LEBANESE REPUBLIC

Creditor Update – Q&A

Table of Contents

1. BANKING SECTOR REHABILITATION STRATEGY

Questions:

- How will the USD72bn losses will be covered?
- Do you expect the difference between the losses computed on a macroeconomic level and bank by bank level will be big?
- You are assuming an average exchange rate for public debt ratio close to 16k and sometimes 20k so are you not considerably underestimating financial losses since the market rate is much higher?
- Some details have leaked in the press with respect to the banking sector restructuring plan. Have you finalized the contours of that plan? Could you comment on whether the Government is planning on having recourse to the State's balance sheet to absorb part of the $72bn losses (specifically by issuing long-term bonds to depositors incurring losses)?
- Will you engage in negotiations with ABL on banking restructuring?
- How will you get agreement from the ABL, consistent with the IMF demands, given they have refused a bail-in, and are threatening to seize govt assets as the price for a bail-in of depositors?
- Banks have already rejected the plan; can you proceed without their approval?
- Can you to clarify the bank deposits fate and the timeframe to avoid large exchange rates fluctuations?
- What is the rationale behind discriminating between small and big depositors?
- How do you intend to payback the < 100,000$ depositor if all the money available in Lebanon as of today is around $10Bn as per the latest statement of the PM; and the depositors with accounts less than 100$k are almost $18Bn in aggregated value?
- What will happen to Depositors at Banks deemed non-viable? Will they be treated differently?
- Do you consider the labor unions' deposits at the banks as normal clients deposits?
- How do you plan to reduce BdL's liabilities unilaterally, without violating constitutionally enshrined property rights?
- Will the Government cover the BdL losses based on article 113 of CMC?
- Lebanese gold reserves are valued at $18 billion. Will they be used to offset any of the losses?
- How will the BdL be recapitalized?
- Where do you expect funds for bank recapitalization could be sourced from?
- As part of the so called " distribution of losses" have you considered a forensic audit of all bank accounts in order to determine responsibilities besides losses?
- How the 25B$ loans in USD in the banking book are going to be treated in the restructuring plan?

Answer:

Financial sector losses are currently estimated at c. US$72 billion and increasing as time goes by. This estimate, though assessed at an aggregated level and derived from Banque du Liban ("BdL")'s balance sheet rather than banks', is quite consensual but is subject to confirmation after bank-by-bank assessments. The final amount however shall be determined during the implementation of our banking sector rehabilitation strategy and might deviate from the current estimate depending on (i) the level of FX reserves and the exchange rate at that point in time, (ii) the market value of the various assets held in the financial system, and (iii) the level of impairment of banks' loan portfolios.

The assessment of the losses is currently based on the working assumption of the currency exchange rate of 20,000 LL/USD. Though the market currently prices the FX rate higher, the current estimate of the losses remains robust. From the official rate of 1,507.5 LL/USD, the working assumption of 20,000 LL/USD represents a depreciation of ~92% while the current market rate of ~28,000 LL/USD would represent a depreciation of ~95%. This additional depreciation is not likely to substantially increase financial sector losses. Sensitivity analyses have been performed and the impact of the change in the exchange rate on losses is minimal.

The Association des Banques du Liban ("ABL") is a partner of importance to the Government and is obviously called to play an important role in our rehabilitation strategy. Besides, the banking sector has been one of the pillars of the Lebanese economy, and the Government is keen on having a well-functioning banking sector that is focused on its main mandate of providing credit to the economy. The Prime Minister and the team negotiating with the International Monetary Fund ("IMF") have had several meetings with representatives of the banking sector to consult and explain the situation and the envisaged way out of the crisis. The Government intends to keep doing so and seek their feedback on every aspect of our strategy, but the final decision ultimately rests in the hands of the Government. The restoration of a viable banking sector that is able to accompany the recovery of the Lebanese economy is not up for negotiations; this is a must. The losses are not to be negotiated either; they are actual losses that need to be absorbed. The sooner all stakeholders acknowledge this unavoidable and simple fact, the sooner they will be in a position to sit down and discuss remedies.

