



► The Lebanese banking sector

2008

published in July 2009

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The Lebanese banking sector



The Lebanese banking sector has amassed assets in excess of 327% of Lebanon’s GDP



There are 65 operational banks in Lebanon of which 53 are commercial banks and 12 are investment banks

Introduction

The Lebanese banking sector has played a major role in fueling the economic growth of Lebanon and ensuring the relative stability of the financial sector as a whole. This was achieved by sustaining a major growth in earnings amid high liquidity levels while operating in a weak domestic environment characterized by political instability and high fiscal deficits.

The sector has steadily grown over the years driven by several comparative advantages specific to it, namely, a banking secrecy law, skillful workforce, relatively stable currency and, more importantly, a strict regulatory framework and conservative policies set by the Central Bank.

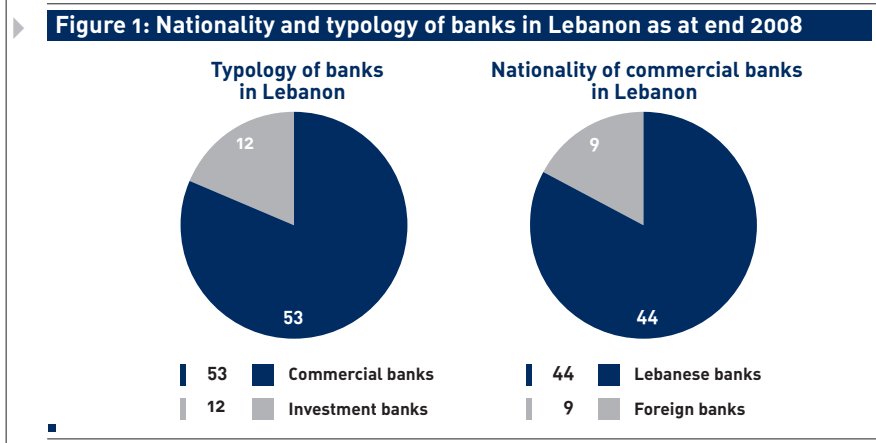
Despite debt to GDP levels of 163% by year-end 2008 with 49% of the net public debt being held by the commercial banks, the sector has amassed assets in excess of 327% of Lebanon’s GDP with customer deposits accounting for 82.5% of the total asset base by end of year 2008.

The oversized banking sector relative to Lebanon’s economy is mainly due to continuous inflows from the Lebanese expatriate community, benefiting from high yields on local and foreign currency deposits compared to peer countries and a perception of conservative practices in the midst of international financial turmoil. A strict financial foresight has shielded banks from exposure to toxic assets and structured products and has strengthened the economy’s ability to weather external shocks.

Moreover, following a relative saturation of potential growth domestically, Lebanese banks have embarked on a regional expansion plan to diversify their sources of revenues and mitigate the country risk by providing a sustainable growth pattern from economic growth potential in the region.

Banking landscape

As at year-end 2008, out of a total of 131 banking licenses granted in Lebanon, only 65 were operational banks compared to 61 at year-end 2002. Meanwhile, over the same period, domestic assets of Lebanese commercial banks grew more than 75% from USD 52.56 bn to USD 94.26 bn. In terms of activity, out of the total 65 banks, 12 are investment banks and 53 are commercial banks of which 44 are Lebanese and nine are foreign.



Source: BDL



The consolidated asset base for commercial and investment banks totals to USD 122.9 bn with domestic operations accounting for 82.9% of total assets in 2008



Over the past few years, the Lebanese banking sector moved from a highly competitive environment to an asset consolidation environment



Audi, Blom and Byblos controlled 40.1% of the total asset base by end of year 2008

The number of operating commercial banks has remained practically unchanged over the years, bearing in mind that the number of commercial banks stood at 53 by year-end 2002. The Lebanese banking landscape has, however, witnessed a net increase in the number of local branches over the same period, rising from 787 branches by year-end 2002 to 860 branches by end 2008, with more than 50% of the branches being located in Beirut and its suburbs. With regard to overseas branches, it is worth noting that Lebanese banking groups currently have more than 200 branches abroad. This is a result of the Lebanese banks' aggressive branch expansion strategy in the framework of their geographical expansion.

It should be noted that the Lebanese banking sector's consolidated asset base (commercial and investment banks) totaled USD 122.9 bn in 2008, with domestic operations accounting for USD 101.8 bn and international operations accounting for USD 21.1 bn, revealing a structure of 82.9% to 17.1%, against 86.5% to 13.5% in 2006.

The Lebanese banking sector has been subject to several transformations over the past few years, moving from a highly competitive and fragmented environment to an asset consolidation environment and witnessing the emergence of undisputed leaders on the market, namely Audi, BLOM and Byblos which controlled 40.1% of the total asset base by end of year 2008. On a broader level, Alpha banks (those with deposits in excess of USD 2 bn) have accumulated deposits equal to 77.4% of the banking sector's total asset base.

Table 1: Alpha banks' key figures 2008 (domestic and international operations)

Banks	Assets (mn USD)	Deposits (mn USD)	Loans (mn USD)	Equity (mn USD)	Profits (mn USD)
Bank Audi	20,412	17,268	6,135	1,961	238
BLOM Bank	17,864	15,108	3,481	1,447	252
Byblos Bank	11,238	8,363	2,786	1,078	122
BankMed	9,554	7,435	3,122	722	70
Fransabank	8,480	7,150	1,715	743	89
Banque Libano-Francaise	6,529	5,361	1,992	504	71
Bank of Beirut	5,808	4,032	1,431	511	66
Credit Libanais	4,453	3,861	994	385	52
Lebanese Canadian Bank	4,141	3,514	975	295	33
SGBL	3,371	2,579	972	310	44
BBAC	3,251	2,836	608	266	28
Total	95,101	77,507	24,211	8,222	1,065

Source: Bankdata Financial Services

Highly capitalized banks are the primary beneficiaries of this wave of consolidation which, in line with international trends but locally driven, is a direct result of a series of:

- Mergers and acquisitions by large banking groups of small- to medium-sized peers,
- Divestments of international banks
- A flight of deposits to large banks

The above factors can be explained by a set of local and international regulations, as well as implicit mechanisms which led to a mandatory consolidation of the sector. These include:

- Restrictions by the Central Bank on the yearly number of branch openings, therefore, hindering the ability of large banking groups to benefit from their potential to grow their assets organically. Acquisitions of peers became a natural catalyst for growth, encouraged by the Central Bank.
- The introduction and application of Basel II capital requirements has benefited highly capitalized banks which had the means and opportunity to acquire struggling local banks unable to meet capital adequacy requirements as well as international banks which exited the Lebanese market due to the application of a 100% risk weight on sovereign holdings, thus increasing drastically the capital adequacy ratio of their respective banking groups.
- Leading banks enjoy strong brand equity, a robust presence and a diversified set of business lines. This led to a movement of the customer base from smaller banks to larger ones and incremental new deposits to shift mainly to the Alpha group. Moreover, the international presence of leading banks was a major dynamic in attracting additional deposits from Lebanese expatriates and GCC nationals giving them the legitimacy to benefit from their cash holdings in Lebanon.

