Emerging Insight

Lebanon – Reform plan opens door to IMF program

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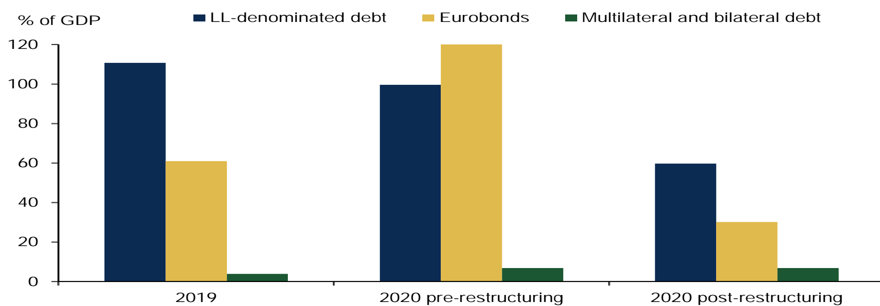
Key takeaways

- The finalized government reform plan has launched the process of negotiations on an IMF program.
- Our main take-aways from the draft reform plan remain valid; we supplement our analysis with some additional observations.
- We view the changes as being for domestic consumption, and to position for tough negotiations with bondholders and the IMF.

By Jean-Michel Saliba and Andrew Macfarlane

Chart of the day: Lebanon – potential government debt profile post-restructuring under reform plan



Source: BofA Global Research

Lebanon in Focus

Reform plan opens door to IMF program

The finalized government reform plan has launched the process of negotiations on an IMF program. Our main take-aways from the draft reform plan remain valid; we supplement here our analysis with a number of additional observations. We view the changes versus the draft plan as positioning to satisfy the socio-political backdrop, and to prepare for difficult negotiations with bondholders and the IMF. The changes introduce efforts to ease deposit bail-in requirements, tough restructuring terms for Eurobond holders (who could face "significant" losses, according to the reform plan) and somewhat softer proposed conditionality in regards to the IMF. We think these changes reflect domestic pushback against the potential size of the financial sector losses. Still, they may not be internally consistent and would entail difficult policy trade-offs. We maintain our view that it could be difficult for bondholders to preserve value in the restructuring in light of the economic and legal challenges.

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Lack of social consensus and poor track record raise implementation risks

The final reform plan does not appear yet to have generated domestic socio-political consensus, despite starting the process of consultations with civil society and groups. Some political parties appear positioned to score points, against the backdrop of renewed protests. The plan as a whole does not appear it will be submitted to parliament for approval. However, the Cabinet will present it to parliamentary commissions and to political parties, and a number of proposed laws and fiscal measures will require parliamentary approval. A National Anti-Corruption Commission law has been adopted in the past month. A key risk is politically motivated or selective application.

No tacit approval from the IMF

We expect the IMF to strengthen the reform program and to require prior actions before Executive Board program approval. These could include a supplementary 2020 budget and structural reforms, possibly including Fx and Electricite du Liban (EdL) measures. A safeguards assessment on the Banque du Liban (BdL) will need to be completed prior to the first program review. This is a standard measure for countries with arrangements for use of IMF resources to ensure the central bank meets the standards required for processing IMF disbursements. It covers five areas of control and governance: a) external audit mechanism; b) legal structure and independence; c) financial reporting framework; d) internal audit mechanism; and, e) internal controls system.

Remarks on the reform plan changes

Significant losses on eurobonds targeted

We understand that the final reform plan incorporates a nominal face-value cut to eurobonds of 75% (supplemented by a 5-year grace period, a 1.2% coupon rate stepping up to 3% after 4 years, on our estimates), keeping recovery value below 20c, in our view. We understand that the nominal face-value cut to domestic debt would be 40%, 10ppt below the draft plan. This reduces the losses to be incurred by the domestic banking sector (reflecting the understanding that external support would not be available to cover past losses), but keeps the government debt level higher than otherwise. The government debt target of 102.8% of GDP post-restructuring in 2020 is consistent with cUS$3bn in foreign-currency borowing by year-end from the IMF and other partners. Authorities now project government debt at 99.2% of GDP in 2024.

Relaxation of capital controls unlikely to be as soon as targeted

A gradual capital controls relaxation from 2021 onwards would lead to US$8.8bn in outflows of currency and deposits that year. We expect capital controls to persist instead for a much longer period. The USD/LL exchange rate is now targeted to be unified at a rate of 3,500 in 2020. The current account deficit is now assumed to shrink in nominal and % of GDP terms to 7.1% of GDP in 2024. This is due to a narrower trade deficit and an improved services balance, the latter's drivers remaining unclear.

