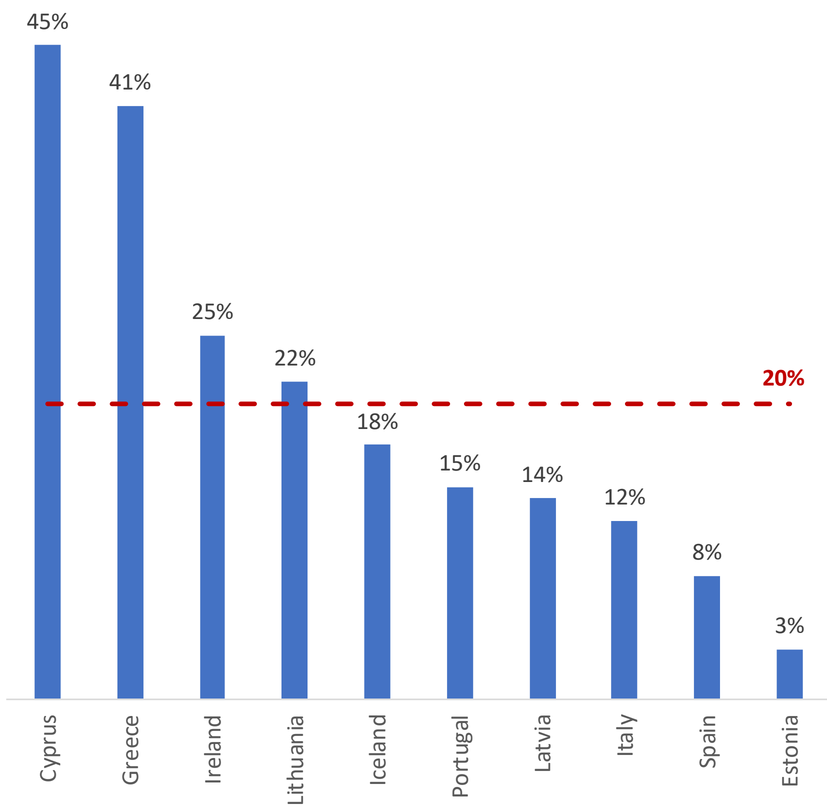


Past experience in other countries suggests $ government revenues will likely shrink by 35-50% over the next few years as GDP contracts, and given the large contribution of the financial sector to total revenues

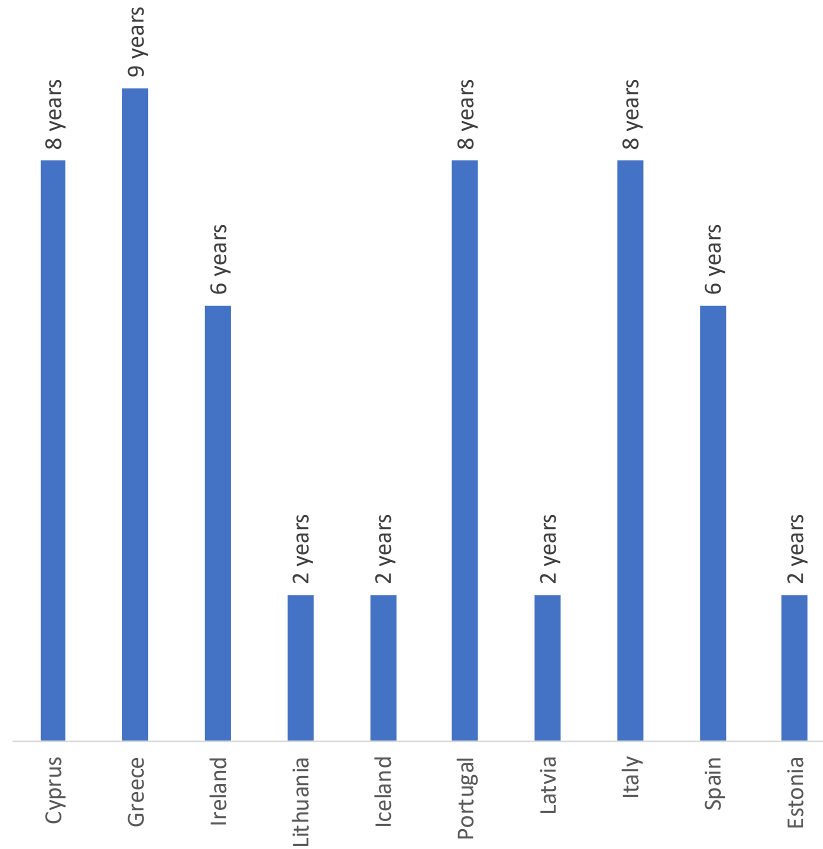
Source: IMF, World Bank, Lebanon’s Ministry of Finance, Banque du Liban.

Change in banks’ non-performing loans of select “crisis countries”

Cumulative percentage point change of banks’ NPLs



Years from trough to peak NPLs

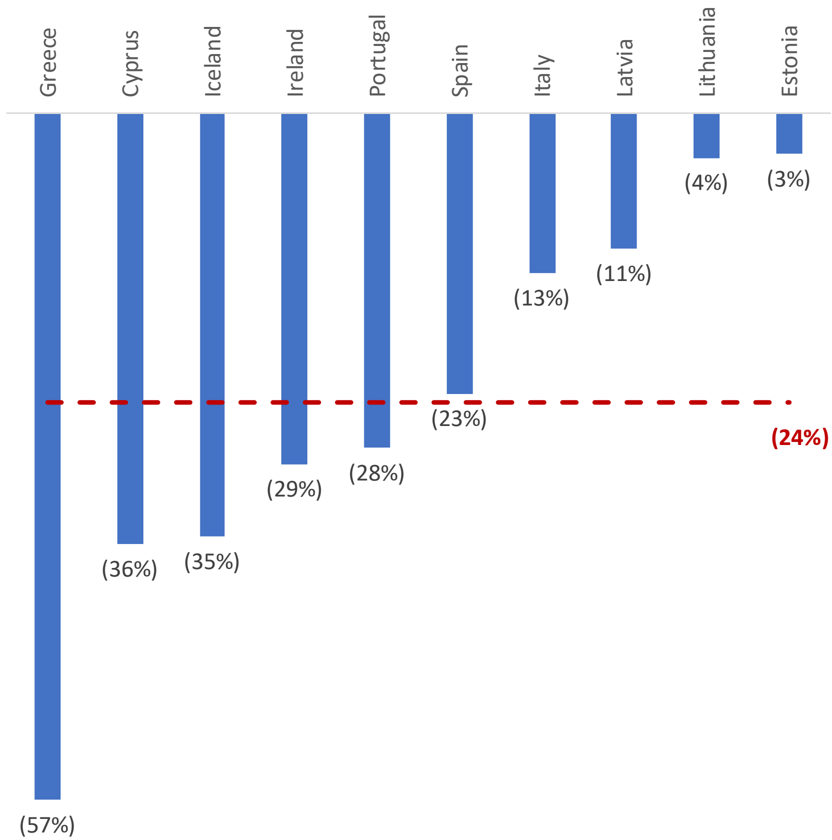


Past experience in other countries suggests an increase in banks’ NPLs of 20% over next few years. Recovery speed depends on willingness to quickly absorb the loss and recapitalize, as well as the sovereign’s ability to help

