A Proposal to help Lebanon overcome its financial crisis

(for discussion)

Presented by Gérard Charvet and Ziad Hayek

Background

- Lebanon is going through a double crisis due to the over-indebtedness of the State and the dollarization of the economy.
- Both matters need to be dealt with simultaneously to restore the confidence of investors and depositors.
- The proposed plan aims to address this dual problem. This is a “rescue plan”, not an “economic plan”.
- The most important feature of the proposed plan is that It can be implemented in as little as 6 months.

❖ A tax-led plan would further exacerbate the economic recession and should be avoided.

Our Understanding

- The State owes $91.6 bn, of which $33.7 bn is in foreign currency.
- GDP is $58.5 bn, thus a Debt-to-GDP ratio of 157%.
- Debt service was >$5 bn in 2019 – almost 10% of GDP.
- The Government is running a deficit of almost 10% of GDP.
- Bank deposits total $167 bn, of which $120 bn in foreign currency.
- Tax levy is about 17% of GDP.
- Oil and gas revenues, if they exist, cannot be expected before 10 years.

Desired Objectives

- Find ways to address the $50 bn loss, which is due to budget overruns and accumulated interest.
- Reduce the ratio of indebtedness to around 70% of GDP. This is necessary for a return to confidence and to reduce the external debt service burden to <1% of GDP.
- Facilitate the development of a productive economy by restoring the competitiveness of Lebanese enterprises, especially vis-à-vis the geopolitical environment.
- Protect depositors' deposits (including foreign and diaspora depositors), which is essential to the well-being of Lebanon's economy.
- Give the banks time to absorb their losses and adapt their business model.
- Protect the economic well-being of Lebanon's citizens.
- Avoid the tutelage of external bodies.

Establish a Defeasance Company

- The Government should pass legislation to establish a company (the "Defeasance Company"), which holds the main State assets (excluding oil, gas and gold):
  - Ogero, MIC 1, MIC 2
  - MEA, MEAS, MEAG
  - EDL Generation and Distribution
  - Casino
  - Régie des Tabac
  - Real Estate holdings
- The Government would effect a debt-for-equity swap by swapping the shares of the Defeasance Company for $25 bn of sovereign debt at nominal value.
- The Defeasance Company's shares would be listed on the Beirut Stock Exchange and possibly other exchanges.
- The Defeasance Company would have an obligation to restructure each company and privatize it by floating it within 5 to 10 years' time.
- The Defeasance Company shareholders would have the option to exchange their shares for shares of the privatized companies, all at market price.

Restore Liquidity

- The same legislation as above would also amend the existing legislation to allow the use of the gold reserves as collateral for a liquidity line of some $10 bn.
  - This will give the Central Bank an additional ability to provide liquidity to the market to restore confidence.
- The Lebanese Pound would be allowed to float, at least for an interim period before instating a crawling peg policy, thus contributing some $20 bn in liquidity. (For purposes of our model, we have estimated the new floating rate at LL 3,000 / $1. Shortly thereafter, three zeros would be eliminated to result in an exchange rate of LL 3 / $1.)
  - The devaluation (free float) will restore competitiveness to the Lebanese economy, stabilize the exchange rate at a real level, and encourage depositors to return to LBP deposits.
  - It should be accompanied by 1) Strict price controls; 2) Reassessment of the minimum wage by taking in consideration the average cost of living; 3) BDL aid for $ borrowers who do not have $ revenues to convert their borrowings into LL.

Make the Banks and major Depositors Shoulder Part of the Burden

The banks and major depositors must assume responsibility for their role in creating the financial crisis and shoulder some of the burden. Specifically:

- Bank shareholders will need to recapitalize the banks to acceptable Basel III capital adequacy levels over 5 years.
- The banks will also need to bear the impact of the LL devaluation on their equity, as well as the estimated $12 bn cost of the recovery effort:
  - $2.7 bn loss of interest on debt converted into Defeasance Company equity;
  - $3 bn as potential loss on the Defeasance Company;
  - $6.3 bn cost to smooth the charge of interest for debtor in $ loans with revenues in LL.
- Depositors who took advantage of returns during this last 3 years well above market conditions will be asked to converted this extra earning into permanent funds for the bank capital up to $10 billions if the amount collected is not sufficient other major debtor will be call to cover the gap.

Restore Confidence and Credit Rating

- The Government would announce all the measures simultaneously as ONE package:
  - Legislation to establish a Defeasance Company, authorize the use of gold as collateral and measures to accompany devaluation.
  - A 10-year plan base on a $30 billion investment over the decade, including:
    - A welfare fund to help employees affected by the restructuring of privatized companies ($10 billion split over the 10 years).
    - An economy recovery program to move the country to a productive economy over the life of the plan ($10 billion split over the 10 years).
    - Commitment to use international financial assistance (e.g. CEDRE funds) strictly for investing in infrastructure and economic development ($10 billion to be draw over the 10 years).
  - Ensure that the budget deficit, including debt service, would not exceed 3% of GDP while maintaining a tax levy of <20% of GDP.
- The Defeasance Company would ideally have a governance model like that of German companies, i.e. an Executive Board composed of independent top-level professionals, and a Supervisory Board representing the banks, civil society and international financial institutions.
- The banks would establish a stabilization fund to help support the Defeasance Company’ stock price when floated – which should be done as early as practicably possible.

Certain Additional Remarks

- The proposed rescue plan can be implemented in as little as 6 months.
- The plan should not appear to be a bailout of the banks, but of the economy.
- The retail sale of State assets over a period of 5 years (instead of using the Defeasance Company mechanism), will see State income largely absorbed by debt service, missing the chance to turn around the Lebanese economy.
- The trade balance will continue to be in deficit until possible oil or gas is commercialized.
- Lebanon's economic stability remains attached to the diaspora and thus to the absolute need to preserve deposits and restore trust.
- A "haircut" will significantly impact the banks' capital and their ability to support the recovery of the economy.

