LEBANON 3.0 – A ROAD MAP TO RECOVERY

The Problem

Over the last two decades in Lebanon, corruption and political divisions raged as successive governments failed to produce any comprehensive economic vision. They have indeed refrained from implementing any substantial administrative reform to reverse institutional decay. Moreover, by not fostering any industrial or agricultural development, governments did not rationalize the balance of payments' deficit. Finally, no corrective action was taken over the last 3 years to address the financial meltdown which led the economy towards a free fall disaster.

A too little too late approach resulting in systemic wrong decisions pressured the Government to default on its fx sovereign debt, the Central bank to incur abyssal losses, and the banking sector to become insolvent while depositors lost most of their money. Other effects included a steep local currency devaluation and a critical hyperinflation culminated into socio-economic agony.

Immediate Measures Year 1 (to be executed in the below order of priority)

1- Set a Capital control law over a maximum of a 6 to 12-month period. Although such a law is not as relevant as it used to be a couple of years back, it shall be set <u>only</u> to catalyze Year 1 reforms measures and radiate seriousness to the IMF so it considers Lebanon case at board level. Beyond 6 months this capital control law might become incompatible with the uniformization of the exchange rate and as such might harm the economy in terms of FDIs investment or local development as it might hamper new money flows into the country.

2- Enact and enforce an extended financial decentralization law.

3- Electricity being at the heart of every economy, enforce as a priority a law to ensure the immediate fixing of EDL with the objective to get full electricity supply within the next 12 to 18 months.

4- The Central Bank is to immediately implement a transparent monetary policy to standardize and unify the exchange rates, and to control the local currency devaluation while addressing rising interest rates. This monetary policy is to be in line, on one hand, with the state fiscal policy, and on the other with the state budget to support a recovery plan over 5 years. Furthermore, it shall forbid the central bank from lending directly or indirectly to the Government.

5- The parliament is to institute the "Rule of Law", and legislate:
  a) A law to guarantee the independence of justice.
  b) A law amending the "bank secrecy law":
    - to enable transparency and accountability through an audit of all public institutions.
    - to fight corruption, money laundering and "the informal economy" across all sectors and to enact a business prone environment enforcing good governance and improving the "ease of doing business".

Lifting bank secrecy shall be mandatory both on public servants and on private institutions (local or International) which deal with public funds or public contracts. This Law will also be critical for the Banking-sector auditing and restructuring process (including the Banque du Liban - BDL).

6- To audit banks, the central bank and the main public institutions (mainly the Electricity of Lebanon EDL and the public Telecom companies) so to properly and accurately evaluate their losses.

7- Set a strong, fair and transparent public procurement law including a law to legally forbid *Monopoly* (el i7tikar) and to open the market to competition (different from *Exclusivity* -wikaleh hasriyeh- which is a private contract between the producer and the reseller based on the reseller performance).

8- To initiate a fiscal process to claw-back onerous earnings and restitute all interest rates above the Eurobond interest rate at any period. In addition to that, enact a fiscal wealth tax that reaches residents whether their assets are in or outside Lebanon; as well as a law to restitute the USD 6 to 7 billion that exited after October 17th 2019, which is to be voted simultaneously with the capital control law (if any).

9- To enact and strengthen public audit (diwan al mou7assabeh) not only to file cases but also to deliver execution on each case. Create a unit that restitute illicit earnings (argent mal acquis) through a settlement process (like the "Lava jato" operation in Brazil) where the collected money will go to a fund that fosters economic development and depositors' money recovery.

Medium Term Measures (to be executed in the below order of priority): 1st to 3rd year

Economic Recovery can only occur if the financial meltdown is solved. Hence the need for a 360-degree plan to close the chronic twin deficit (budget and balance of payments):

1- A strong and smart fiscal policy and strategy to close budget deficit (a 3-year balanced budget), strengthen tax collection and nurture the public sector while training its workforce to transition over time to the private sector. In addition to the institution of fiscal measures/reforms to support the recovery process and attract external and local investors. Capitalizing as such on the Lebanese economy and SMEs will help create jobs.

2- A restructuring of the public sector and rescheduling of its debt (Eurobond and Tbills) to ensure debt sustainability. Here, evaluate if the Government could, through a one-time offer, buy the Eurobond debt at a discounted fixed price.

3- Set a full strategy to squeeze-off the balance of payments' deficit including any Fx shortage, as well as a fiscal strategy that will impose high taxes on non-critical products (such as in Singapore), while providing a tax shield for FDIs.