▶ Banking regulations

Banks and other financial institutions fall under the jurisdiction of the Banque du Liban (BDL), the banking regulatory authority. The BDL controls access to the banking industry, defines the scope of banking activities and sets prudential regulations and codes of practice for banks. The Banking Control Commission (BCC), established in 1967, is the Central Bank supervisory authority. It is responsible for supervising banking activities and ensuring compliance with the various financial and banking rules and regulations. In order to preserve the stability of the banking system, the monetary authority has imposed a number of prudential banking measures on banks, most of which are as follows:

– Lending requirements

Lending to related parties (e.g. shareholders, chairman and members of the board of directors, top management and their families) may not exceed 5% of shareholders' equity and needs to be secured. Banks can only lend a single entity (be it a customer or a group owned by the same customer) 20% of a bank's shareholders' equity. Credits termed 'big risk' (credits exceeding 15% of shareholders' equity) should not exceed eight times a bank shareholders' equity. Moreover, banks can only lend up to 50% of the value of stocks and up to 60% of value of the real estate projects.

– Investment requirements

Banks can finance debt originated from foreign entities up to 50% of their capital provided that the debt has an investment grade rating. Investments in structured products are limited to 25% of the banks equity provided the product is capital guaranteed with the approval of the Central Bank. Investment in derivatives instruments is not allowed except for hedging purpose and after a specific approval from the Central Bank.

– Reserves requirements

In terms of required reserves on LBP accounts, banks are obliged to hold the sum of 25% of their demand liabilities in LBP and 15% of their term and other liabilities in LBP with the Central Bank. These reserves pay a zero interest rate but certain deductions are allowed under a number of special lending schemes to some productive sectors. It is worth mentioning that initiatives are being taken to decrease the reserve requirement on LBP

loans.

Banks are required to hold 15% of all their liabilities denominated in foreign currencies (FC) with the Central Bank. These deposits are remunerated on the basis of prevailing market interest rates and according to their maturities. In addition, banks must maintain at least 10% of their liabilities denominated in foreign currencies as net liquid assets.

– Capital adequacy ratio

Banks are required to meet a solvency ratio of total capital to risk weighted assets (for credit market and operational risks) of at least 8%, according to Basel II regulations.

– Accounting practices standards

Accounting practices standards are in conformity with international standards, namely IAS 1, 32, 37 and 39.

– Loan classification and provisioning

Rules for Loan Classification and Provisioning are in conformity with those defined by the Basel Committee on banking supervision.

– Internal Control Policies and Procedures

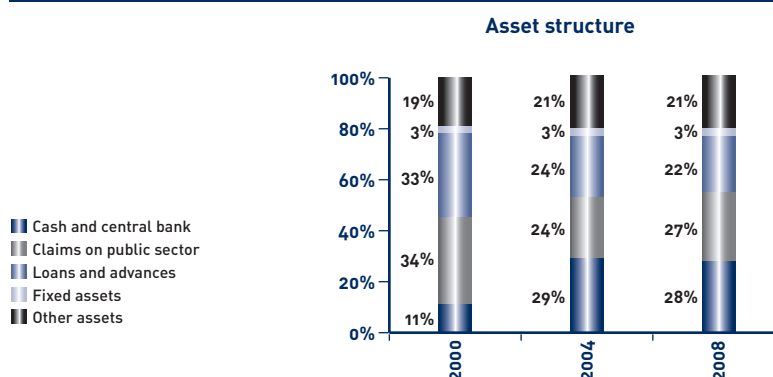
Banks have to develop Internal Control Policies and Procedures in accordance with the principles for the Assessment of Internal Control System issued by the Basel Committee on Banking Supervision.

► Balance sheet structure

The Lebanese banking sector has always acted as the backbone of the economy, providing funding for its sovereign debt by attracting and accumulating customer deposits. Sources and uses of funds are interdependent and provide a status quo position essential for the monetary and fiscal stability of the country. In fact, the asset structure of commercial banks in Lebanon is dominated by claims over the public sector, accounting for more than 25% of the total. Also, deposits with the Central Bank are a major constituent of total assets accounting for a 27% share (including certificates of deposits). The asset allocation reflects the large exposure to sovereign risk, with more than 50% of their assets being made up of government and central bank paper.

Moreover, the loans and advances' contribution to the uses of funds which stood at 22% in FY08 should be interpreted in conjunction with the private sector loans to GDP ratio reaching 86.9% in 2008. This mirrors the fact that the relative modest contribution of loans to the asset structure is counterbalanced by the significant lending activity relative to the size of the domestic economy. Liabilities are mainly composed of customer deposits which account for 83% of the total balance sheet. The figures below show the balance sheet structure of Lebanese commercial banks.

► **Figure 2a: Lebanese commercial banks balance sheet structure**

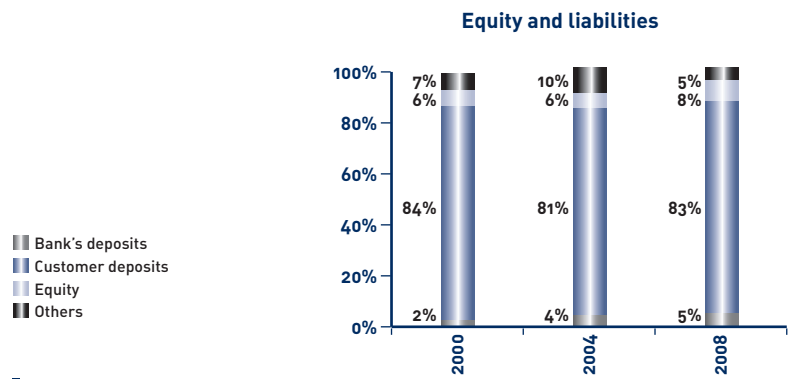


Source: BDL



Sources of funds are mainly composed of customer deposits which account for 83% of the total balance sheet