The contours and guiding principles of our resolution strategy are broadly agreed, but the practical details and means of its implementation remain to be finalized. As outlined in the presentation, it revolves around three major objectives: (i) protecting the most vulnerable, (ii) respecting the hierarchy of claims, and (iii) ensuring immediate return to solvency.

The Government does not plan on discriminating *per se* between small and big depositors. The deposit protection scheme that is embedded in our bank rehabilitation strategy is intended to be uniformly applicable to all depositors. The ambition is to protect all deposits below US$100,000, regardless of their nature, total size, and the banks in which they are held[1]. This represents some US$35 billion in aggregate and appears feasible on a consolidated basis. The Asset Quality Review ("AQR") performed for all banks

[1] This latter distinction is still being debated amongst the Government, the BdL, the Banking and Control Commission ("BCC") and the IMF.

should be able to confirm that this is a viable level from a solvency perspective on a bank-by-bank basis and could lead to a revision of this intention.

Liquidity is a different issue that will have to be handled separately with appropriate means and with the objective of managing the FX fluctuations. In this respect, the protected deposits are likely to be subject to withdrawal limits that would be relaxed in line with the developments in the economy at large and its balance-of-payments position in particular.

The audit of the BdL and the AQR of the banks will then determine how much exactly of deposits the system can sustain. This will then drive calculations of the protected threshold and the preservation rate for deposits above the protected threshold. There are several schemes under consideration to increase the recovery rate for these deposits, including but not limited to bail-in or conversion of dollar deposits into liras, and possibly the creation of special-purpose vehicle (“SPV”), to the extent they are credible and do not further impair public finances and debt sustainability. Therefore, recourse to the State’s balance sheet to absorb part of the losses, if considered at all, shall be limited.

The Government does not have the financial capacity to cover BdL’s losses or recapitalize the BdL[2]. It is expected that BdL will run with zero (or small negative) capital for some time and rebuild its capital base over time. Similarly, the gold will not be used to explicitly cover losses but will stay on BdL’s balance sheet to ensure FX stability and the credibility of the monetary policy going forward. Regarding the reduction of BdL’s liabilities, several implementation techniques are currently being assessed against their compatibility with the Lebanese constitution.

Finally, insofar as banks’ recapitalization is concerned, fresh capital should come from existing or new shareholders. Failing to achieve the capital increase target would lead to a bank being resolved and/or having to merge with some other viable bank. There is no pre-determined idea of the number of banks that will survive since this will be based on the ability of banks to comply with the required capital and liquidity requirements. We have not yet considered a forensic audit of all bank accounts.

[2] Still being discussed with the IMF if some part recapitalization is feasible, but even if an agreement is reached, it would be a very small part of the currently estimated BdL losses.

2. DEBT RESTRUCTURING STRATEGY

Questions:

- When you talk about arrears; are these interests that have not been paid or debt that has not been amortized? Will the interest in arrears ever be paid?
- How will the debt/GDP ratio will go down from 360 % in 2021 to 127 % in 2022?
- Can we have more details on the Eurobond restructuring plan to reverse international default status?
- What is the envisaged haircut in percentage terms on sovereign debt? Does the restructuring include Certificates of Deposits?
- What about Eurobonds held by individuals?
- Is Lebanon open to offering USD creditors a stake in state-owned banks' equity as a potential upside instrument?
- What is the rationale behind excluding bilateral creditors from the perimeter of the restructuring? Will they be putting in additional financing at concessional rates?
- For a Government that earns and collects tax in devalued LBP, how fiscally realistic is it to assume no restructuring of LBP-debt?
- Is there any intention to consider the Eurobonds with custody in Clearstream and Midclear different in term of settlement? Especially that they relate to the same instrument and should be treated same under same prospectus?

Answer:

Debt arrears include both principal and interest arrears. Interest in arrears will form part of the amounts eligible for debt restructuring. It is premature to discuss the upcoming debt treatment and to comment on the potential use of upside instruments. The restructuring package will be negotiated in good faith and full transparency with creditors. However, it is no surprise that the debt treatment shall be severe in order to restore long-term debt sustainability. The working assumption used in the chart showed in the presentation entails a significant nominal haircut and the rescheduling of the balance over the medium to long term, with a grace period and a moderate interest payment. This is one of the many treatments that may work and is intended for illustrative purpose only.

