11 MAY 2022

LEBANESE REPUBLIC

General Situation Update for Lebanon's Creditors

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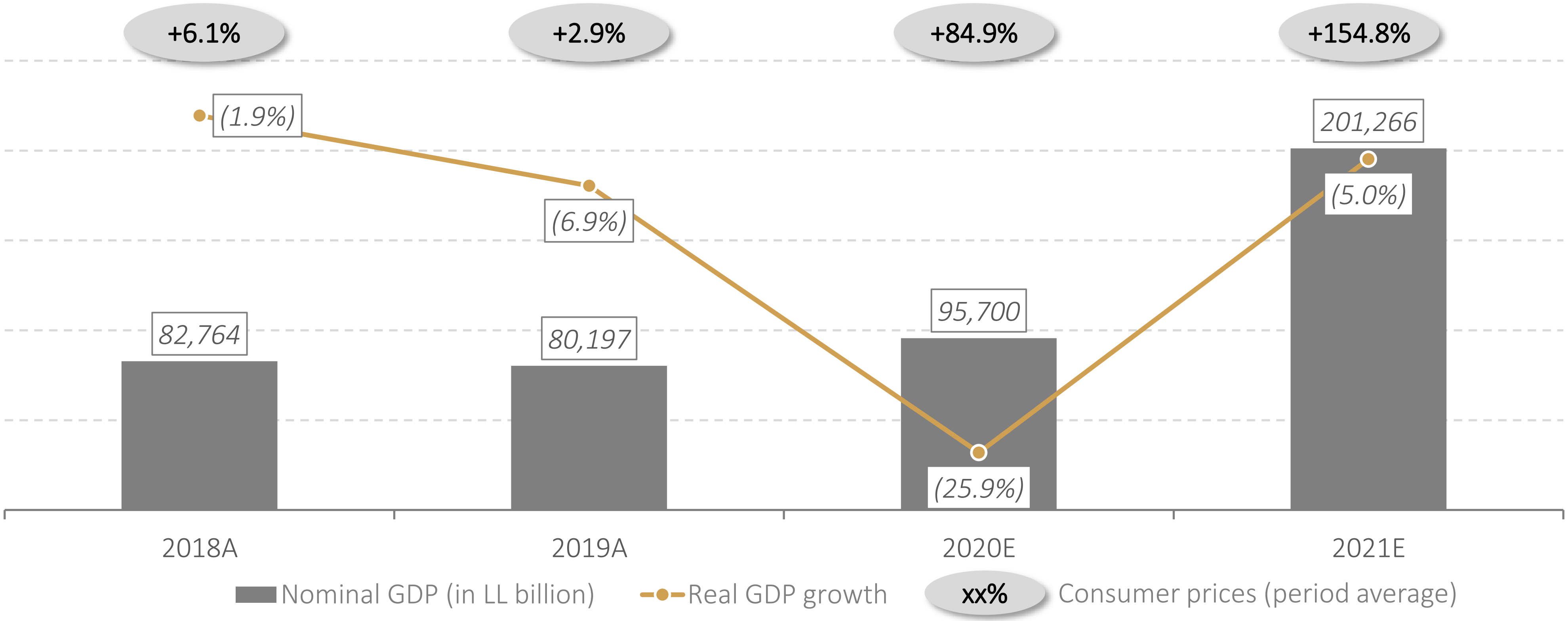
I Lebanon's Macroeconomic Situation: Where Are We Now?

Since 2019, Lebanon has been facing an unprecedented crisis, with a dramatic economic contraction and a rampant inflation



The crisis has been compounded by the COVID-19 pandemic and the August 2020 explosion of the Port of Beirut. It led to a large increase in poverty, unemployment and emigration as living conditions have deteriorated dramatically.

Source(s): Lebanese authorities, International Monetary Fund ("IMF") staff estimates and calculations

The lira has lost almost 95% of its value

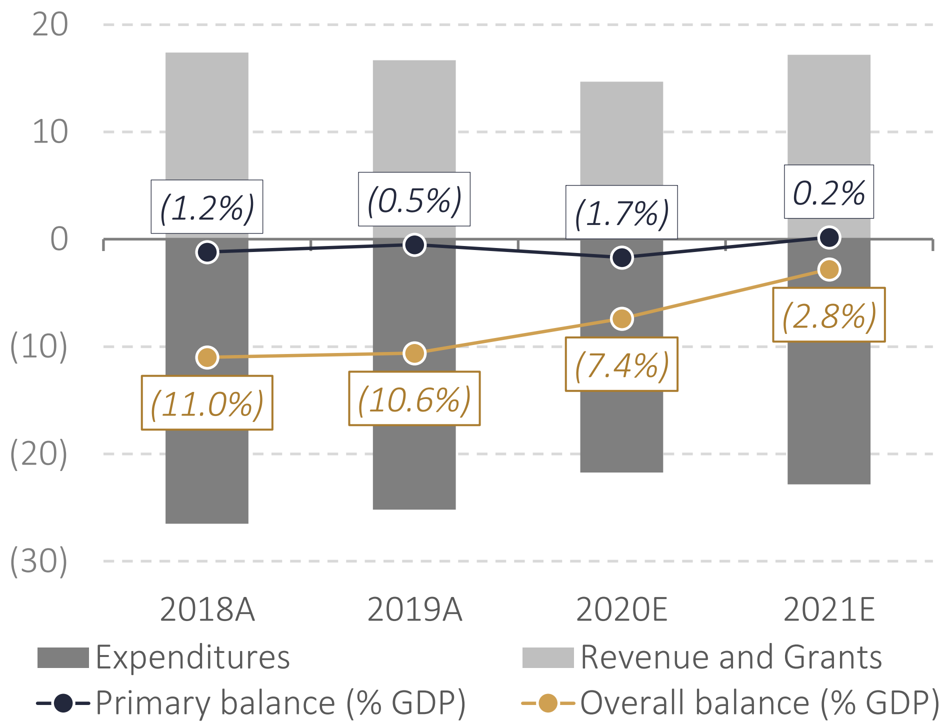
The Lebanese lira lost c. 95% of value since late 2019, currently trading at c. 27,000 to the dollar on the parallel market, and the Lebanese people have been living with a multitude of exchange rates, which have had distortionary effects on the economy.