4- Enact a law to protect private deposits (like the law protecting Gold) and to treat ALL depositors on a *pari passu* basis without any discrimination between small and big depositors for deposit recovery. This shall go along with a plan to address the equitable recovery of deposits where all actors (State, Central Bank and banks) would participate to maximize deposits' redemption i.e. Avoid any Haircut as to build **trust and confidence** in the system. (No Gold is to be used to cover losses or debts).

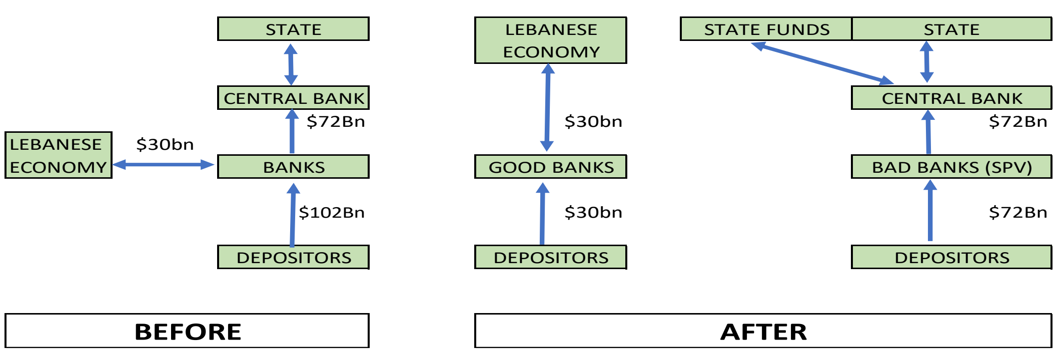
5- A “Bank resolution law” with a Good-Bank/Bad-Bank streamlining approach, enabling the sector to restore its viability and sustain the economic recovery. After a QAR (Quality Asset Review) on each bank, create the “Bad-Bank” that will include all the bad assets and the equivalent bad liabilities (i.e. the “unavailable” deposits related to the estimated expected loss of $72bn at the BDL). This bad bank will be a financial SPV (Special Purpose Vehicle - not a bank) that is 100% owned by the central bank. The SPV will protect depositors form any Haircut through the future collection of the “unavailable” deposits after the bank restructuring process. Hence, through time any BDL asset recovery and/or recapitalization will offset the bad assets of this SPV – Note that as per the CMC clause 113, the Government shall recapitalize the BDL; to be done through a state asset management company to be described below.

This SPV will be securitized with OTC bonds to be emitted proportionally to all depositors’ money making them direct shareholders (of the SPV). These bonds can be transacted. They will build value over time and will distribute return as the central bank is being re-capitalized (o recover “unavailable” deposits within the system (hence the need to create a NEW BDL).

The recovery amount for the SPV shall be reduced by the set-up of a wealth tax and fiscal reforms as well as by the claw-back of all interests above the Eurobond rate (as described above). Advice shall be sought from the IFC to build on their expertise in assets recovery and in the use of state-owned funds returns, so to gradually participate in recovering the SPV’s bad assets over a 10 to 15-year period.

This “Bank resolution law” shall also set-up the right and transparent governance at the BDL (Bank Du Liban), the SIC (Special investigation committee), the BCC (banking Control commission), the banking sector and the CMA (Capital Market Authority) along with the CMA special court so to avoid conflict of interest, and to ensure independence of governance bodies and their limited mandate in time. It shall also create the needed risk management framework and financial watch-dogs to avoid any such banking crisis occurring in the future.

After a restructuring, merger and a re-capitalization process of the BDL and the banking sector, and after identifying the roles, the responsibilities and the accountabilities of the banks’ shareholders, boards and executives, there will be fewer banks. The remaining banks will represent the “Good banks” owning the “good assets”. The new “good” banking sector will be smaller but stronger and healthier (as separated from any bad asset in the SPV), and as such, creating the needed trust and confidence to re-ignite the financial sector and foster economic recovery.



(The “before & after” states and numbers depict a simplified structure of the needed system)

In parallel, run a valuation of the state assets over a 10-year period. Assuming asset restructuring and the creation of new assets (i.e. concessions etc.), the State asset value could reach at least $150billion. Then create an Asset Management Company AMC (or sovereign fund) to manage and improve the performance of state-owned enterprises/assets, with an international independent executive board (update the current 520 fiduciary law to help set-up this independent board with a fiduciary account). Contract specific PPP/BOTS private sector partnerships to improve on one hand, the quality and return of state assets (like in Sweden) and on the other to create new ones (like Dubai's Palm). Performing funds can thus generate between 5 to 7% return per year into a fiduciary account that will be used to fund and recover the economy. Note that **NO state assets will be sold in this process**.