Measures to support growth recovery will need donor support

Real GDP growth assumptions are now more optimistic than the earlier draft program, particularly in the short-term, and are assumed to rebound to positive territory from 2022 onwards. Some government planned measures may partially offset the impact of the large ongoing deleveraging process and subsequent fiscal consolidation. However, the financing of these measures has not yet been mobilized and will require discussions with international partners. The measures would cost an annual US$2.1bn (8.2% of 2020 GDP) over 2020-24 and include: a) sectorial strategies; and, b) government and donor guarantees to support essential imports, exports and subsidized loans. In addition, five new commercial banking licenses with combined equity of US$1bn to finance the real economy are to be considered.

Fiscal targets unchanged but starting position likely to be optimistic

The government fiscal targets for 2024 are broadly similar to those in the draft program, and stand at 1.6% and -0.7% of GDP for the primary and fiscal balance

respectively. The revenue and expenditure yields of the proposed fiscal consolidation measures are also broadly similar to those in the draft reform plan despite the higher nominal GDP base. However, the projected primary and fiscal balance for 2020 are now seen at -1.5% and -5.3% of GDP respectively, about 2-2.5ppt of GDP smaller than the projections in the draft target. The government's intention to compensate civil servants through one-off nominal inflation indexation will require careful calibration to anchor inflation expectations, in our view.

There are no explanations as to how the 2020 fiscal projections could be met and the data year-to-date is not sufficient to clarify the trends. Domestic debt increased by LL0.4trn (US$0.3bn at the official Fx rate; 0.5% of 2020 GDP) over January-February 2020, and public sector deposits at the BdL dropped by LL1.6trn (US$1.1bn at the official Fx rate; 1.8% of 2020 GDP) over 4m20. The increase in BdL holdings of T-bills and T-bonds roughly matches the drop in banking sector holdings of T-bills and T-bonds. We suspect the public sector deposits at the BdL could be reported on a net basis, and thus their drop could instead reflect higher BdL claims on the government through outright monetization that may not be captured under the domestic debt stock stated above. It is unclear if the government arrears have increased, but the Cabinet authorized in mid-April the reimbursement of LL0.4trn (US$0.3bn at the official Fx rate; 0.5% of 2020 GDP) in arrears to private hospitals in regards to the COVID-19 crisis.

Smaller deposit bail-in requirements implied

The government reform plan implies a 15ppt lower deposit bail-in requirement, on our estimates, excluding further measures to raise capital. We estimate the deposit bail-in requirement would represent 45.1% of post-devaluation total deposits of the top 10% depositors (or 47.3% of post-devaluation unguaranteed deposits of the top 10% depositors by value in the banking sector). This compares to our estimates of 60.3% and 63.5% for post-devaluation total deposits and of post-devaluation unguaranteed deposits of the top 10% depositors by value in the banking sector, respectively, in the earlier draft reform program.

The implied 15ppt drop in the banking sector deposit bail-in requirement versus the earlier draft reform program reflects a number of factors, which may not transpire eventually: a) smaller face-value cut to domestic sovereign debt; and, b) the incorporation of the valuation account to BdL capital. We understand the valuation account may represent gains on BdL's gold holdings; yet, the BdL appears to hold gold at market value on the asset side of its balance sheet.

Threshold for depositor bail-in not specified

Authorities did not explicitly specify in the final reform plan the threshold to be considered a "large" depositor. The draft reform plan suggested that assets of 90% of depositors (holding less than US$100,000 pre-devaluation) would be preserved. PM Diab later verbally suggested that assets of 98% of depositors (holding less than US$500,000 pre-devaluation) would be preserved. However, no official commitment was published, apart the expression of a commitment to protect the vast majority of depositors and preserve the assets of the National Social Security Fund (NSSF) and of professional organizations.

Measures to reduce bail-in needs require strong execution; prospects uncertain

The government intends to reduce the deposit bail-in requirement through a number of measures. However, the ability to achieve this target requires strong execution and political will, and, at best, could only offer partial relief to depositors. The government suggests the BdL could receive the profits of stakes in a newly created Public Asset Management Company (PAMC) that would hold key government non-hydrocarbon assets (State-Owned Enterprises and real estate). Authorities recognize that divestment of government assets raises inter-generational equity concerns.

The government's preliminary objective is to recover US$10bn in stolen assets over the next 5 years and inject it into a Deposit Recovery Fund (DRF) that would receive the

private sector deposits targeted for bail-in. We estimate this preliminary government target implies a 20% recovery on the transferred deposits to the DRF.