Source(s): lirarate.org as at 10 May 2022

Fiscal metrics have benefitted from the forced adjustment of budget expenditures in real terms, while public debt has reached c. 360% of GDP

1 Primary and overall budget balance

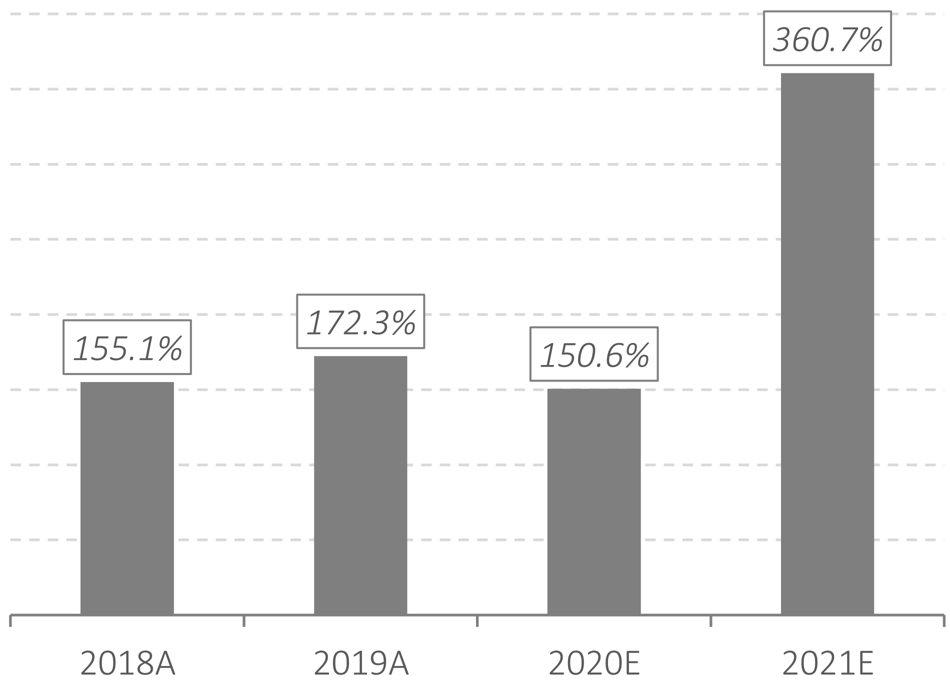
in LBP trillion



The improved fiscal metrics conceal the severe reduction in purchasing power for civil servants resulting from the depreciation.

2 Lebanon outstanding central government debt[1]

As of 31 December 2021

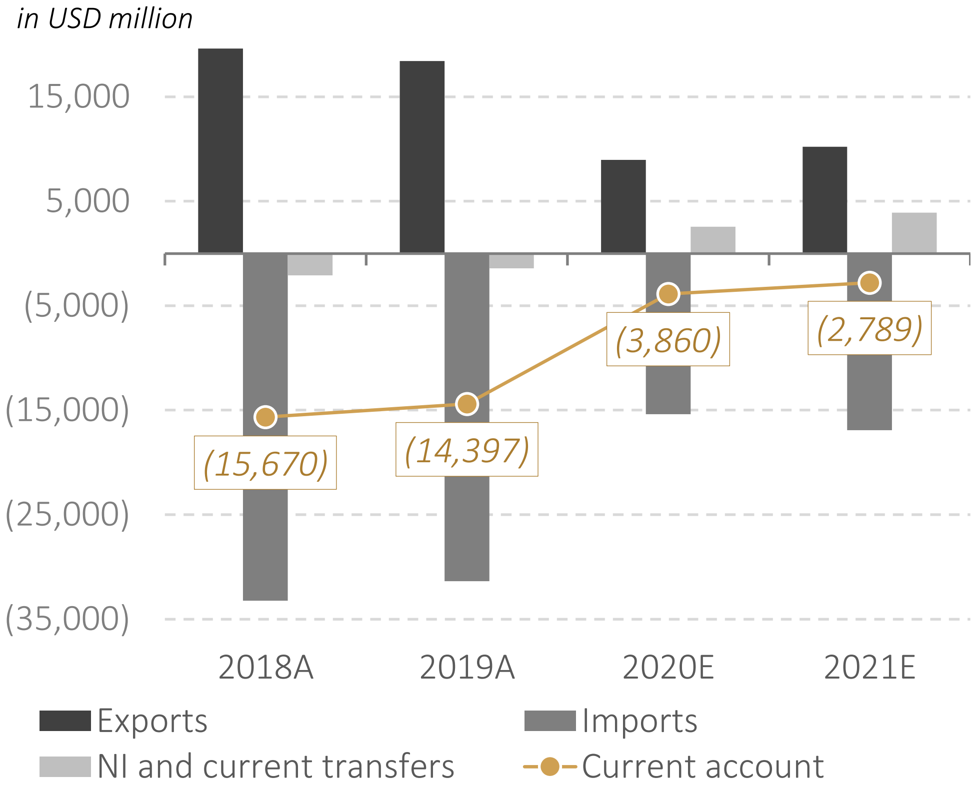


The debt-to-GDP ratio has ballooned as a result of the depreciation of the domestic currency.

Source(s): *Lebanese authorities, IMF staff estimates and calculations*
Note(s): (1) At official USD / LL exchange rate, except for 2021 at parallel market rate (weighted average)

