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Morgan Stanley: Restructuring Lebanon’s public debt challenging task

BEIRUT: Global investment bank Morgan Stanley said Lebanon would face an uphill task in its efforts to restructure the country’s public debt estimated at $96.5 billion.
It added that the restructuring of Lebanon's public debt will be challenging, given that the country requires substantial debt relief that is equivalent to more than 100 percent of GDP.
It indicated that the interlinkages are complex between the balance sheets of commercial banks on one hand, and those of the government and Banque du Libanon on the other.
“Addressing the public sector's vulnerabilities will be insufficient to achieve sustained economic growth in the future,” Morgan Stanley said.
Lebanon has publically announced its intention to restructure its public debt, breaking a taboo for the first time since the country borrowed from local and foreign markets to finance its needs.
Morgan Stanley estimated that Lebanon’s total public debt, which includes the government’s debt and the Certificates of Deposit in Lebanese pounds and U.S. dollars issued by BDL, and excludes BDL's holdings of government debt, amounted to $96.5 billion at the end of 2019 or the equivalent to 178 percent of the 2018 GDP.
“Further, the large share of Lebanese Eurobonds held by nonresident investors could significantly increase the risk of holdouts, through which bondholders could block a sovereign debt restructuring and seek full repayment," it said, adding that "the restructuring vote will take place separately for each Eurobond series due to the absence of an enhanced collective action clause in the Eurobonds' contracts,” it explained.
It noted that changing the terms of the contracts requires the consent of at least 75 percent of the holders of each bond series, and that BDL is not allowed to participate in the restructuring vote as per the contracts.
“In addition, the authorities could achieve the needed debt relief by restructuring the portion of the debt that is held by resident financial and nonfinancial institutions, which amounts to $84 billion out of the $96.5 billion in total debt,” the investment noted.
However, it considered that the restructuring of the domestic debt could be challenging, given that the banking sector is the main creditor of the sovereign.
“Any restructuring of the domestic debt will impact the banks' capital position, which will, in turn, lead to contingent liabilities for the sovereign to recapitalize the banks,” the report said.
It estimated the banks' claims on the public sector at 7.5 times their capital positions.
“Bail-in of deposits will be politically sensitive, even though the banking sector's deposits are equivalent to more than 300 percent of GDP,” the report noted.
However, it considered that, with the ongoing capital control measures and limits on deposit withdrawals, the bail-in option was not "inconceivable".

It indicated that Lebanese authorities should have four objectives to address the debt burden during the restructuring process.
“First, the authorities should adopt a reform plan to tackle the country's structural challenges, and should address the overvaluation of the exchange rate to narrow the current account deficit. Second, the government should ensure that it will be able to meet its gross funding requirements in the coming two to three years in order to have time to implement the needed reforms. Third, the government should reduce the public debt level to 70 percent of GDP, which it considered to be a sustainable level. Fourth, the sovereign should take into account the contingent liabilities related to the capitalization of banks ahead of the restructuring process,” the report said.
Morgan Stanley modeled three different scenarios of debt restructuring from the perspective of foreign investors.
It noted that its "harsh" scenario stipulates a reduction in the principal payments on Eurobonds, while the domestic debt and bank deposits would not undergo a haircut on the principal.
“Instead, this scenario would incorporate a reduction in coupon payments on domestic debt and a limited adjustment of the exchange rate,” the report said.
It assigned a probability of 60 percent for this scenario, as it considered it to be politically easier to implement.
In contrast, it indicated that its "soft" and "medium" scenarios are easier for Eurobond holders but are stricter on domestic creditors, as the two scenarios imply a haircut on domestic debt and on bank deposits, in addition to the haircut on the Eurobonds, as well as a larger adjustment to the foreign exchange rate.
It assigned a 20 percent probability to each of the two scenarios.
“The materialization of multilateral or bilateral financial support would be positive for Lebanon. Lebanon's quota at the International Monetary Fund allows the country to have a funded program of $3.8B over a three-year period,” the report said.
But it added that Lebanon's funding needs are significantly higher.
It added that it would be difficult for Lebanon to get exceptional access to an IMF funding package, given that the fund classifies the country's debt as unsustainable and may push for a debt restructuring prior to providing the package.

Further, it considered that bilateral funding from Gulf Cooperation Council countries to be unlikely, due in part to the current low oil price environment.

It also noted that the pledges made at the CEDRE conference are unlikely to materialize, given that the disbursement of the funds was tied to fiscal consolidation of 1 percent of GDP annually to reduce the fiscal deficit to 4 percent of GDP by 2023.

It said that Lebanon's fiscal deficit is now in double digits, which makes the initial fiscal deficit target ambitious, and which means that the terms of the package may need to be renegotiated.