Figure 2b: Lebanese commercial banks balance sheet structure

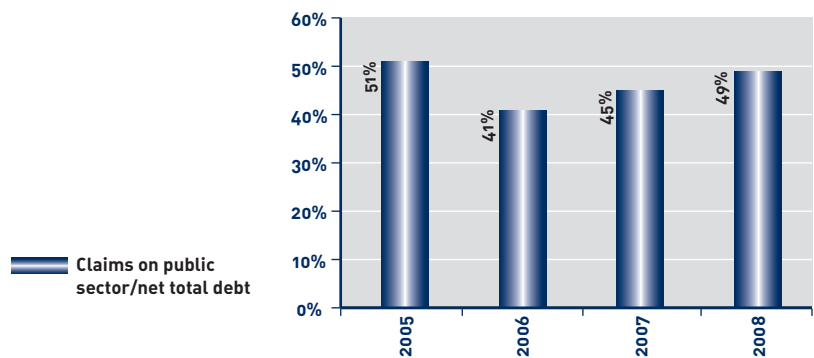


Source: BDL

Lebanon's debt burden remains among the highest in the world in terms of debt to GDP and debt to revenue ratio. The debt to GDP ratio stood at 163% at end 2008. However, it is important to mention that Lebanon has achieved a zero default history over the years, even during the civil war and times of financial pressures in 2005 and 2006.

The domestic banking system (including the Central Bank) holds around three quarters of government debt. As shown in the graph below, local banks hold the majority (about 49% by year end 2008) of outstanding government paper.

Figure 3: Percentage of government debt held by Lebanese commercial banks

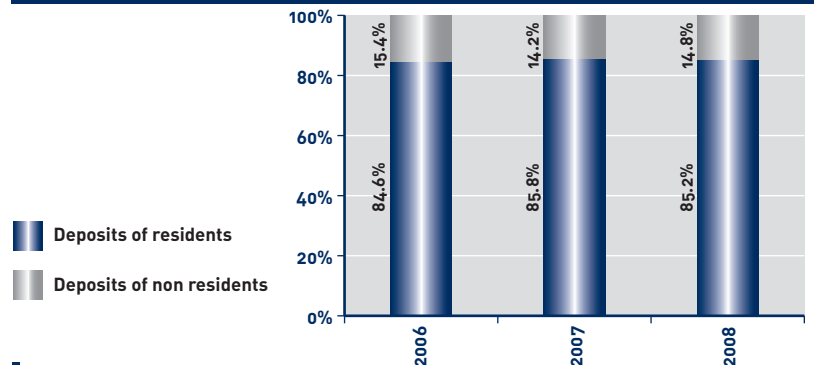


Source: BDL, ABL



Residents deposits account for 85% of total deposits

Figure 4: Residents and non residents breakdown of customer deposits at end 2008



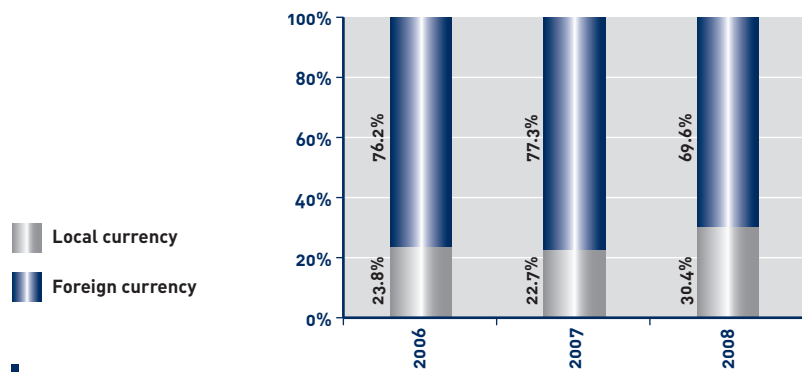
Source: BDL

In addition, the balance sheet structure of banks is dominated by foreign currencies as witnessed by the deposits' dollarization rate standing at 77.3% in 2007. Nonetheless, we have noticed a reversal in the trend in 2008 as the dollarization rate dropped from 77.3% in December 2007 to 69.6% in December 2008 pinpointing a renewed confidence in the Lebanese pound and the economy as a whole, as well as a growing interest differential in favor of the local currency. This renewed confidence in Lebanon's financial system has mainly been bolstered by the Central Bank's large cushion of foreign exchange reserves, which protects the exchange rate peg, and its effective regulation of domestic banks.



Dollarization rate of deposits dropped from 77.3% in December 2007 to 69.6% in December 2008 pinpointing a renewed confidence in the LBP and the economy as a whole

Figure 5: Currency breakdown of customer deposits



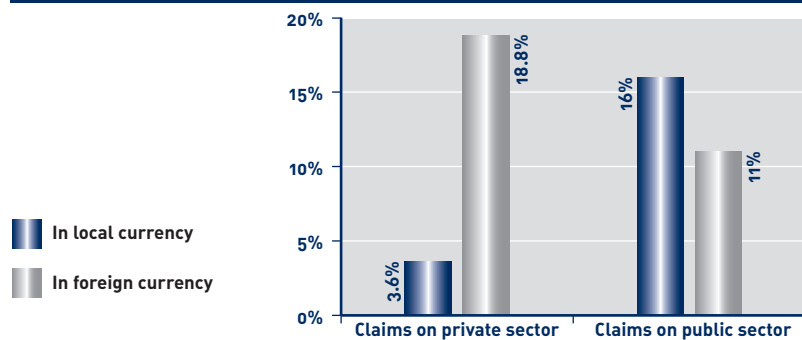
Source: BDL

Foreign exchange positions play a major role in providing equilibrium to the balance sheet structure of a Lebanese bank and the allocation of assets.

On the asset side, the high exposure to the public sector is mainly denominated in local currency while the loan to deposit ratio in LBP is only 14.2%. Loans and interbank deposits are largely denominated in USD with a loan to deposit ratio in foreign currencies of 32.7%.

The graph below highlights the claims on the private and public sectors in local currency and foreign currency as a percentage of total assets.

Figure 6: Claims on private and public sectors as percentage of total assets



Source: BDL

It is important to highlight that there is a major mismatch in maturities between assets and liabilities and more specifically between claims on public and private sectors which are usually long-term commitments and customer deposits whose maturities range from one to three months.

Also a large portion of deposits bear zero or low interest (i.e. demand deposits) and contribute to higher interest spreads.

At end 2008 current deposits in LBP were remunerated at a 1.53% rate while current deposits in USD were remunerated at a 0.56 % rate. These demand deposits constitute an important portion of total deposits (11% of total deposits at end 2008), and therefore are reducing cost of funds leading to a higher net interest income.

