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The New Financial & Banking Restructuring Plan: Analysis & Critique

I. Introduction

Five years ago, the financial crisis caused the banking sector and exchange rate regime in Lebanon to collapse which dragged with it the whole Lebanese Economy. The crash marked by the Eurobonds default and the subsequent insolvency of major banks has resulted in US$ 72 billion of losses, or 83% of USD deposits at banks, according to the World Bank. The banking sector's losses as a share of GDP, which is more than three times the GDP, is among the largest worldwide. As the country struggles with the economy's contraction, currency devaluation, banking sector crash, and widespread poverty, the need for a comprehensive, effective and immediate banking restructuring plan has become indispensable. In response to this crisis, the Council of Ministers in coordination with the Central Bank has proposed a new Financial and Banking Sector Restructuring Plan (FRP). This plan aims to start the repayment process to depositors, despite the fact that repayment ratios depend on many factors, and to stabilize the financial system and restore confidence in it.

II. Analytical Description of the FRP

The Foreign currency deposits subject to restructuring in the plan are around $86B. The amount is derived as below:

	Foreign currency deposits held in banks in Lebanon as of the restructuring date
(Minus)	Fresh deposits (as per BDL's circular 150)
(Minus)	Legally protected deposits (e.g., public sector deposits, embassies operational accounts)
(Minus)	Cash collateral accounts subject to settlement of outstanding liabilities
	Foreign currency deposits subject to restructuring

Key Foundations for the Success of the Restructuring Plan

- Implementation of the Reform Program signed in September 2022 as a preliminary staff agreement with the International Monetary Fund (IMF)
- Improving the Lebanese Government's Revenues to cover part of depositors' rights without negatively impacting its main obligations
- Establishing Sustainable Economic Growth is a must to restore public trust and support the economy
- A consensus among political parties is essential to accelerate the implementation of the reform plan, accompanied by a clear timeline and measurable indicators for progress
- Certain measures specifically 4 & 5 (M4 & M5) require the care of BCCL and independent auditors.

The FRP consists of ten measures. Out of the $86 Billion deposits, $40 billion of the deposits is planned to be solved through monetary measures (settlement of guaranteed eligible and ineligible deposits and lirafication) and the remaining $46 billion are planned to be solved through non-monetary measures (freezing deposits of unspecified sources, recovery of excess interest, Bail-in, zero coupon bonds, and deposit recovery fund) We will briefly go through each measure in what follows.

Measure 1 (M1): Dividing deposits between eligible and ineligible deposits.

In this step, there are pre-requisite issues that should be done:

- Waiving bank secrecy towards Banking Control Commission of Lebanon (BCCL) and the independent external audit
- Banks prepare the data subject to the audit by the banks' external auditors in addition to the independent external auditors and / or BCCL

Eligible deposits are calculated as follows:

Balance A = I + II – III – IV

I: Balance as of 17.10.2019

II: Cash or Incoming Transfers from outside Lebanon between 17.10.2019 and 09.04.2020 (date of issuance of BDL circular 150)

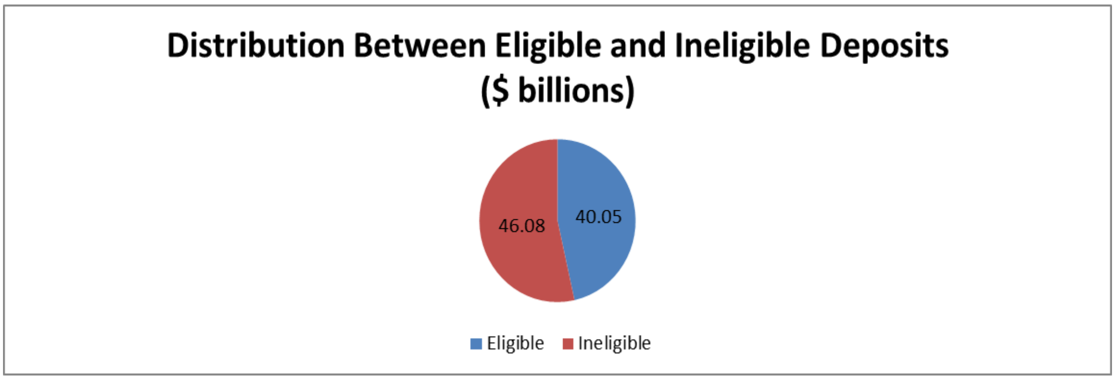
III: Cash withdrawals + Transfers to outside Lebanon + Usage of International Credit Cards