Other measures being considered to reduce bail-in requirements include: a) a claw back of the deposits that left Lebanon despite the de-facto capital controls[1]; b) a claw back on the dividends of bank owners received over the period 2016-2020; c) a claw back on excessive interest income serviced by the banks to depositors; d) a claw back of financial engineering proceeds; e) a marking of real estate on banks' balance sheets to market value, and a use of their foreign assets; and, f) a marking of real estate owned by BdL to market value.

Prospects for material recovery on these measures appear uncertain, in our view. Based on annual reports of the largest 12 domestic banks, we estimate their total foreign subsidiaries had equity of US$2.2bn. It is unclear what multiple needs to be applied to book value and over what time frame such sales could materialize. We understand the value of BdL's portfolio of real estate assets could be cUS$2-3bn. Banks paid out common and preferred dividends of LL4.8trn (US$3.2bn at the official Fx rate) over 2016-18, but only a portion of that would have gone to bank owners and could thus be clawed back according to government plans. Uses of the proceeds of financial engineering operations have included boosting banking sector capital and government tax revenues, which can't be clawed back. A claw back on excessive interest income paid out to depositors and generated through the 2016 financial engineering operations could raise cUS$3bn on our estimates. However, it is unclear how much of these deposits were retained post-2016 operations. Furthermore, these deposits may already have been included in the target for bail-in and thus do not generate savings.

Don't read too much into CDS recovery

The recovery value in the Lebanon CDS auction was driven by market pricing at the time but also technicals in the auction itself, in our view. We would emphasize that the final price of 14.125 should not be relied on as an infallible guide to where the eventual restructuring will take place. However, we maintain our view that it could be difficult for bondholders to preserve value in the restructuring in light of the economic and legal challenges.

The current market price of Lebanon bonds (~17pt) should, in principle, reflect the current market expectations of where the restructuring will end up. Clearly, those expectations could change over time. The CDS auction itself is simply a snapshot on one particular day (in this case, 23 April) and is also impacted by the cheapest to deliver bond considerations. With the restructuring likely still months away from completing, the Lebanon CDS auctions may not be an accurate representation of the final restructuring recovery value.

We show below various final prices for sovereign CDS auctions in recent years. In EM, Ukraine is an example of where the CDS recovery was close to the restructuring level. However, that was only because the market already knew what the restructuring offer was at the time of the auction, in our view.

Table 1: Results of recent sovereign CDS auctions

Date	Country	Final price	Net open interest, US$mn	
Jan 2009	Ecuador	31.375	77.5	to buy
March 2012	Greece	21.5	291.6	to sell
Sept 2014	Argentina	39.5	96.0	to buy
Oct 2015	Ukraine	80.625	15.4	to sell
Dec 2017	Venezuela	24.5	105.1	to buy
April 2020	Lebanon	14.125	108.7	to sell

Source: Creditex, Markit, BofA Global Research

In cases such as Venezuela (Dec 2017, final price = 24.5) or Argentina (Sept 2014, 39.5),

[1] A legal discussion can be found in Zouein, G., Capital Flight from Lebanon: Finding A Legal Strategy in the Absence of Official Capital Controls (April 2020)

the CDS auction final price provided little insight as to where bond prices would go. In Venezuela's case, there has been no progress on restructuring, and bonds have collapsed to around 10/11pt in the current crisis. In Argentina's case, bonds rallied hard in the months after the 2014 auction on growing expectations of payment. In both cases, the CDS final price provided little insight into future prices.

CDS final prices are determined after two stages. The first stage calculates the 'initial market midpoint', which can be roughly thought of as the average of the highest bids/lowest offers in the auction (with crossing bids/offers being excluded). The second stage matches net open interest (the difference between buy and sell physical settlement requests) with limit bids/offers; the last limit bid/offer is used to determine the final price of the auction.

The net open interest in the case of Lebanon was US$109mn to sell, so dealer bids were likely lowered to account for this. This would explain why the CDS final price was below secondary market levels the previous day, in our view. This is simply a technical feature, and should not be interpreted as reflecting fundamental valuations, in our view.

Current market dynamics may complicate bondholder negotiations

The COVID-19 crisis has increased momentum for multilateral support to vulnerable EMs. It may strengthen the government hand - provided it undertakes reforms, and weaken the staying power of bondholders. However, given the challenging market conditions, bondholders may wait out in the hope that they may get a better deal in the restructuring if the global conditions improve. Further complicating the situation is the current G20 push for the private sector to provide debt relief to the poorest countries in the world (the International Development Association borrowing countries). Lebanon is not in this group, and the G20 debt relief is in fact calling for NPV neutrality. However, a side effect could be that authorities use this as a justification to seek more lenient terms from investors, while bondholders may be reluctant to do so.