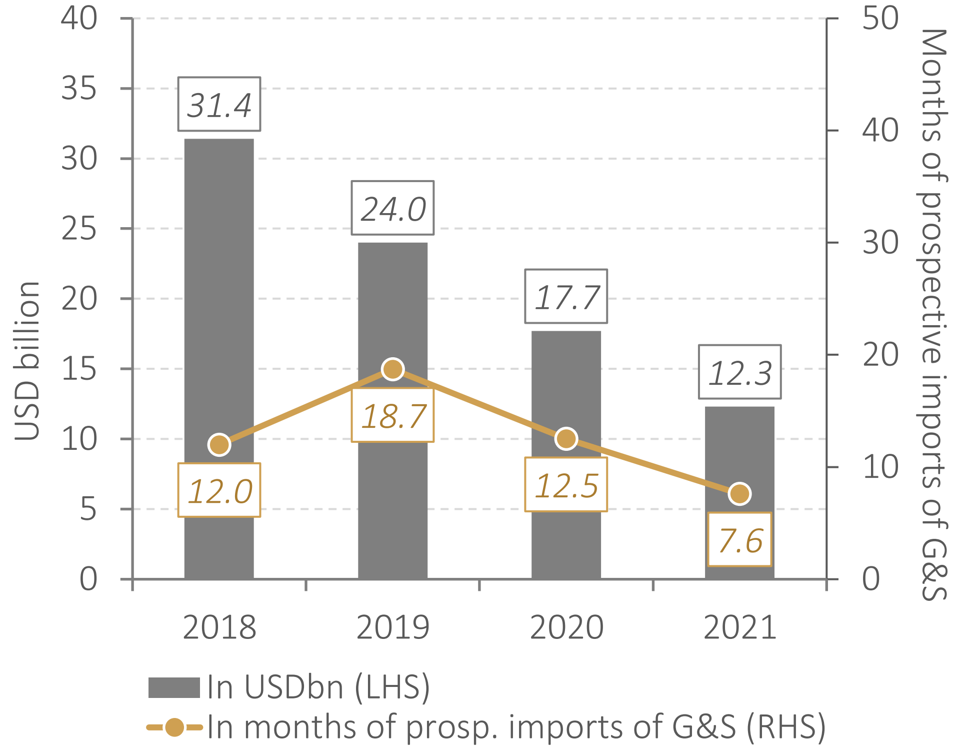
The current account adjustment has largely materialized while FX reserves have reached all-time lows

Current account balance[1]



The drastic imports contraction has allowed the current account to adjust but at a high cost for the population.

Gross foreign currency reserves[2]



FX reserves (excl. gold) continue to decrease at a very rapid pace, reaching c. USD 12 billion at the end of 2021.

Source(s): *Lebanese authorities, IMF staff estimates and calculations*
Note(s): (1) As per IMF methodology, excluding official transfers; (2) As per IMF methodology, excluding gold, Eurobonds and encumbered reserves

Losses in the Lebanese financial sector have reached c. US$72 billion

Estimated losses resulting from the devaluation, the expected sovereign debt restructuring and the restatement of selected BdL and banking sector assets

BANQUE DU LIBAN ("BdL")

c. US$ 63 billion

COMMERCIAL BANKS

c. US$ 9 billion

c. US$ 72 billion

Lebanon's intertwined and oversized financial sector – faced with massive losses resulting mainly from years of financial engineering operations aimed at defending the peg – needs to be recapitalized.

Source(s): *Lebanese authorities*
Note(s): BdL data as of 31 December 2021; Commercial banks consolidated data as of 31 October 2021

II Overview of the Staff-Level Agreement

The nature and magnitude of the Lebanese crisis requires a comprehensive economic reform package supported by the IMF and Lebanon's international partners

Years of unsustainable macroeconomic policies	Massive losses at the central bank and in the banking sector
Structurally large budget and current account deficits	Dramatic fall in the value of the Lira
An overvalued exchange rate	Triple digit inflation
An oversized financial sector overexposed to the Sovereign	Deep-seated economic crisis with large contraction of the economic activity
Severe accountability and transparency problems, and failure to implement much-needed structural reforms	Sovereign default on Eurobonds
Exogenous shocks (Syrian refugee crisis, COVID-19, war in Ukraine…)	Large increase in poverty, unemployment, and emigration

Since its formation in September 2021, the Mikati government has made it its top priority to secure a program with the IMF.

Where do we stand?

On April 7th, after months of negotiations and in a major step towards addressing the country's ongoing crisis, the Lebanese authorities reached a Staff-level Agreement ("SLA") with the IMF Staff on a set of comprehensive economic policies supported by a 4-year US$3 billion loan facility.

The agreement is subject to approval by IMF management and the Executive Board, after the timely implementation by the authorities of a set of Prior Actions and confirmation of international partners' financial support.

The objectives of the contemplated IMF program are to:

- Backstop the recession, restore macroeconomic stability and spur economic growth
- Consolidate public finances along debt sustainability objectives while enhancing social safety nets and rehabilitating infrastructure
- Ensure fair and equitable burden sharing of financial sector losses
- Allow the banking sector to resume its activity of extending credit to the private sector
- Re-focus monetary policy
- Mend the social fabric torn by rising levels of poverty and growing income disparities
- Improve public sector institutional governance, transparency and accountability

The government has delivered on its promise to reach a preliminary agreement with the IMF ahead of the 2022 elections. This deal provides a clear roadmap in terms of policy implementation and will serve as an anchor for the next political leadership.

The agreement hinges on the completion of the following Prior Actions:

#	Prior Action	Responsibility
1	Cabinet approval of a bank restructuring strategy	*Government*
2	Parliament approval of an appropriate emergency bank resolution legislation	*Parliament*
3	Initiation of a bank-by-bank assessment of the banking sector by reputable international firms	*BCCL / BdL*
4	Parliament approval of a reformed bank secrecy law	*Parliament*
5	Completion of the audit of the BdL's foreign asset position, based on TOR approved by the IMF	*BdL*
6	Cabinet approval of a medium-term fiscal and debt restructuring strategy	*Government*
7	Parliament approval of the 2022 budget	*Parliament*
8	Unification of exchange rates for authorized transactions	*Govt / BdL*
9	Parliament approval of a capital control and deposit withdrawal legislation	*Parliament*