In addition, we believe that the regional expansion being undertaken by Lebanese banks will heavily impact the balance sheet structure of the sector as a whole. This will lead to a more significant growth in loans to the detriment of sovereign holdings. At the same time possible efforts to reduce the sovereign debt, following privatization of state owned companies, will have a similar impact on the asset mix and push banks to provide more loans to the private sector.

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The Lebanese banking sector registered a remarkable growth over the years despite the persistent political instability and the global financial turmoil that surged in 2008

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Since the mid-nineties, customer deposits in Lebanese banks have been growing steadily, driven by the inflow of wealth from expatriates and the petrodollar ample liquidity.

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At end 2008, customer deposits stood at USD 77.8 bn

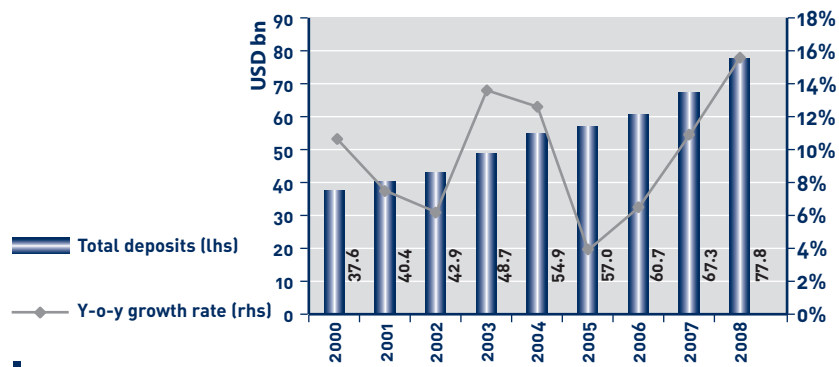
▶ Banking sector growth

The Lebanese banking sector has registered a remarkable growth over the years, with all major aggregates reporting solid progression despite the persistent political instability on the domestic scene since 2005 and the global financial turmoil that surged in 2008. The aggregate banking sector domestic figures suggest that commercial banks' assets moved from USD 45.03 bn at end 2000, to USD 94.26 bn at end 2008, underlying a CAGR of 9.7%. This was mainly triggered by customer deposits which rose from USD 37.6 bn to USD 77.8 bn over the same period. Loans stood at USD 14.8 bn by year-end 2000 and increased to USD 21.1 bn by year-end 2008, mainly driven by a significant year on year growth of 15.9% and 18.6% in 2007 and 2008 respectively. As a result of the significant growth in activity, the bank assets to GDP ratio reached a new record high of 327%.

– Deposit growth

Customer deposits in Lebanese banks have been growing steadily since the mid-nineties. This trend has been essentially driven by the inflow of wealth following the civil war from Lebanese expatriates, and by the ample petrodollar liquidity in the region that flew into the Lebanese banking sector in the aftermath of the September 2001 events. Supported by the conservative and prudent policies of the Lebanese Central bank and the attractive interest rates on deposits compared to regional peers, Lebanese banks have emerged as a “safe haven” for depositors remaining resilient to the exogenous shocks.

▶ **Figure 7: Customer deposit growth over the period 2000-2008**



Source: BDL

Between 2000 and 2008, deposits in Lebanese domestic commercial banks grew from USD 37.6 bn at end 2000 to USD 77.8 bn by year-end 2008, at a CAGR of 9.5%. However, it should be noted that deposits have not grown at the same pace over the last decade: after having recorded an impressive CAGR growth of 13.1% in the 2003-2004 period, the growth rate in deposits slowed to a CAGR of 5.2% for the 2005-2006 period, in the aftermath of a series of exogenous shocks including the Hariri assassination in February 2005 and the war between Israel and Hezbollah in July 2006. During these two episodes, reserves came under major pressure while deposits witnessed slight outflows. However the pressure was managed fairly quickly, with reserves rebuilt and deposits recuperated, highlighting the immunity of Lebanese banks in time of crisis.

Starting 2007, and despite the persistent deadlock between the government and the opposition, deposit growth recovered, increasing at a CAGR of 13.2% for the 2007-2008 period.

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Loan growth was very slow from 2000 to 2006 reflecting a relative inertia from the private sector and the conservative lending strategy adopted by Lebanese banks.

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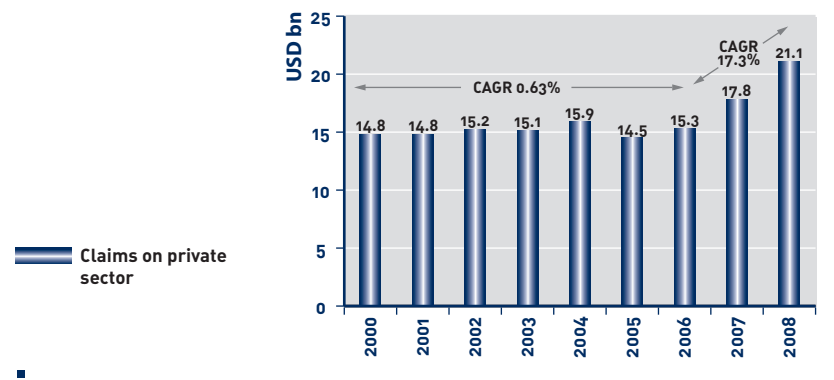
Loan growth accelerated over the past two years supported by a solid economic activity with steadier political and security situation

In 2008, the Lebanese banking sector recorded an outstanding performance in the light of a global financial crisis. Although deposit inflows took a short breather in the aftermath of the Lehman failure, they have resumed at a rapid pace since then, adding USD 10.5 bn of customer deposits in one fiscal year, of which USD 2.6 bn were added in the last quarter of 2008, during the peak of the worldwide financial crisis. It is worth noting that during Q4 08, the share of non-resident deposits to total deposits grew to reach 22% as a result of the increased confidence in the Lebanese banking sector.

– Loan growth

Between 2000 and 2006, outstanding loans from domestic operations grew at a CAGR of 0.63%. This sluggish growth suggests a relative inertia from the private sector, which is not surprising given the low growth of the Lebanese economy over the same period. Moreover, this reflects the conservative lending strategy adopted by Lebanese banks in order to preserve a high asset quality.

