FFA Private Bank s.a.l.

The Lebanese banking sector

2009

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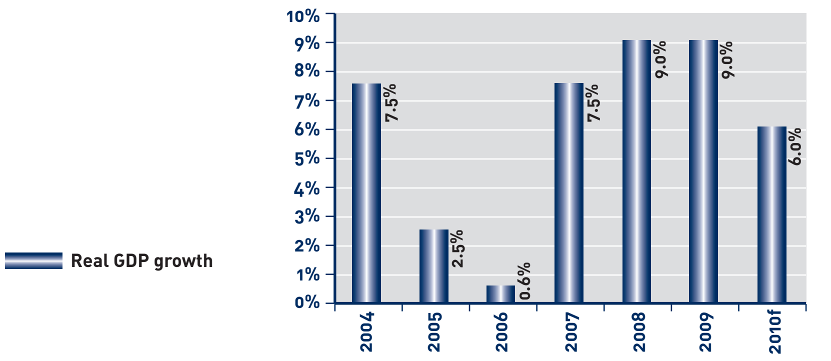
Soaring economic growth in 2009, despite the challenging global environment

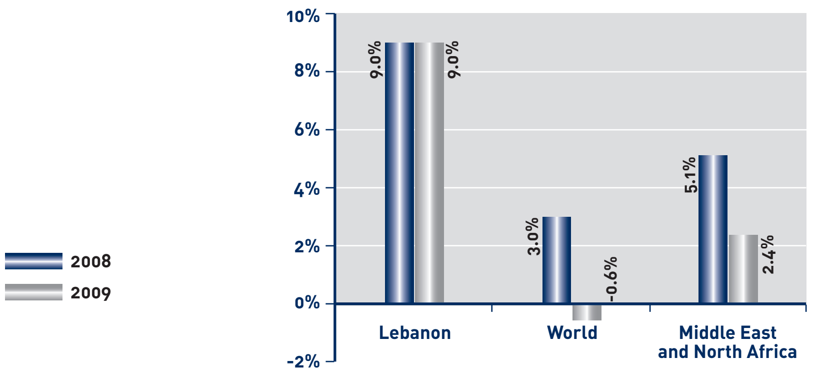
After the Lebanese GDP slowed significantly in 2005 as a result of the negative impact of the political unrest on capital flows, investment and tourism, confidence is returning and the growth outlook is encouraging. In line with the strong economic growth in 2007-2008, and despite the uncertainty that preceded the parliamentary elections of June 2009 and the formation of a government of national unity in November 2009, the relatively stable security situation that prevailed in Lebanon throughout 2009 formed favorable ground for the economy to grow vigorously. Bolstered by a buoyant performance in several sectors amid enhanced confidence from the improving political stability, Lebanon's economic growth stood at 9% in 2009 according to the most recent IMF growth estimates, once again proving the Lebanese economy's resilience to the recent global and regional financial turmoil.
At this growth level, Lebanon's nominal GDP reached USD 33.59 bn in 2009, up from USD 29.49 bn in 2008, according to the IMF. With regard to regional and international benchmarks, it should be noted that Lebanon's economic growth in 2009 outpaced by far that of the region (which stood at 5.1% for the year) as well as global economic activity which witnessed a negative growth rate of 0.6%. Lebanon's exceptional scenario is a direct result of the specific fundamentals of the economy and the prudent regulations set by the Central Bank (BDL).

Figure 1: Real GDP growth in Lebanon



Source: IMF

Figure 2: Real GDP growth benchmark



Source: IMF

Strong performance in key sectors

"Real estate, tourism and banking, which are seen as the backbone of the Lebanese economy, reported strong performance in 2009