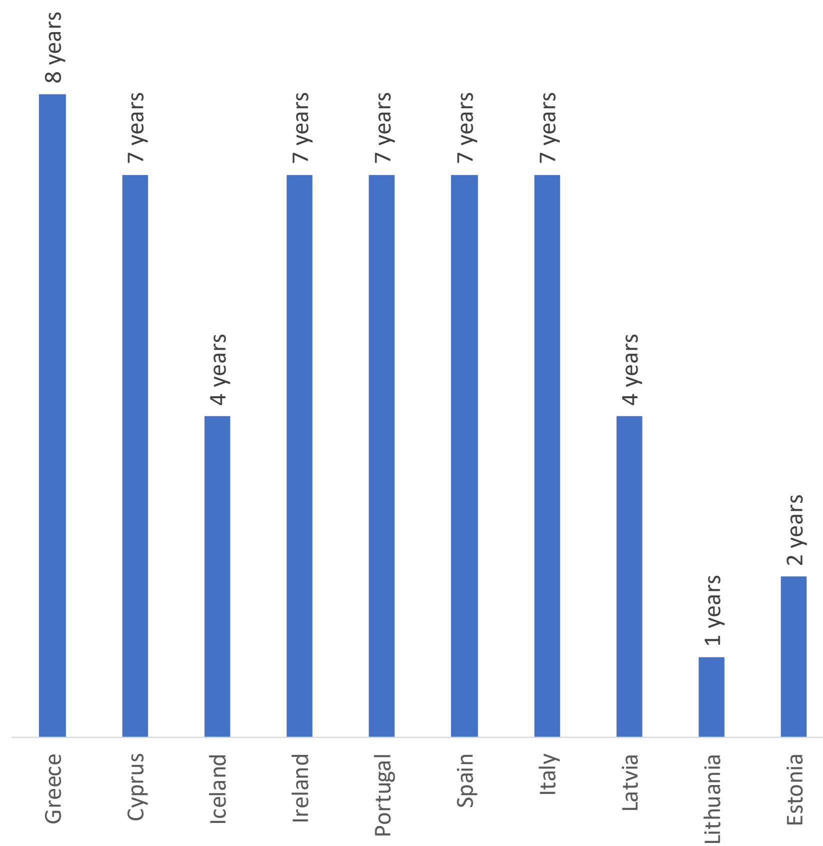
Source: IMF, World Bank, Lebanon’s Ministry of Finance, Banque du Liban.

Change in banks deposits of select “crisis countries”

Cumulative contraction of banks’ deposits in $ terms



Length of deposit erosion period

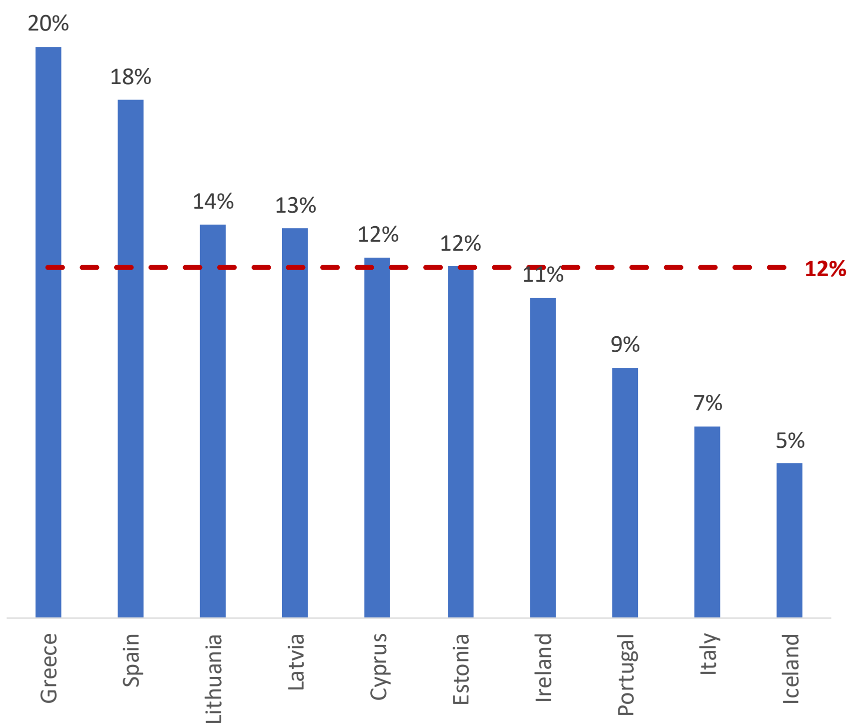


Past experience in other countries suggests we should expect banks’ deposits to shrink by 25-35% over the next few years transforming the banking sector. Banking rely on trust and confidence: it will take a long time to regain confidence.

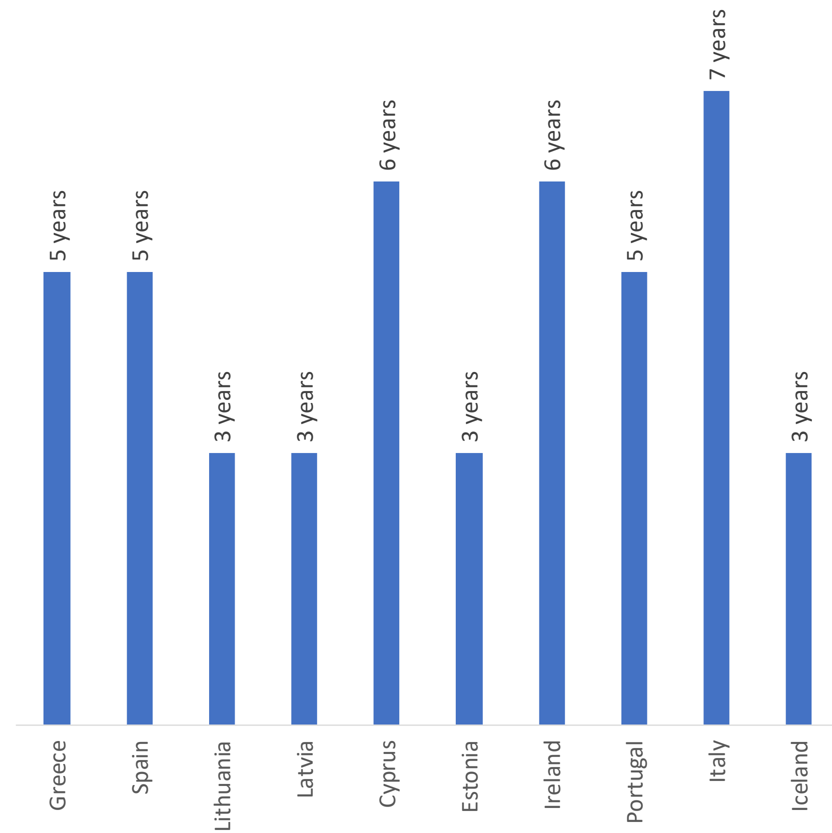
Source: IMF, World Bank, Lebanon’s Ministry of Finance, Banque du Liban.