Figure 8: Claims on private sector growth over the period 2000-2008



Source: BDL

However, as shown in the graph above, the tendency was clearly reversed in the 2007-2008 period. The demand for loans accelerated and the recovery in loan growth started with the claims on the private sector steadily increasing from USD 15.3 bn by year end 2006 to USD 21.1 bn by year end 2008, at a CAGR of 17.3%. The most significant increase remains lending activity growth over 2008: loans grew by USD 3.3 bn, the equivalent of 18.6% year-on-year, supported by solid economic activity with steadier political and security situations especially after the Doha agreement that took place in May.

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The Lebanese banking sector has reported a regular growth in profits in a seven-year track and total profits stood at USD 1,068 mn

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The net interest income accounts for 69% of the Lebanese banking sector's total income, implying a close correlation between the performance of the banks and the interest spread

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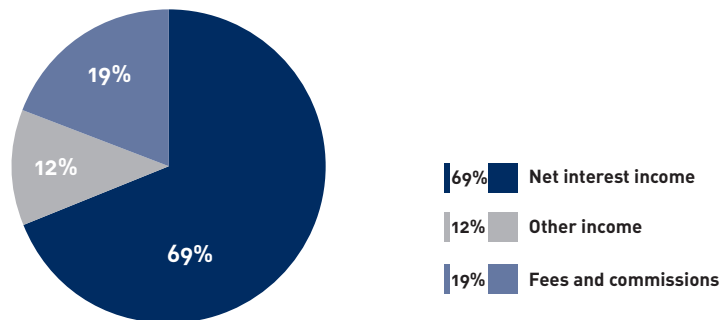
As a result of the financial crisis and efforts to support the global economy, LIBOR rates have plummeted resulting in increasing pressure on foreign currency spreads for Lebanese banks while customer deposits rates remained relatively stable.

► Profitability

The Lebanese banking sector demonstrated a strong performance in the last few years having reported regular growth in profits across a seven-year track. Profitability was favored by the impact of the regional expansion and considerable profits were generated by cross-border entities as well as by the recovery in loan growth registered over the past two years. Net profits from domestic operations grew by 20.8%, 27.7%, 29.2% and 25.6% y-o-y in 2005, 2006, 2007 and 2008 respectively, mainly driven by higher spreads and growing commission and fee income. By December 2008, total domestic profits of the banking sector stood at USD 1,068 mn.

In order to further analyze the profitability of the Lebanese banking sector, it is worth taking into consideration its two major components: net interest income and non interest income. The graph below depicts the breakdown of income for the year 2007.

► **Figure 9: Breakdown of income 2007**



Source: Bilanbanques 2008

– Net Interest income

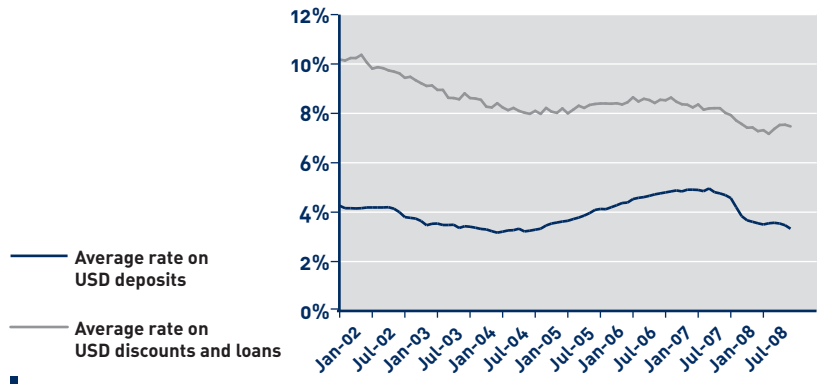
The profitability of Lebanese banks is still mainly driven by net interest income. In 2007, the Lebanese banking sector's consolidated figures (domestic and foreign) showed that net interest income accounted for 69% of total income. Thus, the performance of Lebanese banks is closely linked to the interest spread between the cost of funding and yields on uses of funds.

The interest rate policy of banks is an essential tool in determining the right approach to deposit growth versus incremental profitability, a recurrent dilemma highly correlated to the macro economic outlook of Lebanon and its fiscal policy.

▪ Foreign currency spreads

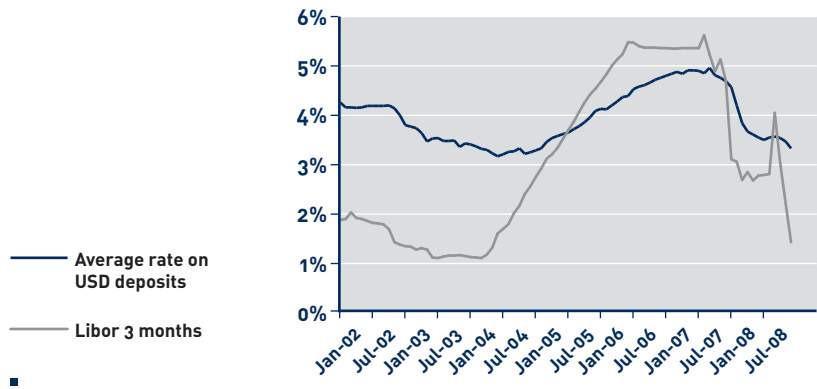
As a result of the financial crisis and efforts to support the global economy, Libor rates have plummeted resulting in increasing pressure on foreign currency spreads for Lebanese banks while customer deposits rates remained relatively stable. The average 3-month Libor rate decreased from 4.98% to 1.83% between December 2007 and December 2008 - a drop of 315 basis points while the weighted average rate on deposits in USD only decreased from 4.75% to 3.45% over the same period. It is worth noting that the impact of Libor rates on foreign currency spread is not perfectly correlated and that pressures on spreads should not persist as Libor is expected to regain momentum.

Figure 10: USD loan rates vs. USD deposit rates



Source: BDL

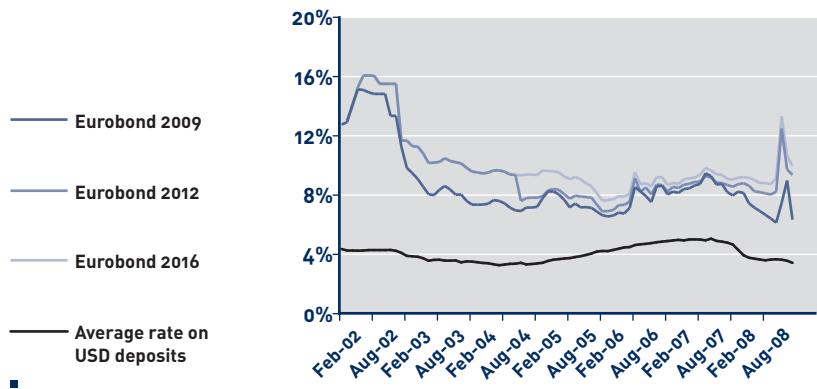
Figure 11: Rate on USD customer deposit vs. 3 – Month LIBOR rates (%)



Source: BDL, Bloomberg

In addition, the weighted average interest on Eurobonds remained stable at 8% while lending rates only decreased 60 basis points from 8.16% in December 2007 to 7.51% in December 2008.