The Government may also set-up a real-estate asset management National Fund and an Oil National fund to generate further public revenues.

This Asset Management Company (AMC) will:

a- Help cover the BDL deficit and gradually replenish the Central Bank liquidity and Fx reserves gaps. This will participate in the recovery of the $72bn "unavailable" deposits parked in the SPV. Any surplus to be invested in targeted social spending and state infrastructure.

b- Establish business-friendly zones with value-add services: Technological, Industrial and Agriculture so to support the private sector and attract skilled labor and fresh graduates. This will improve production and productivity, and enhance exports while building substitute products for local consumption.

c- Help improve the quality of the state assets, increase fiscal returns and stop financial bleeding (@EDL, @BDL, @public-sector, @telecom). It will empower the balance of payments through strategic fiscal and monetary planning by:
(1) boosting goods and services exports,
(2) fostering direct investments into infrastructure development,
(3) improving state services and reducing corruption through an e-government platform,
(4) Supporting SMEs and the private sector growth (SMEs being the main job creators and exporters)

6- <u>Build CONFIDENCE and TRUST in the system</u>

Confidence cannot be enforced through a haircut and/or "Lirafication" as proposed in the current Government plan, but instead through:

- a gradual recovery of the "unavailable" deposit,
- a deep reform in the banking sector including the BDL,
- structural reforms in the public sector,
- the restructuring/rescheduling of the debt
- the unification and stabilization of the exchange rate.

And MOST importantly, confidence will occur once the needed liquidity is created in the system for any day-to-day financial transaction.

To do that, it is essential to understand that No bank in the world can re-pay back in one shot more than 15 to 20% of its customers' liquidity needs (in line with Basel and LCR ratios). Hence, it is essential to separate the problem between Losses ($72bn) and the needed liquidity so to re-ignite the financial system. However, the main objective is to find the liquidity and NOT to immediately recover the $72 billion "estimated" loss (although losses shall be recovered through time).

Having that in mind, the objective of any recovery plan is to deliver 2 things:

(1) Create the needed <u>***confidence and trust in the system***</u> to make depositors un-willing to pull their money out from the banks

(2) Find the needed <u>***day-to-day***</u> <u>***liquidity***</u> to make depositors feel they get the full usability of their money like they did before the crisis, and whenever they want in the future.

This liquidity actually exists. A rough calculation on the current GDP shows that Lebanon would only need to inject in the system a liquidity estimated at 15 to $20 billion:

a- The first $7bn should be a "rolling" yearly liquidity, that can be funded progressively and increasingly through the asset management company (described above) <u>to provide the annual continuous liquidity for consumers</u>.

b- The second $7bn, will have to be available as a buffer <u>to absorb a one-off money withdrawal</u> as spike in USD fresh demand could happen when exchange rate is unified and stabilized. Those $7bn are available between the BDL and the banking sector after its restructuring (Central Bank $4bn + banks $3bn).

c- The last $4bn will be used <u>to capitalize the new "good" banking sector</u>. Half can be provided by the Central Bank and the other half may come from external international banks with good reputation once the bank restructuring process is in place and after the sign-off with the IMF.

7- Lebanon needs a permanent "Social Net" strategy to reduce disparities and ensure equity and equality. However, during the transition recovery period (1 to 3 years) a tactical and targeted social net must be set to cover any social needs and any security risk. This could require $2bn over a 3-year period funded through the world-bank and through other international institutions or governments (if Lebanon shows seriousness in its structural reforms and upholds a strong corruption fighting system)

8- Improve the infrastructure (transport, fiscal subsidies for employment creation, hospitality for tourism) to create a competitive ecosystem for GDP growth. This shall go along with the improvement and subsidies of the education and R&D sectors, while focusing on the actuarial strengthening of the health (CNSS) and retirement systems.

All the above actions shall always be measured versus the purchase power per capita improvement to fostering consumption, investments, and growth

In conclusion,

Lebanon 3.0 needs to develop business activities in general and international trading in particular, while attracting foreign direct investment.

It requires:

(a) the support of the parliament to vote the needed laws and later to execute the needed reforms
(b) an agreement with the IMF to bolster trust in the newly restructured system.

This state of things will entice international institutions like the WB, EIB, EBRD and the IFC to get back locally to business and support the Lebanese Government and the economy towards optimal governance.

Such a positive momentum will fast-track recovery and prosperity, and most importantly will bring back HOPE.