Change in unemployment rate of select "crisis countries"

Cumulative percent point change in unemployment



Years from trough to peak unemployment

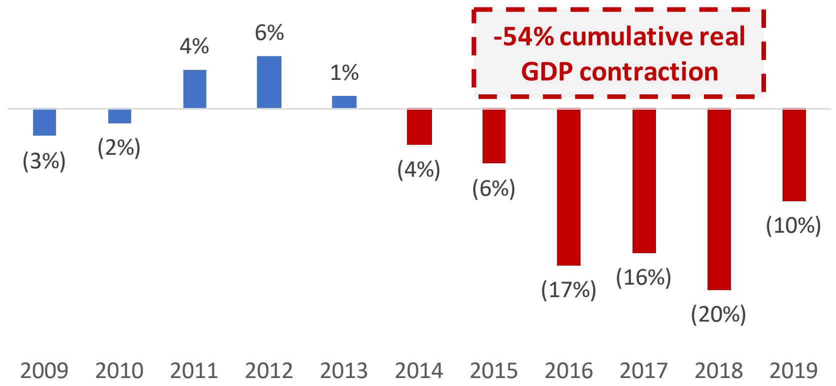


Past experience in other countries suggests we should expect the unemployment rate to increase by 10-20 percentage points over the next few years. Providing and expanding a targeted social safety net is critical.

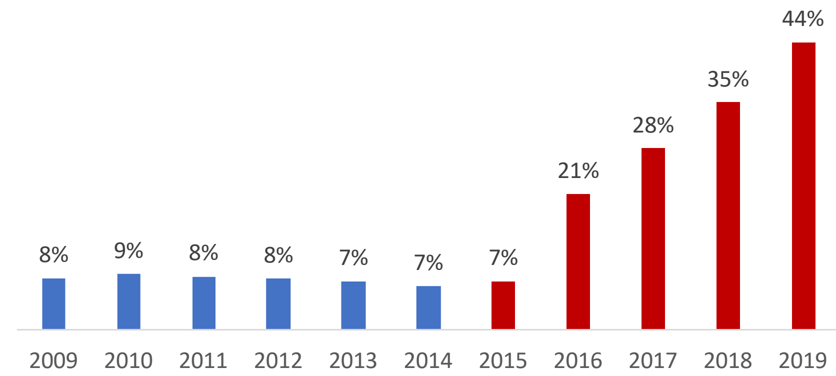
Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

The cost of inaction is high – Venezuela case study

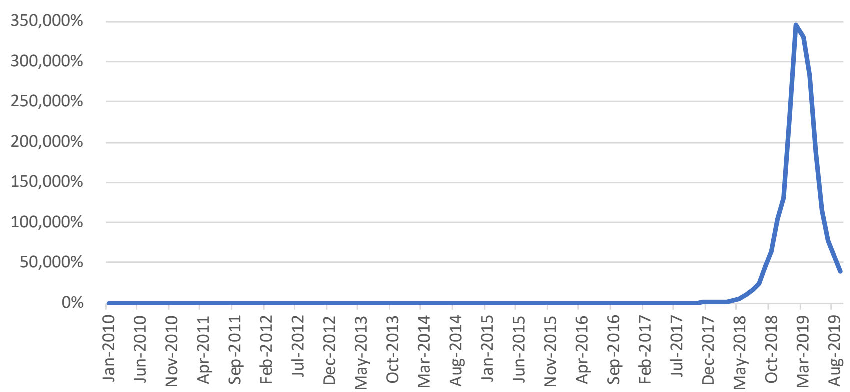
Real GDP growth (%)



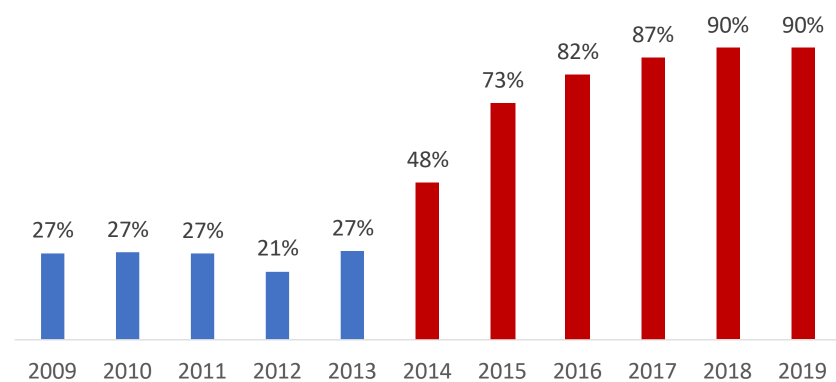
Unemployment rate (%)



Inflation rate (%)



Households income below national poverty line (%)



The cost of inaction is high and only increases with time as demonstrated in Venezuela. Urgency to act is required.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

The cost of inaction is high

Key considerations

- ***Balance of Payment:*** Further disruption in supply of critical materials such a medical resources.
- ***Currency:*** Further weakening of currency with risk of spiralling potentially leading to hyperinflation.
- ***Fiscal:*** Increasing deficits given weak economy (limits tax collection) and the rigid cost structure. Funded through money printing by BdL.
- ***Government debt stock:*** Increasing in LBP and significantly more relative to GDP.
- ***Banque du Liban:*** Deterioration in net negative FX reserves position. Further loss of credibility in ability to manage LBP or save the banking sector.
- ***Banks restructuring:*** Recapitalization amount only increases with time leading to higher amount of "haircuts" through forced partial conversion of USD deposits and/or large depositors bail-in.
- ***Private sector:*** bankruptcies, non-performing loans, job losses, loss of competitiveness. *Major* implications for country's long-term potential.
- ***Social:*** significant increase in unemployment, poverty rates, emigration. *Major* implications for country's long-term potential.