Devaluation Impact on BDL Balance Sheet

ASSETS (in LBP billion)		(as of end Feb 2020)
LBP / USD Exchange Rate	***1507***	***3000***
Gold	21,882	43,560
Foreign Currencies	54,549	108,591
Other Foreign Assets		
Claims on Customers		
Loans to Commercial Banks	22,372	22,372
Loans MLT Banks & Fin. Cos.		
Loans to Public Sector		
Securities Portofolio	57,559	57,559
Fixed Assets	394	784
Assets related to Swaps	18,081	18,081
Other Assets	41,705	52,034
Adjustment		
TOTAL	**216,541**	**302,981**

LIABILITIES (in LBP billion)		
	1507	***3000***
Currency in Circulation outside BDL	12,544	12,544
Deposits - Commercial Banks	169,293	253,940
Beposits - MLT Banks & Fin. Cos.		
Deposits - Customers		
Deposits - Public Sector	7,990	7,990
Valuation Adjustment	13,737	13,737
Securities other than Shares		
Foreign Liabilities		
Special Long Term Liabilities		
Capital Accounts	5,667	5,667
Other Liabilities	7,309	7,309
Adjustment		1,793
TOTAL	**216,541**	**302,981**

Addendum: Budget Forecast

	Present Situation (estimation)	After Restruturing	2020	2021	2023	2024	2025	2026	2027	2028	2029	2030
Total Government debt (billion)	91,20	37,58		39,91	41,44	42,79	43,91	44,75	45,51	46,30	47,12	47,65
Foreign currency debt	33,70	8,70		9,28	9,84	10,40	10,97	11,55	11,32	11,12	10,95	10,50
Internal debt	57,50	28,88		30,63	31,60	32,39	32,94	33,20	34,19	35,19	36,17	37,15
Defeasance Equity	25,00											
Rate of exchange	1507	3000	3000	3150	3245	3342	3442	3545	3652	3761	3874	3990
GDP	58,50		50,72	52,17	53,18	54,21	55,26	56,34	57,43	58,55	59,68	65,48
debt ratio	156%		74%	76%	78%	79%	79%	79%	79%	79%	79%	73%
REVENUES (billion)	9,71		8,64	9,08	9,49	9,96	10,47	10,80	11,15	11,50	11,87	13,20
Income &capital gain tax	2,22		1,95	1,23	1,27	1,30	1,34	1,38	1,43	1,47	1,51	1,56
Corporation tax	1,40		0,70	0,91	1,10	1,32	1,60	1,68	1,76	1,85	1,94	2,52
Property tax	0,76		0,84	0,88	0,91	0,93	0,96	0,99	1,02	1,05	1,08	1,11
Customs duties	0,70		0,70	1,41	1,43	1,46	1,49	1,52	1,55	1,58	1,62	1,78
TVA	2,72		2,36	2,43	2,47	2,52	2,57	2,62	2,67	2,72	2,78	3,05
Inheritance tax	0,07		0,08	0,09	0,09	0,09	0,09	0,10	0,10	0,10	0,11	0,11
Domestic tax	0,95		1,04	1,12	1,18	1,24	1,30	1,37	1,43	1,51	1,58	1,79
Other tax	0,88		0,97	1,02	1,05	1,08	1,11	1,15	1,18	1,22	1,25	1,29
Tax / GDP %	17%		17%	17%	18%	18%	19%	19%	19%	20%	20%	20%
BUDGET EXPENDITURE (without debt service)	9,86		8,64	8,52	8,86	9,21	9,58	9,96	10,37	10,79	11,23	12,31
Public service personnel expenses	6,71		5,87	4,00	4,20	4,41	4,63	4,86	5,11	5,36	5,63	6,36
Other operating expenses	2,19		1,91	2,01	2,07	2,13	2,20	2,26	2,33	2,40	2,47	2,55
capital expenditure	0,97		0,85	0,51	0,54	0,56	0,59	0,62	0,65	0,69	0,72	0,81
Economy recovery program				1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00
Social welfare				1,00	1,05	1,10	1,16	1,22	1,28	1,34	1,41	1,59
Surplus / Deficit	-0,15		0,01	0,55	0,63	0,75	0,89	0,84	0,78	0,71	0,64	0,89
DEBT SERVICE												
Debt interest in foreign currency	2,2		0,58	0,56	0,57	0,57	0,58	0,58	0,55	0,51	0,47	0,44
Public debt interet in LL	3,4		1,74	1,53	1,42	1,30	1,15	1,00	1,00	0,99	0,99	0,98
Expenditure & debt/Revenues %			126,80%	116,89%	114,25%	111,27%	107,97%	106,79%	106,87%	106,87%	106,91%	103,96%
Expenditure & debt service / GDP %			-4,57%	-2,94%	-2,54%	-2,07%	-1,51%	-1,30%	-1,33%	-1,35%	-1,37%	-0,80%
Average interest on foreign currency	6,66%			6,00%	5,75%	5,50%	5,25%	5,00%	4,75%	4,50%	4,25%	4,00%
Average interest on TB & CD	6,03%			5,00%	4,50%	4,00%	3,50%	3,00%	3,00%	2,90%	2,80%	2,70%
Economy growth				3,00%	2,00%	2,00%	2,00%	2,00%	2,00%	2,00%	2,00%	10,00%
Inflation			10,00%	5,00%	3,00%	3,00%	3,00%	3,00%	3,00%	3,00%	3,00%	3,00%