IV: Foreign currency loans settled through checks in local dollars

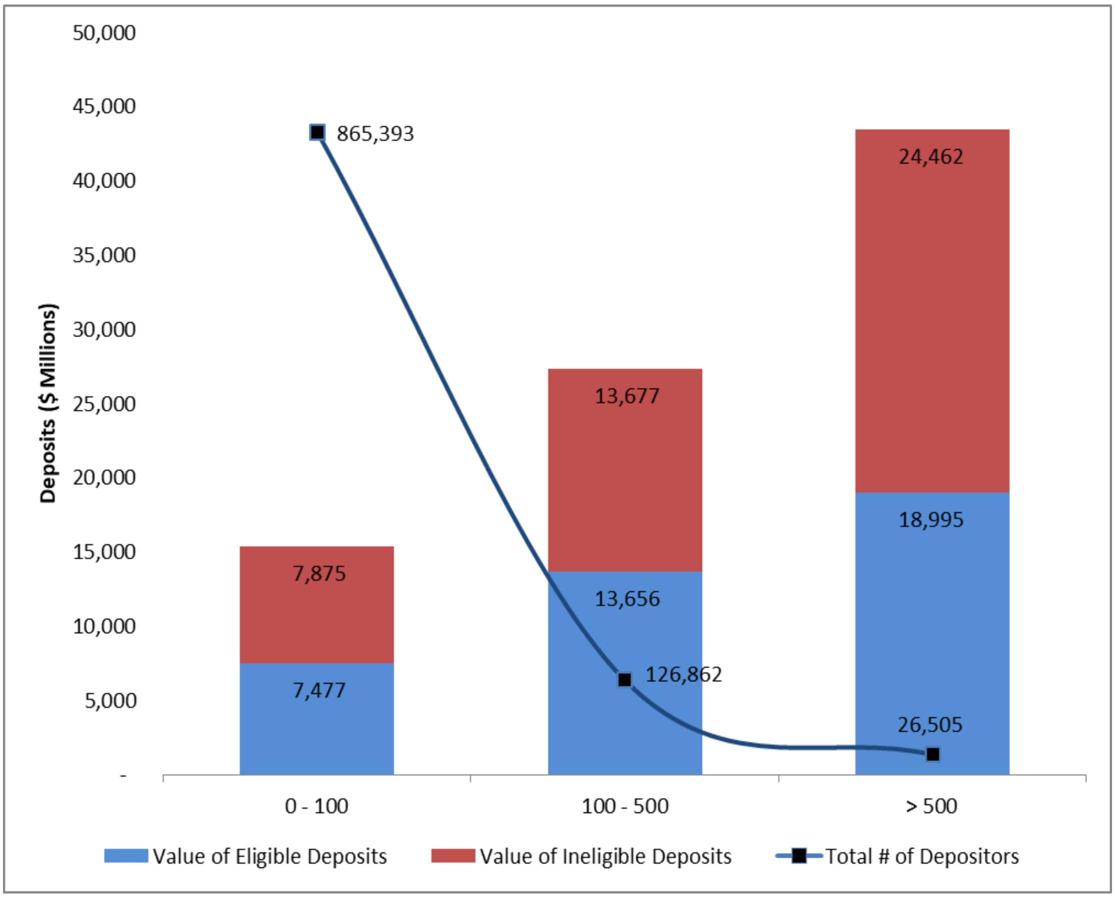
Balance B = Balance at the date of the restructuring

Therefore, the eligible balance is the lesser between Balance A and Balance B.

As per the plan, total deposits were estimated at $86.14 billion out of which $40.05 billion (46.5%) are eligible and $46.08 billion (53.5%) are ineligible.



Estimated depositors totaled 1,018,760 and are distributed as follows:



Measure 2 (M2): Freezing of Deposits with Unspecified Source of Wealth

Every client who has deposits at the banking sector exceeding $500,000 in case of normal clients and exceeding $300k in case of a politically exposed persons will have to renew their KYCs and there will be an enhanced due diligence regarding the origin of the deposits starting January 1st, 2015.

The client has a period of 3 months from the date his bank / Special Investigation Commission (SIC), BCCL notify him to renew the KYC and submit to the bank the needed information.