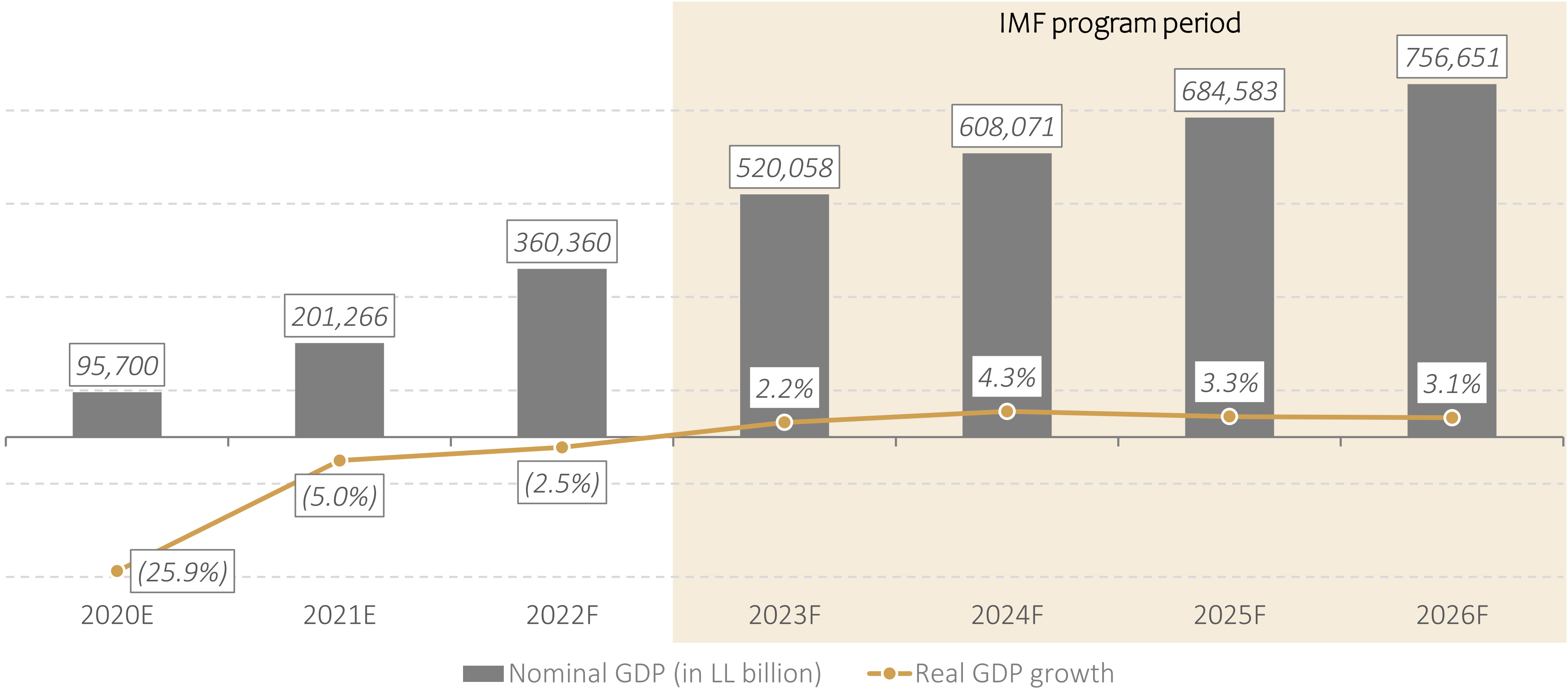
Financial sector (1–5) Fiscal and debt (6–7) Monetary framework (8–9)

The implementation of an ambitious set of Prior Actions, with clear responsibilities, has been requested by IMF Staff. Their implementation will lay the groundwork for the successful implementation of the contemplated IMF-supported program.

Note(s): Another Prior Action, which has already been completed, is the approval by the Cabinet of an energy sector strategy