In terms of perimeter of our debt restructuring, it is yet to be decided, again in full coordination with creditors and other stakeholders, e.g., the IMF. So far, our working assumptions do not contemplate the restructuring of bilateral debt, which does not represent a significant share of our indebtedness. We expect this will be discussed on a case-by-case basis, depending on how each bilateral partner intends to support the Lebanese program, either through debt relief or fresh financing (e.g., CEDRE commitments).

Regarding LL-denominated debt, it should be reminded that the currency depreciation has reduced the value of these securities by c. 95% already. Further relief does not seem appropriate at that point. Besides, servicing LL-denominated debt in depreciated currency should not pose substantial fiscal challenge under assumed fiscal consolidation path, at least compared to the numerous other challenges that the Government will be facing to restore and ensure long-term sustainability of the public finances.

Finally, there is no reason *a priori* to treat Eurobonds differently depending on their clearing or settlement mechanisms. The guiding principle remains the uniform treatment of all Eurobonds. Technicalities will be looked at in due course.

3. IMF PROGRAM

Questions:

- How much political buy-in has the Government achieved in connection with the details of the program and specifically the bank restructuring and distribution of losses?
- Can you give a status update on the implementation of the Prior Actions?
- What can a caretaker Government achieve or implement out of the conditions / requirements set by the IMF?
- How much Donors money would be needed according to the IMF program?
- How much financial support is needed from international partners as part of the IMF program? Has the Government sounded out these partners to determine if such support is forthcoming?
- Is the $8-10bn of financial support consider the unlocking the financing pledged from the 2018 CEDRE conference?
- When is the return to Financial Markets envisaged by the IMF program?

Answer:

The IMF program, the banking sector restructuring and the way to deal with the losses have been key topics for discussion in Lebanon since 2020. The Staff-Level Agreement ("SLA") reached in April 2022 is a key achievement that is the result of consultations with various stakeholders. In fact, right after the agreement on the SLA, the President of the Republic, the Speaker of Parliament, the Prime Minister, endorsed the agreement and expressed their full support to the reform package.

It represents a satisfactory synthesis of different views, that both the Government and the IMF deem credible enough to lay the ground for the adoption and implementation of a program and trigger support by the international community.

The political buy-in shall now materialize in the delivery of all Prior Actions that are required to get the program approved by the IMF Executive Board. Almost half of the Prior Actions require Parliament approval, hence requiring appropriate political buy-in and collective responsibility. We are hopeful that the new Parliament will quickly act on the draft laws that are Prior Actions, and the Government intends to do its share of explaining and convincing to get to a final agreement with the IMF. The Government believes that this program and the underlying economic and reform agenda are the only ones that will be able to restore Lebanon's macro-fiscal stability and address the immense social challenges facing the country promptly and decisively.

Regarding the status of Prior Actions, they have all been initiated, with the only caveat of the bank resolution legislation, where technicalities are still being discussed between the Government, the BdL and the BCC with technical inputs from the IMF experts.

In terms of process and timeline, it should be noted that a caretaker Government can still work towards the implementation of the Prior Actions, and the laws can be debated and voted by Parliament as long as the draft laws were introduced by the Government before it became a caretaker Government. This is essentially the case for all Prior Actions requiring Parliament approval, except for the bank resolution law.

The draft law related for this last Prior Action can be submitted by a member of Parliament for adoption (in case the Government cannot).

In terms of program financing, it is expected that the IMF will disburse c. US$3 billion over 4 years, with the rest of the financing gap being covered by official support (including donors' money pledged from the CEDRE conference) and exceptional financing delivered through external debt restructuring. The objective will be to restore appropriate FX reserves to support the BdL monetary regime going forward and provide enough buffer to bring back confidence. Exact figures remain to be firmed up as we get hopefully closer to a Board approval. The Government, the IMF, and friends of Lebanon will mobilize financial support from donors while knowing that the prospects for support will become much stronger when Prior Actions start being implemented.

Donors' money committed during the CEDRE conference are expected to be mobilized, though probably not up to the full amount committed (US$8-10 billion) or over a longer period. The actual amount and timing of donor's money will be driven by the absorption capacity of the new Lebanese economy as well as the targeted fiscal trajectory, to the extent these funds are supposed to be used for capital expenditures and therefore impact the budget balance.