Then, the SIC will be responsible for determining the deposits that are not complying with the information submitted by the bank, BCCL, and independent audit company. The non-complying deposits will be transferred to banks' off balance sheets and will be removed from the banks' deposits in Central Bank's liabilities.

As per the plan, the deposits from unknown origin are estimated at around $2.5 billion dollar from the eligible deposits and $1.5 billion from the ineligible deposits; therefore, representing around 4.65% only from the deposits that are to be restructured.

Measure 3 (M3): Recovery of interest paid on deposits that exceed a pre-specified limit

The plan suggests that interest paid that exceeds 1% for the period from January 1st, 2015 till December 31st, 2020 will be deducted. On banks' books, the deducted interest will be decreased from clients' deposits in its liabilities and on the assets side, banks' deposits at Central bank will be lessened by the same amount. On Central Bank's books, these recovered interests will be deducted from banks' deposits in its liabilities while decreasing the same amount from the accumulated losses of Central Bank.

After freezing the deposits of untraceable or unknown origin in M2, the remaining deposits (eligible or ineligible) that exceed $100,000 will be lessened by the interest exceeding 1% during the above specified period. As per the plan, the estimated claw back of excess interest based on existing customers is around $9.16 billion out of which $4.76 billion are from eligible deposits and $4.4 billion are from ineligible deposits.

Measure 4 (M4): Settlement of Eligible Guaranteed Deposits

The plan proposes that the first $100,000 of all eligible deposits in the banking sector is guaranteed and will be settled in11 years on a monthly basis.

50% of the settlement of guaranteed eligible deposits will be paid through banks' liquidity with correspondent banks and 50% through banks' liquidity at the Central Bank.

The estimated guaranteed eligible deposits that will be settled are around $11.81 billion and will be settled within 11 years as follows:

In USD '000

Year	BDL Share*	Banks' Share	Total	Monthly Installments ($)
1	864,057	864,057	1,728,114	400
2	832,802	832,802	1,665,604	500
3	692,463	692,463	1,384,926	500
4	614,879	614,879	1,229,758	500
5	725,856	725,856	1,451,712	600
6	465,705	465,705	931,410	600
7	464,846	464,846	929,692	600
8	532,318	532,318	1,064,636	700
9	433,950	433,950	867,900	700
10	195,245	195,245	390,490	700
11	81,826	81,826	163,652	800
Total	**5,903,947**	**5,903,947**	**11,807,894**	

*Basically, these amounts are from Banks' deposits at Central Bank deposited before the banking system crisis, i.e. the Central Bank will be returning them to banks in fresh dollars

Measure 5 (M5): Settlement of Guaranteed Ineligible Deposits

As per the plan, from the ineligible deposits, there will be a settlement up to $36,000 within a period of 11 years on a monthly basis.

The settlement will be 75% in USD and 25% in LBP. The LBP settlements will be done by the Central Bank covered by the state. Regarding the USD settlements, 50% will be done through banks' liquidity with correspondent banks and 50% through banks' liquidity at the Central Bank.

		Settlement in LBP		Settlement in FC		
Year	Full Amnt ($000)	Amount in $	LBP Proceeds* (in Millions)	Central Bank Share**	Banks' Share	Total
1	1,089,182	272,295	**24,370,440**	408,443	408,443	816,886
2	872,177	218,044	**19,514,950**	327,066	327,066	654,132
3	805,008	201,252	**18,012,056**	301,878	301,878	603,756
4	718,556	179,639	**16,077,690**	269,458	269,458	538,916
5	688,031	172,008	**15,394,701**	258,012	258,012	516,024
6	575,939	143,985	**12,886,635**	215,977	215,977	431,954
7	562,748	140,687	**12,591,488**	211,031	211,031	422,062
8	529,623	132,406	**11,850,323**	198,609	198,609	397,218
9	480,822	120,205	**10,758,387**	180,308	180,308	360,616
10	393,908	98,477	**8,813,695**	147,716	147,716	295,432
11	202,813	50,703	**4,537,951**	76,055	76,055	152,110
Total	**6,918,807**	**1,729,701**	**154,808,316**	**2,594,553**	**2,594,553**	**5,189,106**

*The $/LBP rate used is 89,500.