A The Underlying Macroeconomic Framework

Underlying macro assumptions – *Gross domestic product trajectory*

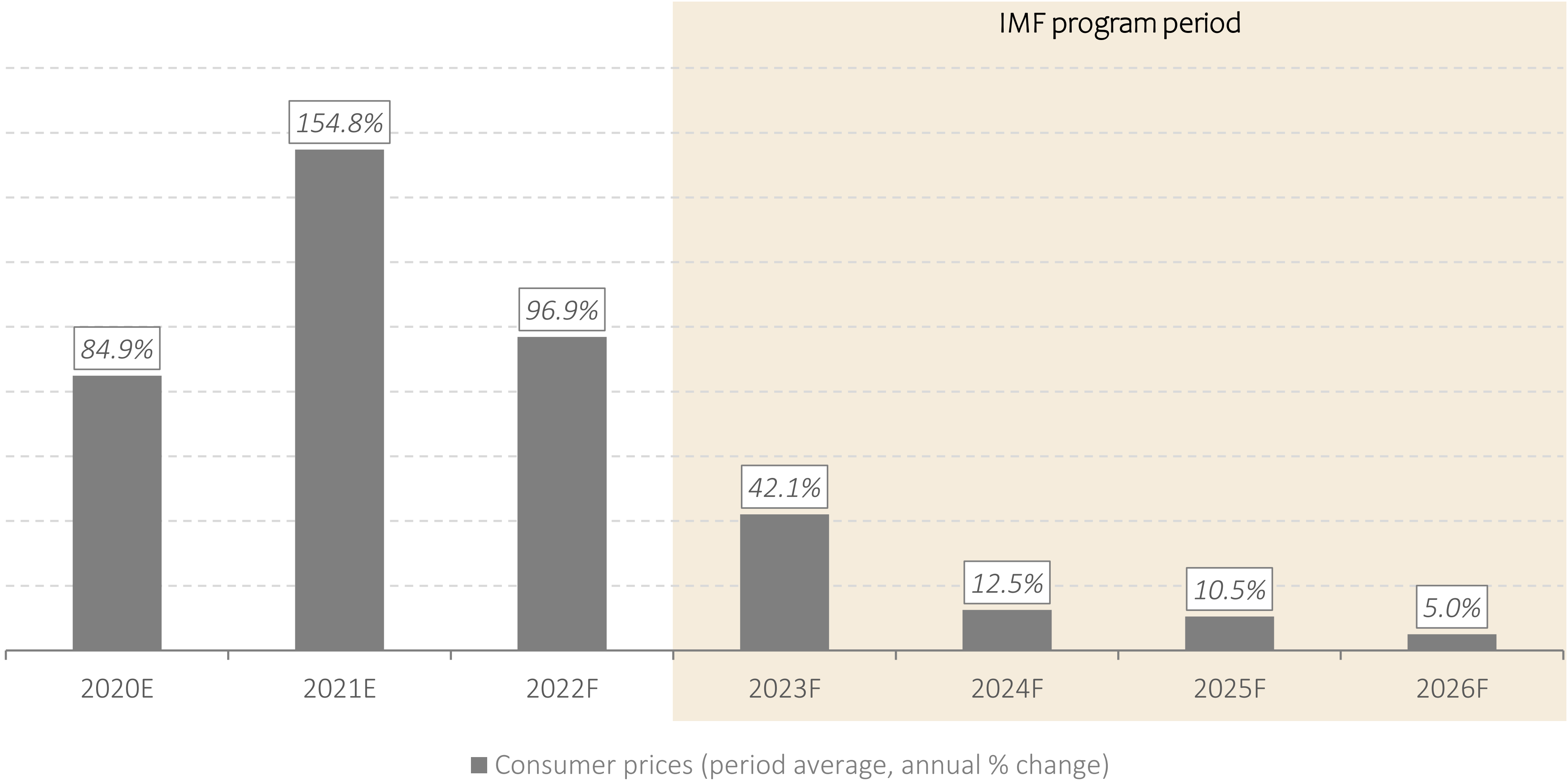


The focus will be on boosting productivity in all economic sectors, with added emphasis on the knowledge economy as a potent driver of growth. The government will provide the right regulatory environment and chart supportive policies for economic activity to thrive[1]

Source(s): *Lebanese authorities, IMF staff estimates and calculations*

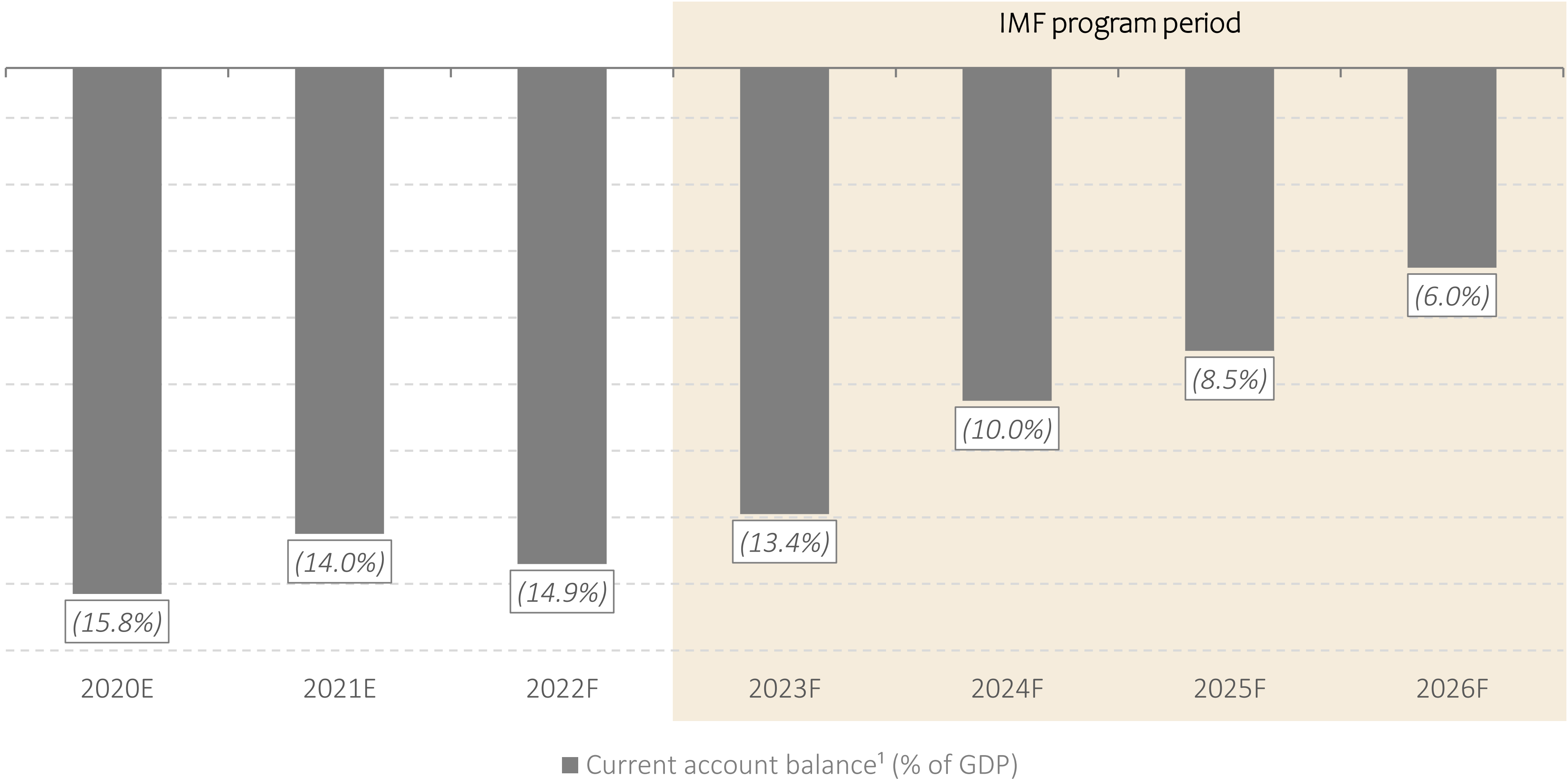
Note(s): (1) In this regard, strengthening digital financial services, enhancing the intellectual property framework, providing affordable and high-speed internet and increasing the supply of electricity will help in building a knowledge and innovation-based economy

Underlying macro assumptions – *Inflation path*



Source(s): Lebanese authorities, IMF staff estimates and calculations

Underlying macro assumptions – *Current account trajectory*



Source(s): Lebanese authorities, IMF staff estimates and calculations
Note(s): (1) Excluding official transfers

B The Building Blocks of the Reform Program

Pillars of the contemplated economic reform program

- **I** FINANCIAL SECTOR RESTRUCTURING
- **II** FISCAL CONSOLIDATION AND DEBT SUSTAINABILITY
- **III** REFORM OF STATE-OWNED ENTERPRISES
- **IV** STRENGTHENING OF THE GOVERNANCE FRAMEWORK
- **V** MONETARY AND EXCHANGE RATE SYSTEM ADJUSTMENT

Building blocks of our financial sector rehabilitation strategy

Pre-requisites to a successful financial sector restructuring

- Finalize BdL audit
  - Financial statements restatement with an upfront recognition of losses
- Draft and enact an emergency banking sector resolution law to support the rehabilitation strategy
- Conduct a bank-by-bank AQR
  - Performed by the Banking Control Commission ("BCC") with the assistance from reputable international firms based on terms of reference agreed upon with the IMF
  - Derive a bank-by-bank "button up" quantification of losses