Finally, under the current macro-fiscal framework agreed with the Fund at technical level, return to financial markets is expected at the end of the program period. This is a working assumption and the timing for such return shall obviously depend on the performance of Lebanon in program implementation.

4. MACRO-FISCAL STRATEGY

Questions:

- How will the rescue plan support the health sector which is a must for the Lebanese people?
- Does the fiscal framework include a revision of the public sector pay scales and the minimum wage? If yes, what is the projected increase?
- What is behind the increase in primary fiscal deficit in 2022 from 2021?
- The IMF SLA has a figure of 4% of GDP for the primary deficit attributed to the 2022 budget by the IMF in the press statement. What is the nominal primary deficit in LL that it refers to?
- Can you speak to the level of the unified exchange rate that is assumed under the macroeconomic program?
- Any estimation about the unification of exchange rate?
- Slide 10, what USD/LBP rate is assumed for the GDP chart in LBP?
- What are the exchanged rates used in the computation of GDPs?
- What is the Government's stance on privatization in the medium-term? Is the Government contemplating utilizing state assets (including gold) via a SWF to partially cover losses?
- You've mentioned that you are going to be stopping the central bank from financing the deficit. What are the concrete measures you'll follow to enhance the independence of the central bank?
- How will you build trust between expats and local banks so that we can invest again in the country?
- Are you planning on creating schemes that involve in investing internationally to maintain or increase funds? will the banks be aiding Lebanese businesses in order to enhance agriculture or to help export products in order to profit
- Can you elaborate on your plan for the electricity sector?

Answer:

In preparing the 2022 budget and the medium-term fiscal framework, the Government aimed at reducing the budget deficits over time in relation to GDP while raising spending on social sectors (including health, education and poverty alleviation).

At the same time, the 2022 budget includes mechanisms to adjust the public sector wages after they collapsed in real terms following the sharp depreciation of the exchange rate. The budget accounts for a social compensation allowance to the public sector, which is a temporary measure awaiting the formal introduction of a salary adjustment. The proposed scheme, as contemplated in the budget, accounts for 100% of the salary allowance, with a floor / ceiling of LL 2 million / LL 6 million for in-duty employees and LL 1.7 million / LL 5.1 million for retirees. While we wait for the ratification of the budget, the Government has granted a social compensation allowance equivalent to 50% of the basic salary (pertaining to the months starting from September 2021 up until February 2022). In the absence of a scheme for the minimum wage adjustment in the economy, knowing that recovery and reform hinges on restoring administrative capacity, the Ministry of Finance's medium-term macro-fiscal framework accounts for a salary scale adjustment to tackle the lost productivity and the severe loss of the purchasing power of public wages. The proposed adjustment brings payroll to around 7% of GDP in the medium-term, from a low of c. 5.5% of GDP in 2021. Of course, this remains significantly below the pre-crisis levels (c. 12% for 2018-19).

The unification of the exchange rate will be at the market rate. There will be no target to be set for the rate and the hard peg that has been followed for years will be abandoned. However, the central bank may intervene occasionally when there is excess volatility in the exchange rate not warranted by economic fundamentals. For the sake of preparing the medium-term fiscal framework, the 2021 average exchange rate was used for 2022 and the Syrafa rate prevailing at that time was used for the medium term.

The increase in the primary deficit in 2022 is due to a large increase in social spending, personnel cost, and transfers to EDL, which were more than the increase in revenue coming mainly from the increase in customs after adjusting the custom exchange rate and from some fees. The nominal GDP in 2022 is estimated at c. LL 360,000 billion. The 2022 budget deficit is projected at 4% of GDP and will be mostly financed by foreign sources. Under an IMF program, the central bank will not finance the budget deficit anymore and this will be monitored through a quarterly performance criterion.

It is to note that the increase in primary deficit in 2022 – as opposed to 2021 – is also the result of a base effect: expenditures in 2021 were at an all-time low due to significant financial constraints that led to a decline in both current and capital spending ratios to GDP.