**Basically, these amounts are from Banks' deposits at Central Bank deposited before the banking system crisis, i.e. the Central Bank is returning them to banks in fresh dollars

Measure 6 (M6): Lirafication

Depositors will be given the choice to withdraw their dollar deposits in Lebanese Lira based on a constant conversion rate of 89,500 LBP for 1 USD for deposits that are $500K and less after implementing procedures M4 and M5. For Eligible deposits, the Lebanese pounds rate used for lirafication is 45%, while it is 30% for ineligible deposits. The withdrawal is on a monthly basis and for a maximum period of 11 years.

Estimated Amounts Involved:

Category	Eligible Deposits	Ineligible Deposits	Total
Amount to be Lirafied, USD '000	7,883,734	13,166,423	**21,050,157**
% Used for Lirafication	45%	30%	
Constant FX Official Rate	89,500 LBP/USD	89,500 LBP/USD	
Total Amount in Millions LBP	323,233,085	355,493,421	**678,726,505**

Measure 7 (M7): Bail-in

Procedure 7 involves the recapitalization of banks using funds from large depositors (bail-in) and is divided into three parts:

Key components:

1. Assessment of Remaining Equity: The remaining equity in the banks will be evaluated to determine its status (positive or negative)
2. If the total equity is positive:
    a. If there are no legal violations, this equity can be valued by external auditors and used to encourage shareholders to participate in the bank's recovery and development
    b. Shareholders will be incentivized based on the evaluation of the remaining positive equity, particularly when determining the new share price that reflects the bank's capital situation
3. If the total equity is negative:
    a. Option A: The bank gets liquidated by the restructuring committee
    b. Option B: If current shareholders covered all negative capital before the restructuring decision, the bank will be allowed to undergo a restructuring process

M7-A: Determination and Distribution of New Equity (estimated at $2.8B or at 6% of Risk Weighed Assets)

Step 1:

- The Banking Control Commission (BCCL) will determine the minimum capital required for compliance with local capital adequacy regulations, specifically focusing on the risk-weighted assets (RWA) calculated at the time of restructuring
- The required capital will be set to equal the Common Equity Tier 1 (CET1) needed at the restructuring date, with new shares issued at a nominal value of $1 each (with the nominal value in Lebanese pounds and the premium in U.S. dollars)
- All newly issued common shares will have full voting rights and will be listed on the Beirut Stock Exchange (BSE)

Step 2:

- Existing common shares will be written off

Step 3:

- Large depositors will subscribe to up to 33% of the newly issued common shares
- Current shareholders will finance 67% of the new shares through a completely new recapitalization, taking into account the existing remaining equity.

M7-B: Treatment of Tier 2 Equity

Step 4:

- The procedure addresses subscriptions from individual investors, specifically regarding preferred shares and subordinated bonds, by allowing repayments of up to $36,000 per investor according to the mechanism for settling ineligible deposits (M5)
- The remaining balance will be converted into CET1 after applying specified conversion rates: 1/12 for subordinated debt and 1/15 for preferred shares

M7-C: Bail-in into Subordinated, non-convertible bonds (estimated at $600M or at 2% of RWA)

Step 5:

- A portion of large depositors' funds will undergo conversion into non-convertible subordinated bonds to cover part of the RWA
- Conversion ratios are set at 1/5 for eligible deposits and 1/10 for ineligible deposits
- The bonds will have a maturity of 12 years, with a principal payment due at maturity and a semiannual coupon rate linked to the six-month Secured Overnight Financing Rate (SOFR)
- These bonds will be tradable

Estimated Amounts Involved:

USD '000	Eligible	Ineligible	Total
Transferred to Common Shares	1,655,622	3,311,244	**4,966,866**
Transferred to Subordinated Bonds	1,484,925	2,969,850	**4,454,775**
Particpation to bail-in	**3,140,547**	**6,281,094**	**9,421,641**

Measure 8 (M8): Transfer to Zero-coupon Bonds

- 50% of the remaining deposits after the completion of Procedure M7 will be converted into zero-coupon bonds
- Eligible depositors receive 20-year bonds, Ineligible depositors receive 30-year bonds; both from institutions rated A or higher
- The Lebanese government will cover 100% of the bonds' nominal value, estimated at around $2.9 billion
- The Central Bank will temporarily finance the government using foreign reserves, to be repaid over 10 years at the 6 month US Treasury rate paid semi annually

Estimated Amounts Involved: The estimated amounts involved in the Zero-coupon Bonds process total approximately $11.9 billion.