Figure 12: Lebanese Eurobond yields vs. USD deposit rates



Source: BDL, Bloomberg



We expect large banks to maintain a foreign currency spreads close to 2%

We believe that in order to sustain a growth in foreign currency deposits, since Lebanese banks are not really in a position to decrease their cost of funding by much, increasing pressure is likely to be witnessed on foreign currency spreads until the Libor rate rises.

Nonetheless, we expect large banks to maintain a level of foreign currency spreads close to 2%.





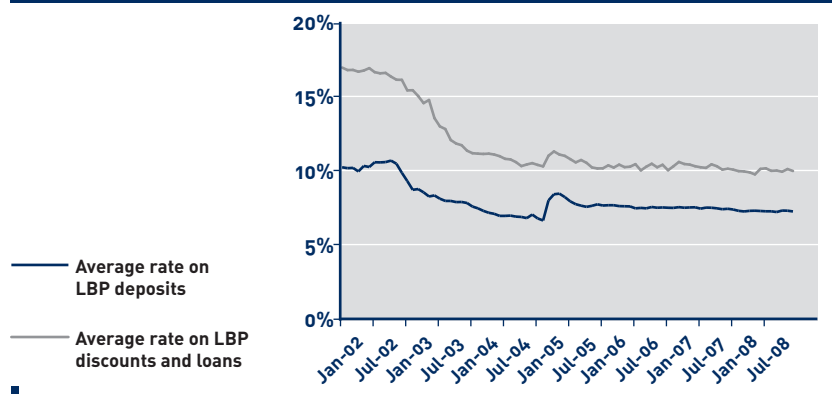
With interest rates on lending standing at 9.95% on issued loans in local currency at the end of 2008, as compared to an interest rate of just 7.47% on dollar-denominated loans, customers have no incentive to borrow in local currency.

▪ **LBP spreads**

Spreads on LBP have traditionally been lower than those on foreign currency, which has provided little incentive for commercial banks to attract depositors in LBP.

With interest rates on lending standing at 9.95% on issued loans in local currency at the end of 2008, compared to an interest rate of just 7.47% on dollar-denominated loans, customers have no incentive to borrow in local currency. Thus, some 85 percent of loans are made in foreign currency (mainly USD) while the small remainder are in Lebanese pounds. In an effort to encourage borrowing in LBP (by reducing interest rates on local currency loans to match the interest rates on loans issued in USD), the Central Bank is currently working on a scheme that aims at reducing the 15% reserves required on local currency deposits, earning zero percent interest, a cost they currently pass onto customers.

▶ **Figure 13: LBP loan rates vs. LBP deposit rates**



Source: BDL

Yields on treasury bonds and average rate on CDs issued by BDL remained relatively constant in 2007 and 2008 while lending in LBP is not material. The weighted return on uses of funds as at December 2008 was 8.41% while the average rate on deposits was 7.26% resulting in a LBP spread of 1.15%.

The BDL has recently issued a great volume of 45-days and 60-days CDs to accommodate the increase in LBP deposits with LBP 11.102 bn outstanding as of end 2008 compared to LBP 4.494 bn in December 2007 at a weighted average rate of 4.4% and 4.89% respectively. Nonetheless the weighted average rate on total CDs issued is 10.99% (December 2008) as longer maturity CDs have been issued in previous years.

LBP spreads are expected to remain constant as long as the dollar pegging system is in place, as safeguarding the peg continues to be perceived as the key to financial stability.



Non interest income witnessed a significant growth in the past few years as a result of a further diversification of the Lebanese Banks' business lines.

– Non interest income

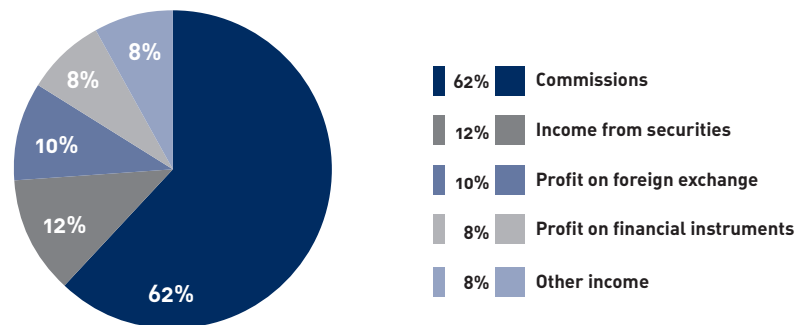
Commissions continue to provide the banks with the bulk of their non interest income.

Non interest income from domestic and overseas operations witnessed a significant growth in the past few years in absolute terms, growing from USD 657.3 mn in 2006 to USD 802.5 mn in 2007. This growth is due to a further diversification of activities from traditional activities to universal banking activities.

However, over the same period, non interest income regressed from 34.43% to 31.21% in percentage terms compared to Net Financial Income.

This segment remains underdeveloped due to the lack of private and investment banking activities on the domestic market. Nonetheless, banks are placing a stronger emphasis on increasing this recurrent and steady income stream which is independent from interest rate fluctuations and is expected to develop following the recovery of the local and international capital markets. The pie chart below depicts the non interest breakdown for the year 2007.

Figure 14: Breakdown of non interest income 2007



Source: Bilanbanques 2008



We expect larger banks to lead the way in diversifying their revenues and further increase their Non Interest Income

We expect larger banks to lead the way in diversifying their revenues and increase their Non Interest Income for the following reasons:

- Investment banking fee-based services require sophisticated transactions and highly qualified employees to undertake them
- Trading and private banking services are mainly the area of expertise of large banks with qualified human resources, high remunerations and IT infrastructure capabilities.
- With little non commercial activity on the local market, the geographical expansion engaged by large banks is expected to generate additional fee-based income.

– Operating Efficiency

Growth in revenues has been supported by a growth in the Lebanese banking sector's operating margin, which rose from 25.13% in 2002 to 43.19% in 2007. This trend can be attributed to the total costs per branch and per staff which have increased drastically over the years, with costs per staff and per branch growing between 2002 and 2007 at a CAGR of 3.2% and 4.6% respectively to reach USD 68,325 and USD 1.41 mn respectively in 2007.