Fair and equitable management of the losses

- Respect the hierarchy of claims in dealing with the losses
  - Main parties involved in the build-up of the losses will be asked to contribute first
- Protect small depositors (e.g., up to $100,000 per depositor per bank)
- Perform restructuring of accounts
  - Bail-in of large depositors and some lirafication of FX deposits
  - Remaining deposits may be returned in USD and/or lira at market-determined rate for liquidity purposes
- Any credible scheme that could bring additional recovery to depositors will be considered

Recapitalization of viable banks / resolution of unviable banks

- Determine which banks need to go into resolution or be combined with other banking institutions
- Assign gradual capital increase targets for the others
  - Based on a forward-looking analysis of their business plans after restructuring
- Inject fresh capital in viable banks
  - Former and/or new shareholders to commit to invest fresh capital in banks deemed viable by the BCC
- Resolve all unviable banks in line with the new emergency bank resolution framework (no pre-conceived notion about the number of banks that should remain in the system)

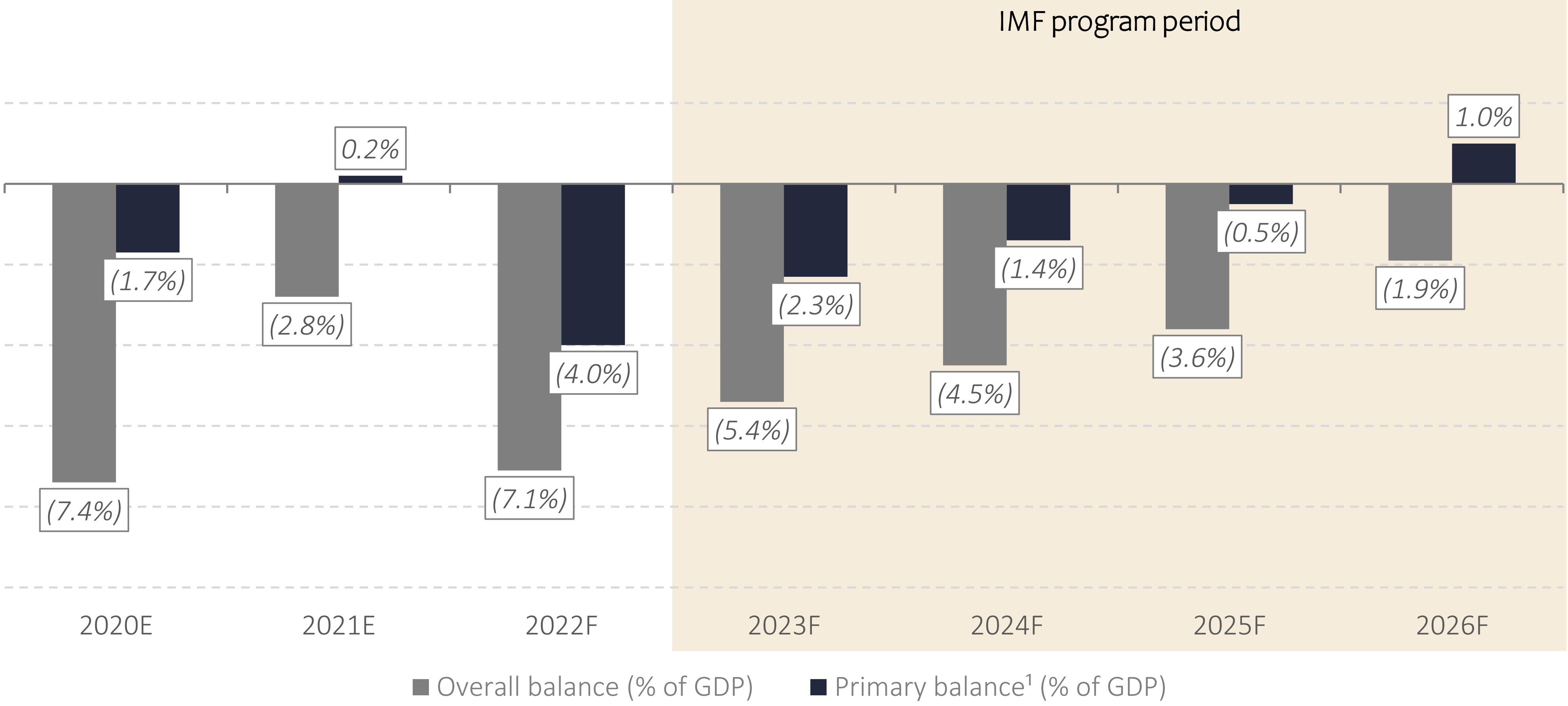
We are committed to (i) restoring the health and viability of our financial sector, and (ii) strengthening the whole banking regulatory framework.

General principles for dealing with the losses

#	Principle	Description	Implication
1	PROTECT THE MOST VULNERABLE	**Safeguard the most vulnerable segments of society** by guaranteeing the value of their deposits.	• We will **protect small depositors** (e.g., up to $100,000 per depositor per bank, depending on the banking sector viability assessment, which could lead to changes in the protection level, hopefully upwards)
2	FAIR AND EQUITABLE TREATMENT	**Respect the hierarchy of claim.**	• Banks' shareholders and debtors will be asked to contribute before depositors
3	ENSURE PROMPT ECONOMIC RECOVERY	Ensure that initiatives **do not hamper the banking sector, BdL and government** from fulfilling their duties.	• Ensure the financial sector's (i.e., banks and BdL) **return to solvency** and appropriate path to restore liquidity • Manage LBP money supply and USD liabilities, avoid inflation and reduce value discrepancy between USD cash and USD deposits • Restore public debt sustainability

We will insist on respecting the most equitable guiding principles for dealing with losses, including the hierarchy of claims.

Our fiscal plan aims at consolidating public finances along debt sustainability objectives



The program will target a cumulative adjustment in primary balance (excl. foreign financed capex) of around 6% of GDP and achieving a primary surplus of 1% of GDP by 2026.