Measure 9 (M9): Transfer to Notes issued by the Deposits Recovery Fund (DRF)

Procedure 9 outlines the settlement of the remaining deposits through securities issued by the Deposit Recovery Fund (DRF):

- The DRF issues conditional securities, payable only upon realization of revenues from the government's assets like Electricité du Liban (EDL), telecommunications companies (like Ogero, fixed-line services, and postal services), airports and maritime and land ports, and Middle East Airlines (MEA)
- The government contributes to the DRF through:
    - 17% tax on profits from loan settlements in foreign currencies in excess of half a million dollars using Lebanese Pounds checks and Local Dollars Checks

    - 20% of the annual net income of the Government's Assets Management Company
    - 1% of the Company's operating income as royalties
    - Any amounts recovered from anti-corruption initiatives by the government
- An independent holding company will be established to manage state assets

Estimated Amounts Involved:

DRF Contribution		
Eligible	**Ineligible**	**Total**
$5.4 Billion	$6.5 Billion	**$11.9 Billion**

Measure 10 (M10): Settlement of the remaining accounts of banks at the BDL

Procedure 10 tackles the settlement of excess remaining balances that banks have with the BDL after prior measures in the restructuring plan.

Key points:

- Excess is the remaining foreign currency balance at BDL, minus net mandatory deposits.
- BDL will issue perpetual bonds in Lebanese pounds for any excess in U.S. dollars, based on the official exchange rate, with an interest rate not exceeding the six-month Lebanese Treasury bond rate minus 2%.
- A five-year grace period for interest payments on these bonds will be provided.

Summary of the FRP by Measure

Bracket (USD 000's)			FCY Deposits		N Compliant	CI back	Guarant	Guarant	Lirafication	Bail-in	Bail-in	Conversion	Transfer
Bracket	From	To	Deposits	Balance	Deposits	Excess Int.	Eligible Dep.	Ineligible Dep.	Residual Dep.	Common Shr	Sub Bonds	to ZCB	to DRF
1	2	5	311,968	176,495			82,407	94,088				(0)	(0)
2	5	10	103,463	343,993			176,923	167,070					
3	10	20	94,589	707,436			357,895	349,540					
4	20	50	100,581	1,454,930			718,096	667,553	69,282				
5	50	100	146,980	4,878,301			2,243,851	2,190,967	443,482				
6	100	200	107,812	7,790,530			3,030,956	1,693,350	3,066,224				
7	200	300	71,075	9,925,943		1,377,169	2,709,481	919,920	4,919,372				
8	300	500	29,101	7,083,560		983,908	1,015,067	333,000	4,751,585				
9	500	1000	26,686	10,323,494		1,424,351	807,333	291,600	7,800,210				
10	1000	2000	16,011	10,968,457	825,898	1,413,457	430,311	133,160		1,188,037	1,065,549	2,956,023	2,956,023
11	2000	5000	6,335	8,535,436	728,787	1,090,044	159,023	47,030		941,157	844,123	2,362,636	2,362,636
12	5000	10000	2,972	8,772,538	832,138	1,095,516	61,323	21,934		994,531	891,993	2,437,551	2,437,551
13	10000		776	5,274,245	548,693	639,685	11,516	6,070		615,422	551,971	1,450,444	1,450,444
14			411	9,906,467	1,111,721	1,140,467	3,716	3,524		1,227,719	1,101,140	2,659,090	2,659,090
Total/Average			1,018,760	86,141,824	4,047,238	9,164,597	11,807,897	6,918,807	21,050,157	4,966,866	4,454,775	11,865,744	11,865,744
%of Total					4.62%	10.60%	13.68%	8.04%	24.44%	7.26%	5.14%	13.12%	13.12%
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III. Key Critique of the FRP

The various measures proposed by the FRP raise significant concerns that must be carefully addressed. However, it is important to acknowledge that having a plan, even with its shortcomings, is better than having no plan at all. Below is a structured critique of the key measures:

1. It is interesting to note that the plan did not distribute the accounts that have balances above $1 million between individual and corporate; noting that some accounts might be for entities such as unions and NSSF (to name a few) that affect thousands of people which might not be fair to be considered as individual clients. Moreover, it is not logical to give them monthly payments as mentioned in M4, M5, and M6, therefore we think that these accounts should also be legally protected such as public sector deposits and embassies operational accounts.