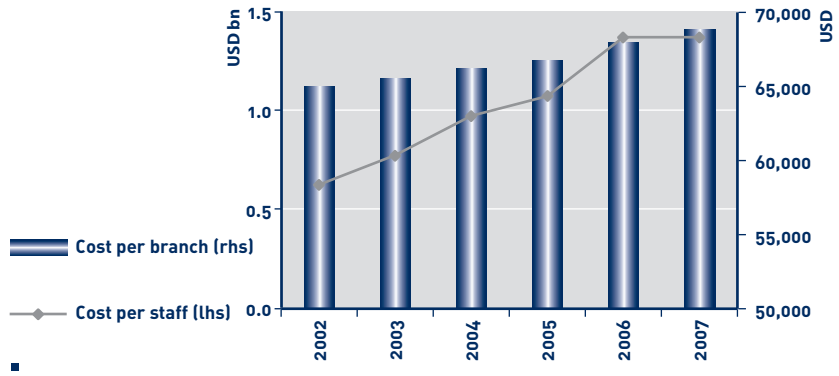
It is worth noting that the cost per staff and cost per branch are somewhat proportional to the bank size; ie. the larger the bank, the higher the average cost per branch and per employee. Thus, while a cost per branch of USD



Even though cost per staff and cost per branch have steadily increased over the years, the cost to income ratio has decreased from 71.3% to 54% over 2002-2007, suggesting a tremendous rise in cost efficiency

1.57 mn and a cost per staff of USD 72,968 were incurred by the alpha group in 2007 the reported figures for the Gamma Group were USD 0.7 mn and USD 44,444 respectively for the same year.

Figure 15: Cost per staff and per branch from 2002 to 2007



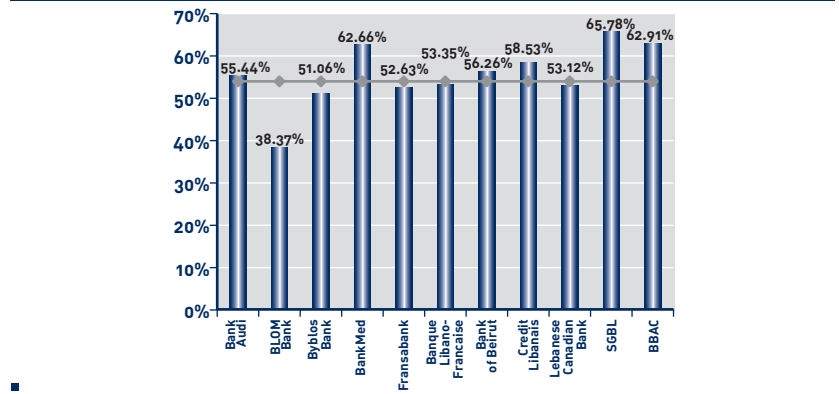
Source: Bilanbanques 2008

A relevant indicator of management efficiency is the cost to income ratio. The latter decreased from 71.3% to 54% over the 2002-2007 period even though the cost per staff grew from USD 58,375 to USD 68,325, suggesting a tremendous rise in efficiency.

The banks' profitability is highly impacted by their cost structure and implementation of their expansion plans.

The graph below shows the cost to income ratio of the Alpha group compared to a sector average of 54%

Figure 16: Alpha Group cost to income ratio vs. sector average 2007



Source: Bilanbanques 2008

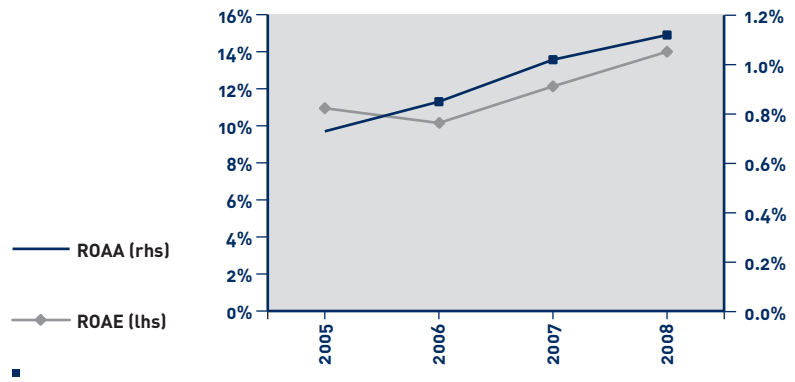


The return ratios of the Lebanese banking sector have improved as a result of a significant surge in net profit from domestic operations coupled with the contribution of international entities to the sector's earnings.

Performance analysis

As a result of a significant surge in net profit from domestic and international operations over the past few years, the Lebanese banking sector has reported an improvement in its profit ratios, namely the return on average assets (ROAA) and the return on average equity (ROAE).

Figure 17: Profitability indicators



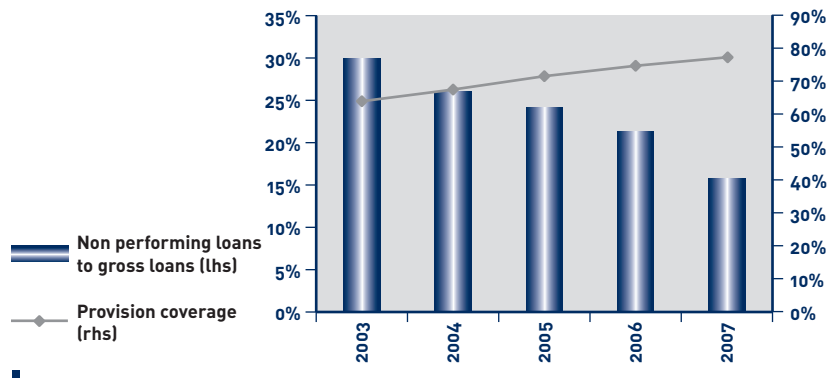
Source: Banking Control Commission

While the ROAA of the overall banking sector rose from 0.73% in 2005 to 1.12% in 2008, the ROAE also reported significant growth from 10.95% in 2005 up to 14.00% in 2008.

Asset quality

Despite the overall difficult political and security environment, the Lebanese banking sector's consolidated figures, including domestic as well as international operations, reveal that asset quality has improved over the past few years. Doubtful loans and substandard loans (non performing loans) as a percentage of total loans fell from 29.9% by year-end 2003 to a much more manageable 15.8% in 2007. During the same period, provision coverage (loan loss provision/non performing loans) crossed 77% compared to 63.8% by year-end 2003. All of this took place within the context of a strong growth in the loan portfolio.