The Lebanese economy is heavily oriented towards the service and trade sectors. The performance indicators of key sectors were all on the rise in 2009, sustaining an optimistic economic performance. Tourism services, financial and banking services, as well as the construction and real estate sectors (which are seen as the backbone of the Lebanese economy) were strong in terms of growth. Flourishing tourism activity was one of the main drivers of the Lebanese economy in 2009. Incoming tourists reached a record number of 1.85 mn for the year according to the Ministry of Tourism, representing an increase of 82% and 38.9%, respectively, when compared to 2007 and 2008. At the same time, the number of airport passengers arrivals increased by 23% in 2009. Aside from the continued expansion in tourism, construction activity also remained strong over 2009: despite a 10.5% year-on-year (yoy) decrease in construction permits, demand for real estate continued to rise, as property sales transactions climbed by 2.3% and cement deliveries, an indicator of building activity, managed to outperform the levels attained in 2008 by 16.1%. Moreover, the financial and banking sectors prospered remarkably despite the global financial turmoil. Underpinned by continuous and strong inflows of deposits throughout the year, the size of the banking sector relative to the Lebanese economy further expanded as witnessed by the bank assets to GDP ratio and the bank deposits to GDP ratio climbing to a respective 343% and 285% at the end of 2009, up from 320% and 264% respectively by year end 2008.

Structural trade deficit largely offset by strong inflows of capital

"Lebanon's structural trade deficit totaled USD 12.76 bn in 2009

Within an environment of retreating international trade, the Lebanese external sector progressed slightly in terms of aggregate trade activity throughout 2009 as total exports and total imports remained almost stable in value. Figures demonstrate that total imports and total exports reached USD 16,247 mn and USD 3,486 mn respectively in 2009, which represents a slight increase relative to 2008 (+0.2% and 0.7% respectively). However, it is worth noting that the increase in trade was substantial on a volume basis as Lebanese exports and imports soared in this regard by 16% and 17% respectively over 2009. It is worth mentioning that the small increase in the value of Lebanese imports can be attributed to the effect of the considerable drop in oil prices relative to 2008. At these growth levels the trade deficit reached USD 12.76 bn in 2009 compared to USD 12.66 bn in 2008.

On the other hand, capital inflows into the country were abundant and attenuated the fears of a scenario in which Lebanon's balance of payments could be affected by the negative spillover effects of the global financial crisis. Capital inflows for the year amounted to USD 20.6 bn which comfortably offset the large structural trade deficit. At a time when many countries across the globe suffered from a decline in foreign direct investment (FDI), those flowing into Lebanon increased significantly in 2009, reaching USD 4.8 bn in 2009, constituting an increase of 10.9% from USD 4.33 bn in 2008 according to the figures released by the United Nations Conference on Trade and Development (UNCTAD). At the same time, remittances from the Lebanese Diaspora, considered to be one of the largest in the world in terms of its proportion to the resident population, remained strong in 2009 at 21% of GDP. According to the World Bank, remittances into Lebanon are estimated to have reached USD 7 bn in 2009,

Capital inflows offset current account deficit and balance of payments reached a record cumulative surplus of USD 7.89 bn for 2009

which represents a marginal drop from the record high of USD 7.2 bn in 2008; this result contrasts with remittances into the MENA region which were severely affected by the global crisis in late 2008 and 2009. More generally, and as a consequence of a large surplus in its capital and financial accounts, the balance of payments (which mirrors net foreign assets in the country) remained broadly favorable as it reached a record cumulative surplus of USD 7.89 bn for 2009, significantly higher than the surplus of USD 3.42 bn recorded in 2008.

Large fiscal deficit and heavy debt burden are the main concerns, yet mitigated by a further improvement in the debt-to-GDP ratio

Public debt and fiscal deficit remain high, whereas debt-to-GDP ratio continue to improve on the back of robust economic growth

The main source of concern remains Lebanon's fiscal deficit which continues to worsen as a result of the heavy burden of massive public debt. In 2009, the fiscal deficit attained similar levels to those of 2008. It reached USD 2.96 bn by the end of 2009, up by 1.3% relative to the whole of 2008. However, it should be noted that the fiscal deficit/GDP ratio narrowed to 8.81% in 2009 from 9.91% in 2008, as a direct reflection of the strong economic growth. Gross public debt continued to rise throughout 2009, as it reached USD 51.1 bn by the end of 2009 compared to USD 47 bn in 2008, translating into an increase of 8.7%. Although the absolute value in the public debt has continued to worsen, it should be noted that the favorable macroeconomic situation has led to a further improvement in the debt-to-GDP ratio as the latter continued to drop in 2009, reaching 152% by the end of the year compared to 159% in 2008 and 168% in 2007. However, it should be noted that this ratio continues to be among the highest in the world.