The draft 2022 budget projects expenditures based on historical spending trends; it assumes market exchange rates for materials and supplies, higher transfers to EDL (as opposed to the subsidized fuel purchases in 2021) and accounts for the 100% of salary for the social compensation allowance to civil servants as opposed to 50% in 2021 (and for two months only). The budget also projects, to a certain extent only, a normalization of spending patterns compared to 2021 (namely operational spending for resumption of basic public service delivery and capex), and much higher hospitalization spending. The normalization of expenditures is faster (since they are based on market exchange rates), whereas the adjustment of revenues is phased in time (adapting tax policies and collection to market exchange rates is contingent upon amending the underlying legal framework and tax schedules). As such, 2022 remains a transitory year in terms of adjustments; the full impact will only materialize from 2023 onwards. Therefore, 2022 account for the implementation of market exchange rates for import valuation, for land registry and for a couple more fees only. To note also that projected revenue collection in 2022 account for reduced collection capacity and compliance. The IMF's 4% primary deficit in 2022 includes substantial foreign financed spending, expected to materialize with program implementation.

While privatization is not considered in the short term, it could be contemplated in the medium and long term once State assets stop being distressed. The use of State assets to cover banking sector losses is limited by the need to ensure debt sustainability. Having said that, there are various schemes under consideration to compensate large depositors, but no final decision has been made yet. The financial sector reform will necessarily lead to the downsizing of the banking sector but nonetheless, once the reforms are implemented and the banking sector resumes financing the private sector and confidence in the system returns, expats will likely resume their relationship with local banks.

5. PROCESS AND TIMING

Questions:

- What would be your timeline for the following events: (i) IMF Board approval, (ii) official start of negotiations with external creditors?
- Could you please indicate on the timeline? When do you expect the closing of the debt exchange?
- In terms of sequencing, when do you expect to focus efforts on reaching a restructuring of the Eurobonds? Would that be after the Prior Actions, after IMF Board approval or at some other time?
- The actions and next steps rely heavily on the approval of Parliament and preparation of draft laws by the Government. In view of the current upcoming elections and Government formation, how likely is it that the plan will be implemented in the short term? How much delay can this plan absorb before not becoming feasible anymore?
- In the case new Parliament and Government want to take a different approach and stance, will this take Lebanon to point 0 in the negotiations?
- Is there a draft bank resolution law already prepared to be submitted to the new Parliament?
- Has the Government determined the constitutionality of having MPs submit legislation that should be coming from the cabinet but can't because of its caretaker status?
- When will funds be disbursed to Alvarez & Marsal to allow the commencement of the forensic audit of the central bank?
- Mr. Chami referred to the BdL FX position ongoing audit by KPMG, but there was no reference to the BdL forensic audit being undertaken by A&M. What's the latest on this?

Answer:

The Government's ambition is to proceed with the implementation of most Prior Actions and has already taken care of those that are its responsibility. However, the adoption of a draft bank resolution law has not yet been submitted to Parliament, but in the presence of a caretaker Government, an MP can introduce this draft to be voted by Parliament. With elections now over, we hope that the new Parliament will get to these as soon as possible.

We expect to resume active interactions and exchange of information with creditors as soon as the new administration is in place, without waiting for the IMF Board approval of our program. We also intend to start consultations and agree key principles guiding the debt restructuring exercise. Actual negotiations however will only start once the program is approved, and the macro-fiscal framework and debt sustainability analysis and targets are stabilized.

While it is difficult to commit to a specific timeline in today's uncertain political environment, the timeline the Government currently has in mind involves the adoption of the IMF program and official start of debt negotiations during the summer / fall of 2022. We are hoping for a Board approval of the program in the next 2 to 3 months. Depending on how long it takes to reach approval with bondholders, we may then target a closing of the debt exchange by the end of the year.

The plan needs to be adopted and implemented in the short term. We have a historical opportunity and responsibility to make it work without delay. Too much delay or protracted negotiations between the Government and the Parliament may indeed hinder our ability to build on current momentum and attract appropriate international support. All eyes are currently on us; time is of the essence.

Regarding the audit of the central bank, it is being carried out by KPMG and should be completed by July. This is separate from the forensic audit that is supposed be carried out by Alvarez & Marsal, which is not a requirement under the IMF SLA.