News and Views

Brazil: industrial production down 9.1% momsa in March

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Industrial production (IP) decreased 9.1% momsa in March (vs +0.7% momsa in February, revised from +0.5% momsa), below our and market expectations at -2.5% and -3.7%, respectively. In yoy terms, IP decreased 3.8% (vs -0.4% yoy previously). Out of 26 sectors surveyed, 21 posted yoy decreases (vs 15 previously), with auto (-16.1% yoy vs -9.4% yoy previously), beverages (-18.7% yoy vs +4.5% yoy) and clothing items (-27.4% yoy vs -3.9% yoy) as the main negative drivers. All four main categories showed yoy decreases. Capital goods decreased 3.9% yoy (vs -4.6% yoy previously), consumer goods decreased 7.7% yoy (vs -3.9% yoy) with durables down 9.7% yoy (vs -10.5% yoy) and non-durables down 7.1% yoy (vs -1.7% yoy) while intermediate goods decreased 1.7% yoy (vs +2.7% yoy).

- **Negative:** IP declined substantially, especially considered that the lockdown only started towards the end of March. This suggests that April's number should be even more negative considered that it captures a full month of economic paralysis. The three-month moving average trend in momsa terms went back to negative territory at -2.4% yoy in March (vs +0.3% yoy previously). In yoy terms, the three-month moving average trend remained in negative territory at -1.6% yoy (vs -0.8% yoy). We expect industrial production to display negative prints in the upcoming months, reflecting the impacts of Covid-19 crisis and drop in oil prices on the industrial sector.

Mexico: Minutes show Banxico sees risks to growth significantly biased to the downside

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The minutes of the central bank's meeting on April 21 are out. The decision to cut the overnight rate at an unscheduled meeting to 6.00% from 6.50% was unanimous. The Board also agreed on the implementation of additional measures to strengthen credit channels and to provide liquidity. The board highlighted the need to strengthen the price discovery process of a wide range of assets, provide sufficient liquidity and prevent market segmentation. Also to strengthen the channels of credit provision so that banks can grant more credit to SMEs and individual. Most board members agreed that slack is increasing considerably. However, most board members also said that uncertainty over the inflation outlook has increased significantly, with some highlighting this is even more the case for the long run. The board highlighted the widening of the output gap and the lower energy prices as the main downward pressures to the inflation outlook and the MXN pass-through as the main upward pressure.

- **To follow:** A large increase in slack is consistent with Banxico continuing cutting rates. However, we interpret Banxico's inflation outlook as something that will keep Banxico on the prudent side. We continue to expect only two more 50bp cuts (May and June) to bring the overnight rate target to 5%.

Philippines: April inflation eased, as expected

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The consumer price index (CPI) rose 2.2% YoY in April, slowing from 2.5% YoY in March. CPI fell 0.1% MoM, falling sequentially for the third straight month. Food inflation was surprisingly higher at 3.4% YoY in April versus 2.6% in March. Food prices rose 0.9% MoM, which we think is more a function of the difficulty in transporting food during the

lockdown, than evidence of actual food shortage. Despite higher food prices, transport (-6% MoM) and housing/utilities (-0.5% MoM), largely brought down the overall inflation measure.

- **Positive**: receding headline inflation should be supportive of the recent moves of the BSP to cut policy rates and undertake measures to aid liquidity. In our estimate, we think inflation bottoms out around April-May, at 2.2% YoY – as demand is constrained by the prevailing lockdown. Note that government imposed this week a 10% tax on fuel, taking advantage of weak fuel prices to raise revenue and offset some of the revenue loss from foregone consumption. The fuel tax may offset some of the downward pressure on fuel prices.

Valuation & risk

Lebanon (LEBAN)

Lebanon faces a highly uncertain near-term outlook and we are concerned a restructuring could see bond prices fall lower. However, political willingness to pay is unclear and could potentially support bonds near-term. There are upside scenarios in softer restructurings which are possible given Lebanon's geopolitical importance. Amidst uncertainty, we Marketweight on bonds.

Upside risks come from the potential formation of a technocratic Cabinet, an end to mass protests, and a return of external depositors in particular. Fiscal consolidation could also lead to renewed donor support.

Downside risks stem from pressure on Fx reserves from deposit flight, ongoing mass protests, uncertain political direction and the potential for a disorderly adjustment.

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Lebanon / LEBAN

Sovereign	Date^	Action	Recommendation
Lebanon / LEBAN	30-Apr-2017		Marketweight
	14-Sep-2017	Upgrade	Overweight
	06-Nov-2017	Downgrade	Marketweight

Table reflects credit opinion history as of previous business day's close. ^First date of recommendation within last 36 months. The investment opinion system is contained at the end of the report under the heading "BofA Global Research Credit Opinion Key."

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