2. Lirafication Measure

a. **Inflation Risks:** While the plan doesn't detail the way this measure will be funded, however, if it was through increasing the money supply, hyperinflation will occur, then, the value of the Lira will decrease against the Dollar, again. In other words, depositors' losses will further exacerbate as what happened previously with BDL circular 158 when there was 50% of the monthly installment paid at 8,000 then 12,000 whereas the $/LBP rate surpassed 90,000. This is also the case with 25% of guaranteed ineligible amounts that will be paid to the depositors in Lebanese Lira.

   At the same time, it is important to note that the Lirafication process is set to last for 11 years and that during that period, the economy is expected to grow, though it is unclear at what pace. Therefore, inflation will still increase if the plan was funded through printing more Lebanese Pounds, but if the right foundation was implemented to support Lebanon's economic growth, as the plan mandates, the currency devaluation will be eased.

b. **Economic Uncertainty:** People who earn salaries in the local currency, like public sector employees, will face a significant decrease in their purchasing power if the local currency was inflated against the dollar. This could provoke more uncertainty and strikes, further destabilizing the economy.

c. **Long Withdrawal Period:** Prolonging the withdrawals period to a maximum of 11 years will restrict the depositors' ability to access their funds quicker which is seen as an unpleasant condition particularly given the economic environment's volatility.

d. **Unfairness of Withdrawal Rates:** Allowing depositors to withdraw only 45% or 30% deprives them of full access to their rightful funds. This could lead to additional lack of trust in the banking system and potential legal challenges.

3. Proposal for Zero-Coupon Bonds

a. **Long Withdrawal Period:** Issuing 30-year zero-coupon bonds means that many retirees who deposited their life savings might not see any benefits from their investments during their lifetime.

Furthermore, the US Dollar's purchasing power is expected to decrease during the mentioned period due to inflation.

b. **Discounted Bond Sales:** Depositors may be forced to sell their bonds at a discount to access their funds earlier and the discount is likely to be substantial given the long maturity.

c. **Government Financing Concerns:** While the Lebanese government will cover 100% of the bond costs, the reliance on the Central Bank to temporarily finance these bonds using foreign reserves raises questions about the effects of this approach. This could strain the Central Bank's resources and impact its ability to manage monetary policy effectively. Moreover, while the plan mandates the Lebanese Government to improve its revenues, this action might not be as successful as planned. As a result, the government might have to partially reallocate spending from essential public services to buying these coupon bonds, negatively affecting the impacted sectors. This move would also increase Lebanon's already high debt levels and create future financial burdens for the government.

4. Transfer to Notes Issued by the Deposits Recovery Fund (DRF)

a. **Dependence on Government Assets:** The reliance on specific assets' profits for repayment introduces significant uncertainty, as the success of these assets in generating revenue is not guaranteed. If these assets underperform or face operational challenges, depositors may face delays or a decrease in their expected earnings.

b. **Establishment of an Independent Holding Company:** The establishment of an independent holding company raises important questions about governance and accountability. Its effectiveness in managing assets and ensuring transparency will be necessary for the success of the DRF.

c. **Funding Structure:** Diverting profits from a government that is already heavily in debt raises significant concerns about prioritizing financial recovery over essential public services since improving the government's revenues may not be sufficient to meet the necessary levels required to finance alone this measure.

5. Settlement of Remaining Accounts at the BDL

Devaluation Concerns: Perpetual bonds are issued in Lebanese Pounds. Therefore, if the Lebanese Lira weakens against the dollar, the real value of fixed interest payments over time substantially decreases. In addition, inflation also decreases the real value of the fixed interest payments.

IV. Conclusion

The latest FRP discussed in this spotlight – though not perfect -- is the most detailed, comprehensive, and realistic plan so far. It distributes burdens on all involved, and perhaps stands a good chance of being accepted by all stakeholders. It is, of course, not easy to implement, but if there is a will – especially political will – then there is a way. Some additional, important implications of the plan that are good to keep in mind: Lirafication accounts for close to 25% of the settlement of deposits, the highest of all measures, and it entails a sum of 833.5 trillion LBP; $40 billion of deposits are settled monetarily, and $46 billion non-monetarily; in monetary terms, deposit recovery ratios are 50.4% for eligible deposits and 38.8% for non-eligible deposits, and they are the lowest – at 25% to 35% -- for deposits between 200K and 500K; and bank's USD commitment to deposits' recovery is around $9 billion.

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