Lebanon Inc foreign currency balance sheet ($ bn)

Assets ($ bn)	Currrent	Projections		
		2020E	2021E	2022E
BdL: Foreign currencies - Beginning of period		22	12	6
Interest income on foreign currencies		0	0	0
Current account deficit (ex. interest)		(5)	(3)	(3)
Principal and interest on non-domestic held Eurobonds		0	0	0
Capital outflows		(5)	(3)	(3)
BdL: Foreign currencies - End of period	22	12	6	0
BdL: Gold	16	16	16	16
BdL: Total foreign currency assets	37	28	22	16
Government (including asset sale)	0	0	0	0
Banks: Private sector USD loans	31	29	27	25
Banks: Other foreign currency assets	11	11	11	11
Banks: Total foreign currency assets	42	40	38	35
Lebanon Inc: Foreign currency assets	**79**	**68**	**60**	**52**
Liabilities and Equity ($ bn)				
Government: Non-domestic held Eurobon	13	13	13	13
Banks: USD deposits	117	116	116	116
Banks: Other foreign liabilities	9	9	9	9
Banks: Total	126	125	126	125
Lebanon Inc: Foreign currency liabilities	**139**	**138**	**139**	**138**
Leb Inc: Net foreign currency position	**(60)**	**(71)**	**(79)**	**(86)**
Relative to GDP	**(115%)**	**(183%)**	**(220%)**	**(247%)**

Lebanon Inc net negative foreign currency position significantly deteriorates with time if no measures are taken.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Snapshot of potential solutions for the way forward

Devising a credible comprehensive economic plan to underpin debt restructuring

Immediately stop the bleeding

- Legalize comprehensive enforceable and transparent capital controls
- Adopt a strategic management of FX reserves
- Secure liquidity to arrest growth fall out
- Audit BDL and sovereign balance sheets
- Expand social safety nets
- Accelerate structural reforms

Implement in parallel a growth recovery plan

- Fiscal consolidation (medium-term framework)
- **Recapitalize BdL's balance sheet**
- **Debt restructuring – equitable burden sharing**
- **Banks' recapitalization**
- Orderly exchange rate adjustment
- Continued expansion of social safety nets
- Growth enhancing structural reforms
- Governance and institutional reforms
- Mobilization of external funding

Key pillars of a comprehensive macro-fiscal and growth recovery plan					
Pillar 1	**Pillar 2**	**Pillar 3**	**Pillar 4**	**Pillar 5**	**Pillar 6**
Macro-Fiscal adjustment and debt restructuring	Banking sector recapitalization and restructuring	Exchange rate and monetary management	Social protection and development policies	Growth stabilization and transformation (Private sector)	Governance and institutional reforms
Donor Engagement and external financing mobilization					
Communication and Stakeholders engagement					

Comprehensive approach is needed. Partial ad-hoc solutions are more harmful and unsustainable.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Confirming Lebanon Inc net negative foreign currency position through audits

Government ($ bn)	
USD assets	
Asset sale	?
Other	?
Total foreign currency assets	**?**
USD liabilities	
Eurobond: Banks	12
Eurobond: Banque du Liban	5
Eurobond: Non-domestic held	13
Total foreign currency liabilities	**30**
Net foreign currency position	**(30)**

Banque du Liban ($ bn)	
USD assets	
Government Eurobond	5
Loans to Banks	8
Foreign currencies	22
Gold	16
Total foreign currency assets	**50**
USD liabilities	
Banks holdings at Banque du Liban	80
Other	?
Total foreign currency liabilities	**80**
Net foreign currency position	**(30)**

Banks ($ bn)	
USD assets	
Government Eurobond	12
Holdings at Banque du Liban	80
Private sector USD loans	31
Other foreign assets	11
Total foreign currency assets	**133**
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Consolidated foreign currency balance sheet ($ bn)

Assets ($ bn)	Currrent
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Liabilities and Equity ($ bn)	
Government: Non-domestic held Eurobonds	13
Banks: USD deposits	117
Banks: Other foreign liabilities	9
Banks: Total	126
Lebanon Inc: Foreign currency liabilities	**139**
Lebanon Inc: Equity = Net foreign currency position	**(60)**

Negative net foreign currency position

Confirming the size of Lebanon Inc losses is critical through a professional and independent audit as a first step towards greater accountability.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban. Feb-2020 data for consolidated banks balance sheet; 15-Apr-2020 data for BdL.

Assessing the banking sector exposure to major risks

	Deposits at Central Bank	Loans to Government	Loans to private sector
Exposure size ($bn)	USD: $80bn LBP: $39bn	USD: $12bn LBP: $14bn	USD: $31bn LBP: $15bn
Loss est. (%)	USD: 20-45%* LBP: 0%	USD: ~70% LBP: ~30%	USD: 20% incremental LBP: 20% incremental
Loss est. ($bn)	USD: $18-40bn* LBP: N.A.	USD: $8-9bn LBP: $4-5bn	USD: $6bn LBP: $3bn