Source(s): *Lebanese authorities, IMF staff estimates and calculations*
Note(s): (1) Including foreign financed social, post explosion port reconstruction and capital spending of c. USD 2.4 billion over the program period

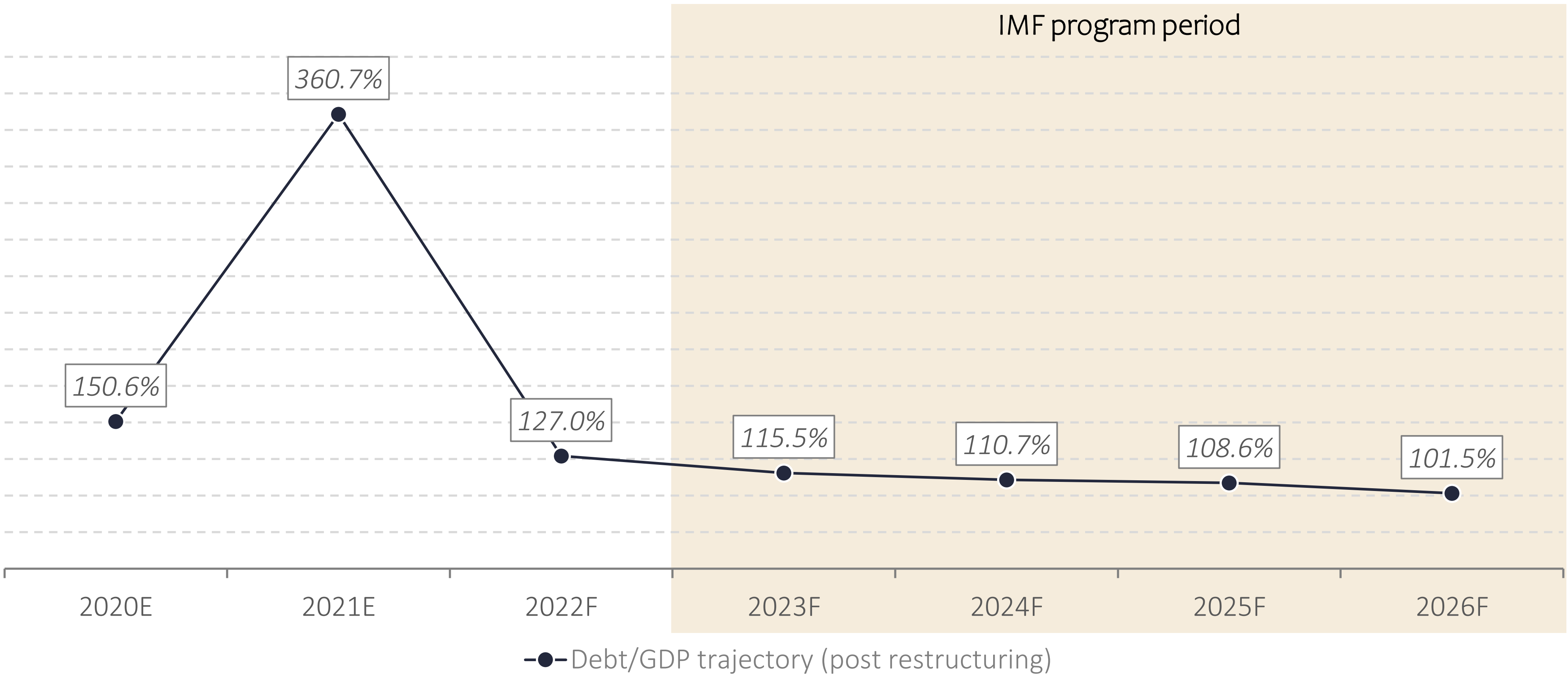
General principles of our ambitious fiscal reform plan

	REVENUE-ENHANCING INITIATIVES	EXPENDITURE RATIONALIZATION INITIATIVES
SHORT-TERM	• **Rebuilding the tax and customs collection capacity** • **Adapting the collection of all taxes and fees on the unified exchange rate,** including import valuation base • **Adjustment of selected fees** along the new unified exchange rate	• **Support higher social spending.** Our immediate commitments include (i) the ESSN[1] project, (ii) the BCCT[2] program, and (iii) the development of an integrated national social registry • **Consolidate the various education and health spending schemes** for more effective public social expenditures • **Accommodate partial recovery of personnel and other spending** that were significantly eroded in last two years due to high inflation • **Revamp capital spending** to rehabilitate failing infrastructure and enhance growth
MEDIUM-TERM	• **Revenue administration measures** to improve compliance and support consolidation • **Tax policy measures** will focus on broadening the tax base and gradually increasing statutory rates	• **Public expenditure review** to help improve efficiency and effectiveness of public expenditure and identify possible avenues for spending prioritization and streamlining • **Reducing the size of the public sector** by attrition and hiring freeze

To enhance the credibility of the public sector adjustment, we will also undertake wide-ranging public financial management (PFM) reforms.