Figure 18: Non performing loans and provision coverage



Source: Bilanbanques 2008

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The sector's asset quality has improved over the past few years. Non performing loans as percentage of total loans fell from 29.9% by year end 2003 to 15.8% by year end 2007.

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The provision coverage also improved over the same period. It crossed 77% up from 63.8% by year end 2003.



The Lebanese banking sector enjoys very high liquidity levels as witnessed by the loans to deposit ratio which stood at 32.2% in 2008.



Lebanese banks are solidly capitalized. Their capital adequacy ratio stands at 11.23%, significantly above the 8% required by the Basel II committee

▶ Liquidity

The growth of the Lebanese banking sector is being undertaken without any detriment to its financial position. While banks around the globe suffered from severe liquidity crisis, the Lebanese domestic financial system remains liquid and well-stocked with cash deposits. Lebanese banks benefit from a strong deposits base, with customer deposits equivalent to USD 77.8 mn representing 82.5% of total liabilities and equity, which is a relatively stable source of funds and safe for liquidity position in times of financial distress and global downturn.

Despite a small contraction in the level of liquidity of the overall banking sector (as witnessed by the net liquid assets to customer deposits ratio, dropping from 85.1% by year-end 2006 to 81.4% by year-end 2007 and the loan to deposit ratio of commercial banks increasing from 28% in 2005 to 32.2% in 2008), the liquidity level remains high with respect to global and regional benchmarks (i.e. 53% for Egypt banks in 2008). This slight retreat in liquidity over the past two years came as a natural result of the lending business recovery registered over the same period with loans growing at a faster pace than deposits. Furthermore, in addition to mandatory reserves at Central Bank amounting to 15% of deposits (in foreign currency) that banks have to maintain at anytime, banks must maintain a level of 10% deposits as liquidity held with banks or Central Banks.

▶ Capital adequacy

The Lebanese commercial banks' consolidated shareholders' equity has been witnessing a steady growth in recent years. It increased by 13.4% in 2008, moving from USD 6.3 bn in FY 07 to USD 7.1 bn in FY 08. This significant y-o-y growth can be mainly attributed to the retention of net earnings. The balance sheet of commercial banks showed a capital to assets ratio of 7.8% in 2006, which witnessed a slight decrease to 7.5% in 2008.

Currently, Lebanese banks are characterized by a good level of capitalization; while the minimum CAR should stand at 8% according to Basel II requirements, the Lebanese banking sector enjoys a CAR of 11.23% according to the BCC, which suggests that Lebanese banks are solidly capitalized.

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Going forward the Lebanese banking sector faces two key risks, namely: its high exposure to the sovereign debt, and its high exposure to political and security shocks

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The major banking challenge for 2009 is still to maintain a relevant growth in earnings within the context of an expected fall in bank interest spreads following the significant contraction of international interest rates.

► Outlook

In light of the good performance of the Lebanese banking sector to date, Moody's has upgraded Lebanon Sovereign Ratings from B3 to B2 citing the country's improved external liquidity and its ability to weather crises. More recently Capital Intelligence, the international credit rating agency, announced it has raised Lebanon's long-term foreign and local currency ratings to B from B-, reflecting a stable outlook.

We believe immediate risks facing the banking sector to remain limited, given its lack of direct exposure to the subprime crisis and its ability to counterbalance the adverse external effect of the global financial crisis. The risk that Lebanese banks will begin to feel the effect of a difficult external environment is mitigated by the country's ability to weather external shocks amidst ongoing deposit inflows, political and security improvements following the parliamentary elections in June, with the impact these improvements might have on investors' confidence, household consumption and touristic sector. As a result, economic growth may maintain a decent pace of growth and will likely be able to sustain a 5% to 6% growth in 2009 according to the latest estimates.

However, going forward, the Lebanese economy and financial system are faced with two key risks. First, the main vulnerability of the Lebanese banking sector is its high exposure to sovereign debt in light of the uncertain political environment; however, the risks are mitigated by the banks high core liquidity level. Any major deterioration of the Lebanese economy triggering a downgrade on its sovereign debt would drastically weaken Lebanese banks. However, we believe this scenario to be highly unlikely in the short to medium term. Second, Lebanon remains exposed to political and security shocks that could adversely affect economic and financial conditions as any rise in political uncertainty might have a negative impact on deposits in the Lebanese banking sector.

In addition, we expect the outlook for Lebanon to remain closely linked to economic parameters that could affect the economy at large as well as the Lebanese banking sector, depending on their evolution. Some of these parameters directly affect the real economy, namely oil prices, exchange rates and interest rates among others. With oil price hovering around USD 65 in July 2009, up from an average of USD 38.6 in December 2008, the Lebanese banking sector is likely to benefit from the potential spillover from the petrodollar increasing liquidity.

The first five months of 2009 were characterized by the following main trends: a reticent lending activity contrasting with 2007 and 2008, an important growth in deposits, as well as a considerable rise in earnings. These trends give us some indications of the anticipated performance for the year 2009. In general, 2009 will be a year of vigilance for the banking sector. The major banking challenge for 2009 is still to maintain a relevant growth in earnings within the context of an expected fall in bank interest spreads following the significant contraction of international interest rates. On the regional front, Lebanese banks' operations abroad will play a key role in attracting additional deposits benefiting from their strong and conservative reputation. However, we anticipate the regional expansion to be hindered by slowing economies in the region which might decelerate the pace of accumulation of assets from regional operations, bearing in mind that the assets, Lebanese banks held abroad, have increased exponentially in the past two years.

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We believe that the immunity and the long term stability of the Lebanese banking sector to be undeniably linked to the consolidation of the domestic achievements over the period 2007-2008, namely the economic growth recovery and the decline in government debt ratios

We believe that the immunity and the long-term stability of the Lebanese banking sector are undeniably linked to the consolidation of domestic achievements that took place over the period 2007-2008, namely the economic growth recovery and the decline in government debt ratios over the past two years. A five percent GDP growth rate (led by a surge in private demand) in 2009 would play a key role in further strengthening the immunity of the Lebanese banking sector. In order to further decrease the debt to GDP ratio to 150% (down from the current 163%), efforts should be made to stabilize public spending as well as the cost of debt servicing. Other requirements to preserve the Lebanese banking sector's resilience in light of the global financial turmoil is to apply the reform program presented at the Paris III conference, to meet the challenges of Basel II and to decrease the high level of loan dollarization that stands slightly above 84%.