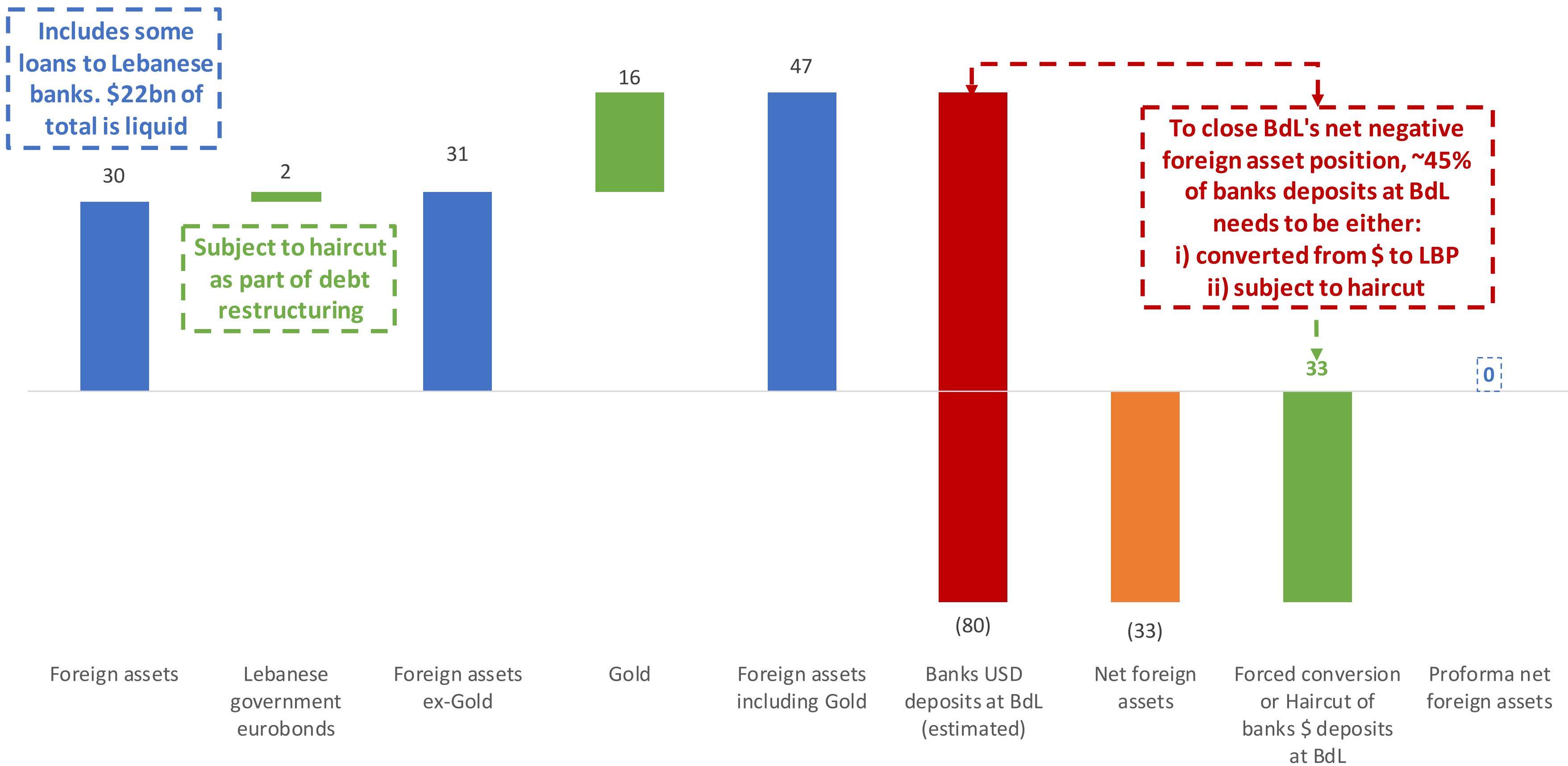
Total potential losses: $40-60bn
Total bank equity: $21bn

Lebanese banks will witness losses from three different buckets of exposure, each enough to require a full recapitalization of the banking sector as total losses could hover around $60 bn.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.
*Note: * Estimated losses based on BdL estimated net foreign FX position of $33-41bn.*

Dealing with Banque du Liban’s balance sheet

Partial forced conversion of banks’ USD deposits at BdL ($ bn)



To close BdL’s net negative FX position, $33-41bn of banks deposits at BdL (~45%) could be either i) converted from USD to LBP at LBP1,500; or ii) subject to a haircut. Each will have different implications on banks’ losses, exchange rate, and inflation.

Source: IMF, World Bank, Lebanon’s Ministry of Finance, Banque du Liban.

Restructuring government debt: Potential scenarios and implications

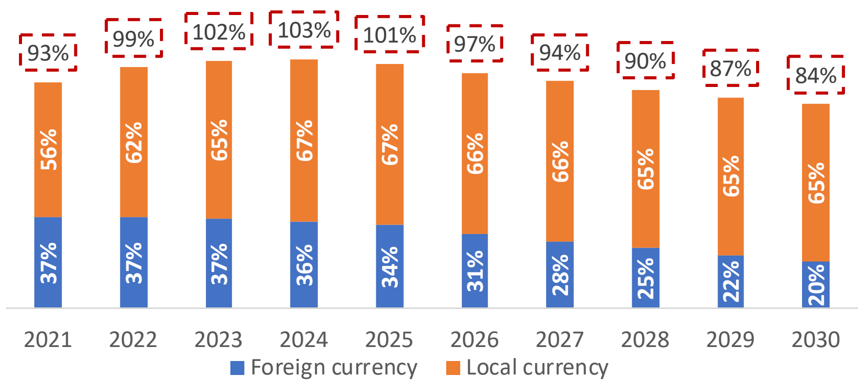
Scenario: 60% haircut to government debt

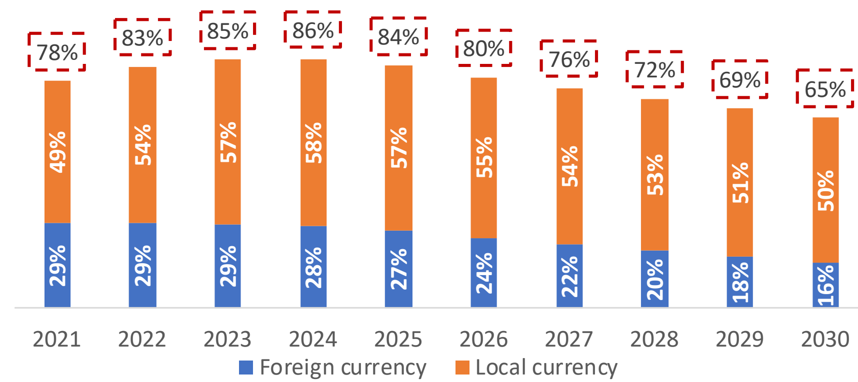
- LBP3,300*
- No debt service holiday
- 60% haircut to T-Bills (100% BdL + 6% non-BdL owned)
- 60% haircut to Eurobond
- BdL closes net negative FX position

Scenario: 70% haircut to government debt

- LBP3,300*
- No debt service holiday
- 70% haircut to T-Bills (100% BdL + 30% non-BdL owned)
- 70% haircut to Eurobond
- BdL closes net negative FX position

Government debt (as % of GDP)





Uses ($bn)

Uses	BDL balance sheet	
	Forced conversion	Haircut
Required banks capital	35	49
BdL net negative FX position	0	0
Total	**35**	**49**
Lebanon Inc net foreign assets position	**(25)**	**(10)**

Uses	BDL balance sheet	
	Forced conversion	Haircut
Required banks capital	38	52
BdL net negative FX position	0	0
Total	**38**	**52**
Lebanon Inc net foreign assets position	**(21)**	**(6)**

Lebanon needs to target 60-80% debt to GDP while addressing BdL negative FX reserves position. This would be critical to lift capital controls, anchor the exchange rate, recap banks & allow credit to flow back to the economy.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban. *Note: * Based on current exchange rate of LBP in parallel market.*

Restructuring and recapitalizing banks: Funding sources (the waterfall of losses)