Note(s): (1) Emergency social safety net; (2) Broad coverage cash transfer

The government is committed to putting public debt on a sustainable path



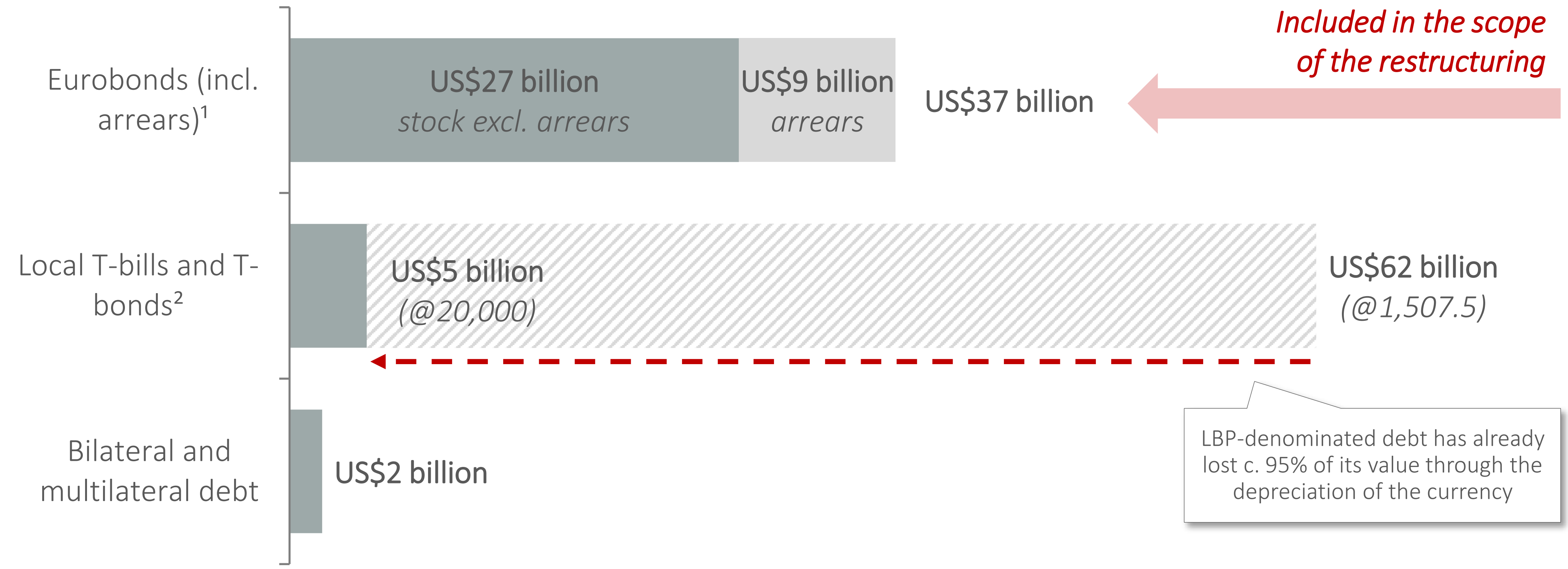
We will reduce public debt to c. 100% of GDP by 2026 and, further, to c. 75% of GDP by 2032. This will be achieved though a combination of (i) fiscal consolidation, (ii) policies to boost growth, and (iii) a restructuring of our public debt.

Source(s): Lebanese authorities, IMF staff estimates and calculations

Contemplated perimeter of the public debt restructuring

Lebanese public debt stock as of December 2021

USD BN



- Local currency-denominated debt and bilateral debt will, to the extent possible, be excluded from the perimeter of the sovereign debt restructuring
- The government will remain current on debt service payments to multilateral partners

Source(s): Lebanese authorities

Note(s): (1) As of April 2022, Banque du Liban held US$5.03 billion worth of Eurobonds; as of June 2021, the Lebanese banking sector held c. US$11.1 billion worth of Eurobonds; (2) As of December 2021, Banque du Liban and the Lebanese banking sector held respectively c. 62% and c. 23% of the local T-bills and T-bonds

General principles for the prospective engagement with bondholders

1. **Transparency**

2. **Good faith efforts** for a collaborative process to restore debt sustainability

3. **Fair treatment** so as to ensure, to the extent possible, a fair burden-sharing between all stakeholders

4. **Consistency with IMF debt sustainability analysis constraints and program targets**

5. Need for a **credible, sustainable and lasting solution** to Lebanon's structural debt and macroeconomic problems

The program objective will be to reform state-owned enterprises, particularly in the energy sector, to provide quality services without draining public resources

1. INCREASING SOE TRANSPARENCY AND OVERSIGHT
2. ENHANCING THE SOE LEGAL FRAMEWORK AND OWNERSHIP ARRANGEMENTS

ELECTRICITÉ DU LIBAN

3. IN THE SHORT TERM, IMPROVE ELECTRICITY SUPPLY HOURS AND IMPLEMENT COST RECOVERY TARIFFICATION
4. INCREASE AND DIVERSIFY POWER SUPPLY
5. IMPROVE FINANCE PERFORMANCE AND TRANSPARENCY
6. REDUCE TRANSMISSION AND DISTRIBUTION LOSSES
7. ENHANCE GOVERNANCE

The reform of the electricity sector is of the utmost importance: today, electricity is a major threat to the livelihood of a large segment of the Lebanese population and a significant impediment to growth. The government has already approved an electricity reform plan.

We are determined to intensify our efforts to strengthen governance, the AML/CFT regime and the control of corruption

The priorities are:

1. CONDUCTING AND PUBLISHING A COMPREHENSIVE GOVERNANCE DIAGNOSTIC WITH THE SUPPORT OF THE IMF
2. STRENGTHENING THE EFFECTIVENESS OF ANTICORRUPTION LEGAL FRAMEWORK AND INSTITUTIONS
3. REFORMING BANK SECRECY LEGISLATION IN LINE WITH INTERNATIONAL STANDARDS
4. ENHANCING AML/CFT EFFECTIVENESS AND THE AML/CFT LEGAL FRAMEWORK

The government has made the improvement of public sector institutional governance, transparency and accountability one of its top priorities and has already approved an anti-corruption strategy and appointed the members of the anti-corruption committee.

Years of exchange rate peg proved costly and unsustainable. The foreign exchange and monetary framework will be adjusted

- Years of overvalued exchange rate
- Unconventional financial operations from BdL to attract foreign currency and support the peg
- BdL monetary financing
- Sharp depreciation of the lira in the parallel market and distortionary effects of multiple FX rate regime
- Rampant inflation
- Scarce and rapidly depleting FX reserves

1. Temporary capital controls and deposit withdrawal restrictions will be put in place
2. FX rates for authorized transactions will be unified
3. Allow for market-determined interest rates and exchange rates
4. Monetary policy will be re-focused on its main mandate of price stability
5. End the practice of central bank financing of budget deficits
6. Improve BdL's governance and autonomy, and strengthen its institutional framework

III Next Steps

Envisaged next steps

Pre-Board Phase

- Lebanese parliamentary elections
- New political leadership to resume the implementation of the program Prior Actions
- Refresh bondholder identification exercise
- Start exchanging materials with bondholders and/or their advisors on the DSA, and publish updated data on debt and debtholder structure
- Provide regular updates to bondholders on (i) the developments of the macroeconomic and political situation on the ground, and (ii) the Prior Actions implementation status
- IMF Executive Board to approve the program

Active Negotiation Phase

- Conduct discussion with bondholders in view of reaching an agreement on the restructuring terms
- Agree with bondholders on the key principles of the restructuring and sign term sheets
- Execution and closing of transactions