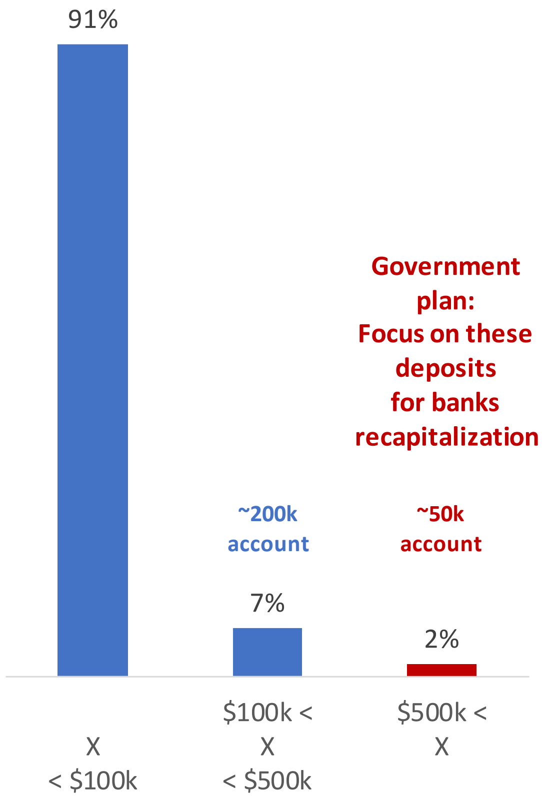
Internal capital generation (current year profits)	First line of defense
Banks existing equity	Second line of defense
External capital injected	Third line of defense
Mergers / Consolidation	Third line of defense
Internal capital generation (reduced interest on deposits)	Fourth line of defense
Forced conversion of $ deposits to LBP; Depositors bail-in (deposit to equity conversion) and potentially one-off tax	Last line of defense

Given the expected size of the losses, depositors are likely to bear some part of the recapitalization cost in return for cleaner, leaner, smaller, better regulated and managed banks.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban.

Restructuring and recapitalizing banks: A partial deposit bail in seems inevitable

Breakdown by number of accounts

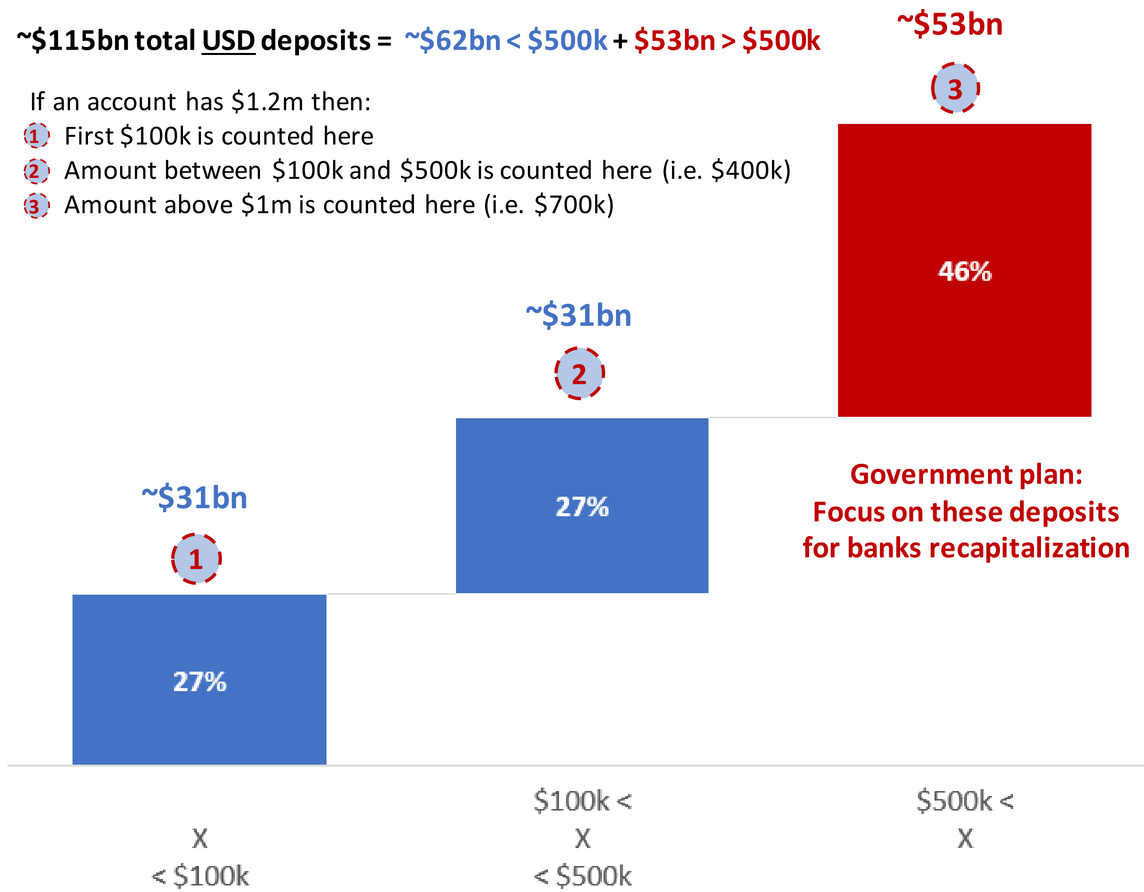


Amount by tranches ($bn)*

~$115bn total USD deposits = ~$62bn < $500k + $53bn > $500k

If an account has $1.2m then:

1. First $100k is counted here
2. Amount between $100k and $500k is counted here (i.e. $400k)
3. Amount above $1m is counted here (i.e. $700k)



The pool of money of the top 2% of depositors (> $500k) is potentially not "enough" to recap the banks as proposed by the government.

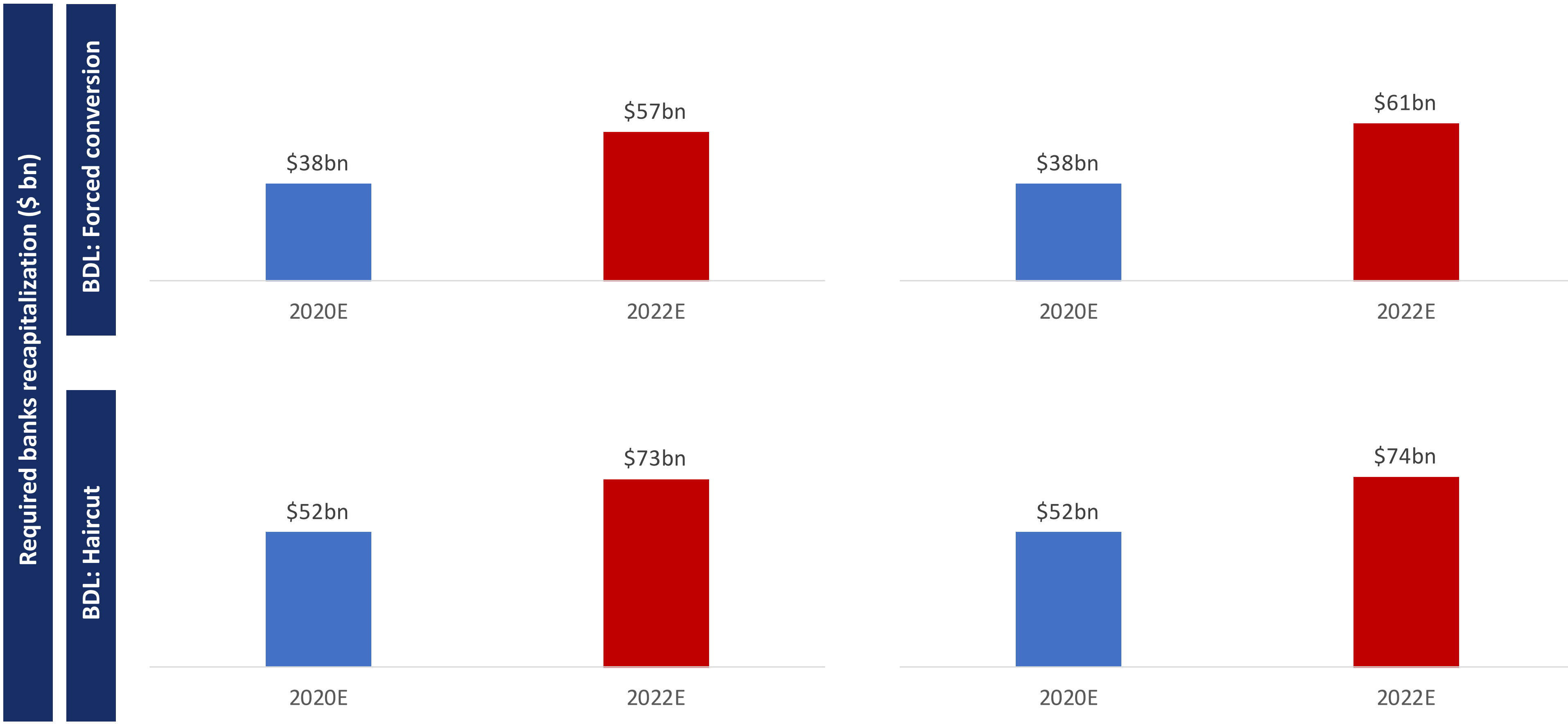
*Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban. Note: *Based on total deposits in the banking sector (USD + LBP).*

Banks/BdL restructuring: Assessing possible options for bridging the funding gaps

- **Forced conversion of banks USD deposits at BDL**
  - Negative implications on the exchange rate and inflation.
  - Massive increase in the money supply: ~80-100% increase in LBP monetary base.
  - Smaller losses vs. haircut to CDs/Depts as it preserves a residual value of banks' assets in LBP.
- **Internal capital generation through reduced interest rates on deposits**
  - Effectively an NPV reduction for depositors but "psychologically" less painful.
  - 0% interest on USD deposits can generate ~$3bn of capital p.a. (i.e. ~ $6bn over two years).
- **External capital injection**
  - $5bn external capital injection saves large depositors (i.e. > $500k) ~10% of their principal.
  - Although small by market standards but requires confidence building measures and reforms.
  - Can encompass sale and monetization of bank assets.
- **Recovered asset fund**
  - Should be credibly pursued to recover stolen monies. Accountability is essential to regain confidence and consolidate rule of law.
  - Lawsuits will take time. However, depositors can be promised compensation if / when stolen money is recovered.
- **Contribution of state assets to recapitalize banks**
  - Subject to debate around fairness: reduces pain of large depositors in order to preserve capital for economic expansion later.
  - However this could be at the expense of tax payers / broader population.
  - Risk of deepening capture in a weak State. Requires very credible and strong institutions and independent judiciary.

Banks restructuring: The cost increases with time

70% haircut to government debt – assuming LBP 5,000 | **70% haircut to government debt – assuming LBP 6,000**



Delaying decisions will have a significantly bigger impact on depositors as the exchange rate weakens further. The cost of inaction is too high and increasing. Urgency is required.

Source: IMF, World Bank, Lebanon's Ministry of Finance, Banque du Liban. *Note: Assumes LBP at 5,000/6,000 given funding of fiscal deficit through BdL.*

How does our proposal differ from that of the Government?

	Government – April 2020 (advised by Lazard)	Moubayed & Zoueі (www.lebanoneconomics.net)
Private sector NPLs	30% total	20% incremental losses (34% total)
Scope of losses at BdL	LBP + Foreign currency	Foreign currency focused
Dealing with BdL losses	Haircut banks assets at BdL (CDs/deposits)	Two options: - Partial forced conversion - Haircut
Targeted BdL net asset position (equity)	-$5 bn net negative equity position in both local and foreign currency (15% of GDP)	- Zero net foreign currency asset position (foreign currency) - Assumes LBP negative equity can be managed/amortized overtime
Haircut on Eurobonds	~75% (estimated)	70%
Haircut on LBP debt	~50% (estimated)	70% (100% on BDL portfolioand 30% on non-BdL- excludes social security..)
Bank recapitalization	No full bail-out Deposit bail-in (2% of top depositors) Asset fund recovery (lack of details)	No bail-out Limiting extent of bail-in by exploring range of possible funding sources

Important to explore a range of policy options/measures and assess pros and cons of each based on evidence/analysis.

Key conclusions and issues for further debate

CONCLUSIONS:

- **Urgency is required.** The cost of inaction is too high and increasing.
- **Deep and comprehensive restructuring is inevitable**, anchored within a **credible fiscal reform and growth recovery plan**
- An **equitable burden sharing** is doable in a way to protect small depositors.

ISSUES for FURTHER DEBATE:

1. There is a **rationale for bail-in**: how to strike the right balance between efficiency and social equity?
2. The **math does no add-up with only 2% of depositors**: Is government's proposed **state assets monetization** a feasible option (politically, legally, etc.)?
   - What assurances and safeguards should an asset monetization process entail in order to prevent state capture and distributing the spoils to cronies?
   - How do we ensure a fair valuation of these assets?
   - Who benefits from any future potential upside upon state assets monetization?
3. Whatever option we choose: **how do we make the model sustainable**?

THANK YOU for your interest and keep in touch!

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Finding a way out of Lebanon's crisis: the case for a comprehensive and equitable approach to debt restructuring

prepared by Alia Moubayed and Gerard Zouein

February 2020

The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not represent the views of their respective employers.
This paper was finalized based on numbers published at the end of 2019, and before the outbreak of the Corona Virus. It does not reflect most recent developments and implications on the Lebanese economy

Synopsis: This paper advocates for an urgent comprehensive growth and fiscal adjustment program supported by the international donor community to deal with Lebanon's dangerous economic and financial crisis while ensuring an equitable burden sharing of the losses. At the heart of this program, a consolidated balance sheet approach is required for restructuring the country's debt (both sovereign and Banque du Liban's) and recapitalizing a right-sized banking sector while protecting small depositors. Using a model-based approach, the scenario analysis argues for taking Lebanon's debt to GDP to sustainable levels (60-80% of GDP) over the next 10 years. It stresses that the debt restructuring strategy should: 1) encompass BDL's USD liabilities; 2) design and implement a banks' recapitalization program that supports a right-sized and solid banking sector able to finance the growth recovery; and 3) ensure the cost of bank recapitalization and the burden of fiscal adjustment are equitably shared through a multipronged socio-economic policy reform framework. The paper estimates that reducing total debt to these levels by 2030 would require no less than a 60-70% principal reduction if the authorities wanted to reduce the extent of an inevitable currency devaluation, and create the fiscal space to support growth and expand social safety nets. Therein, the objective should not be to cut primary spending indiscriminately, but rather to improve its composition and efficiency. The paper warns that inaction and/or delays by using piecemeal solutions is regressive, exacting bigger losses on small depositors and the most vulnerable in society.

Note: The numbers presented in this paper are based on publicly available information as of December 2019 and estimates (e.g. the banking sector USD deposits at BDL, government arrears and contingent liabilities, etc.). As such, the analysis that follows could be subject to material changes should some of this information prove to be substantially different from what is publicly disclosed (e.g. the foreign currency liquidity at BDL). The material is used as part of various citizens' initiatives which aim to engage stakeholders inside and outside Lebanon in order to shape the priorities and direction of future economic reforms while stressing the importance of an evidence-based policy framework for dealing with the crisis. The authors welcome any comments and suggestions for improvements as the objective of this paper is to help raise awareness about Lebanon's multifaceted crisis and contribute to the public debate. They also recognize that some aspects of the analysis need further study notably in terms of the legal and regulatory feasibility of some proposals.

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نحو مخرج لأزمة لبنان المالية: لمقاربة شاملة وعادلة لإعادة هيكلة ديون لبنان

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الآراء والخلاصات المعروضة في هذه الدراسة تمثّل من كتبها بصفتهم الشخصية، وهي لا تمثّل وجهة نظر أرباب عملهم أو الشركات حيث يعملون
أعدّت هذه الدراسة استنادا إلى أرقام منشورة في نهاية العام 2019 ،و قبل انتشار وباء الكورونا، وبالتالي فهي لا تأخذ بعين الاعتبار المستجدات الأخيرة وتداعياتها على الإقتصاد اللبناني منذ ذلك الحين

لمحة: تدعو هذه الدراسة إلى إطلاق برنامج طارىء وشامل للنهوض الاقتصادي والإجتماعي وللتصحيح المالي، تدعمه الجهات الدولية المانحة لمواجهة أزمة لبنان الاقتصادية والاجتماعية والمالية الخطيرة، بشكل يوزّع الأعباء بشكل عادل. وتشدّد الدراسة على ضرورة اعتماد مقاربة موحّدة لميزانيات القطاع العام ومصرف لبنان والمصارف تبنى على أساسها عملية إعادة هيكلة المديونية وإعادة رسملة القطاع المصرفي بشكل يحمي صغار المودعين. وبالاستناد إلى نموذج رقمي، تشير السيناريوهات المعروضة إلى أهمية استهداف مستوى دين عام مستدام يناهز 60-80٪ من الناتج المحلي الإجمالي بحلول العام 2030، كما وعلى ضرورة أن تتوفّر في عملية إعادة الهيكلة العناصر التالية: 1) أن تشمل مطلوبات مصرف لبنان بالعملات الأجنبية، 2) أن تترافق مع تنفيذ برنامج لإعادة رسملة المصارف يهدف إلى إعادة بناء قطاع مصرفي حجمه متّسق مع حاجات الإقتصاد التنموية، ج) أن تُوَزَّع أعباء التصحيح المالي وإعادة رسملة المصارف بشكل عادل وفق برنامج إقتصادي إجتماعي متكامل الأهداف. وتقدّر هذه الدراسة أن خفض نسبة الدين إلى هذه المستويات بحلول عام 2030 سيتطلّب اقتطاع 60-70٪ من مجمل أصل الدين العام (بالليرة وبالعملات) إذا ما أرادت السلطات التخفيف من حدّة تدهور سعر صرف الليرة اللبنانية المتوقّع والسماح بتوسيع المساحة المالية لدعم عجلة النمو وتوسيع شبكات الأمان الإجتماعي. وليس الهدف من التصحيح المالي خفض الإنفاق الأولّي بشكل عشوائي، بل تحسين كفاءته وجودة مكوّناته والحدّ من الهدر. وتحذّر الدراسة من التقاعص والتأخير في اتخاذ القرارات الصائبة. فكلفة عدم المبادرة كما الإستمرار بالتدابيرالمجتزأة، سيكون لها أثرا رجعيا إذ تحمّل أعباء كبيرة للمودعين الصغار وللفئات الأكثر تهميشاً في المجتمع.

***ملاحظة:** الأرقام الملحوظة في هذه الدراسة مبنية على معلومات منشورة بنهاية العام 2019، كما وعلى بعض التقديرات (مثلا: ودائع القطاع المصرفي بالدولار لدى مصرف لبنان، المتأخّرات الحكومية، ...). بالتالي يمكن أن تتغيّر نتائج الدراسة إذا ما تبدّلت هذه الأرقام أو المعطيات بشكل كبير و(لاسيما ما يخصّ العملات الأجنبية لدى مصرف لبنان). وتجدر الإشارة إلى أنّ مواد وخلاصات هذه الدراسة عرضت ضمن مبادرات مواطنية عديدة منذ العام 2019 تهدف إلى إشراك المواطنات والمواطنين داخل وخارج لبنان في صياغة أولويات وتوجهات السياسات والإصلاحات الإقتصادية وفق أسس علمية لمعالجة الأزمة. ويرحّب فريق العمل بأيّة إقتراحات و/أو ملاحظات تساعد بتحسين هذه الدراسة وتطويرها بهدف رفع مستوى الإدراك حول الأزمة الاقتصادية المتعدّدة الأوجه والمساهمة في النقاش العام. كما يدرك فريق العمل بأنّ بعض جوانب الدراسة بحاجة إلى مزيد من البحث لاسيما في ما يتعلّق بالجوانب القانونية والتنظيمية لبعض الإقتراحات.*

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