Encouraging prospects for growth in 2010, should the political situation remain stable

Robust growth in all major economic indicators over the first five months of 2010

Tourism, banking and construction are expected to remain the key drivers of growth. Over the first five months of 2010, all major economic indicators reflected a positive trend. Real estate activity registered robust growth. While property sales transactions surged by 39.5%; cement deliveries and construction permits were 9.9% and 59.1% higher compared to the same period in 2009. In the same period, tourism activity rose significantly. Figures released by the Ministry of Tourism show that 732,855 tourists visited Lebanon in the first five months of 2010 compared to 569,724 during the same period of 2009, representing a 28.6% increase. At the banking sector level, deposits demonstrated a healthy growth pattern. Following 3.6% growth over the first five months of 2010, the deposit base of commercial banks reached USD 99.2 bn at end May 2010, while lending to the private sector soared by 10.8%. De-dollarization of deposits, an indicator of confidence in the Lebanese banking sector and the Lebanese economy as a whole, continued its progression as deposits in foreign currencies stood at 62.7% by the end of May 2010, down from 64.5% at the end of 2009. On a broader level, capital inflows into Lebanon during the first five months of 2010 remained strong and managed to more than counterbalance the structural trade deficit which resulted in a substantial balance of payment surplus of USD 1.21 bn compared to a surplus of USD 1.66 bn in the same period of 2009. Within such a buoyant environment and given the gradual recovery of regional economies and the expansionary fiscal plan set by the Lebanese government for 2010, we expect the

> **Real GDP growth estimate at 6% in 2010 according to the IMF**

Lebanese economy to remain on a positive path overall provided that political stability is maintained. According to the IMF's World Economic Outlook for April 2010, real GDP growth is expected to reach 6% in 2010, which suggests that economic growth will maintain a healthy trend although at a more moderate pace. As for the expectations of Lebanese official sources regarding GDP growth for 2010, it is worth noting that the BDL Governor expects economic growth to reach 7% to 8% in 2010.

Lebanese banking sector introduction

Driven by several comparative advantages, the sector has grown robustly over the years, overcoming episodes of political unrest

Robust growth over the years driven by several comparative advantages

In an open and liberal financial market, the Lebanese banking sector is perceived as the backbone of the Lebanese economy and the promoter of Beirut as a prosperous financial center. Sustaining a long war and booming in time of peace, the sector has grown robustly over the years and played a significant role in the recovery of the economy. The Lebanese banking system benefits from the prudent regulatory framework set by the Central Bank of Lebanon and the conservative practices and risk management of Lebanese banks themselves, along with other comparative advantages, namely the banking secrecy law, good management, a skillful workforce and relatively stable currency. More recently, the Lebanese banking sector has been consolidating its position as a regional safe haven for depositors as a direct result of the high yields on local and foreign currency deposits compared to peer countries along with the perception of conservative practices in the midst of international financial turmoil.

Since 2008, outstanding growth and maintained financial soundness suggest that the sector has emerged unscathed from the global financial crisis

Resilient and outperforming in a global financial crisis context

Since the inception of the global financial crisis at the end of 2008, the Lebanese banking sector has demonstrated its ability to weather external shocks, overcoming threats and instability, performing exceptionally well and emerging unscathed from the adverse effects of the global financial crisis. In the context of Lebanon's improved economic growth, increased confidence and strict financial foresight that has shielded banks from exposure to derivatives and structured products, the Lebanese banking sector is benefiting from unremitting deposit inflows from residents as well as from the Lebanese Diaspora. Consequently, the size of the sector is expanding considerably and earnings are also on the rise. In this regard, figures indicate that Lebanese banks recorded a positive double-digit jump in their consolidated net profit (+17%) for 2009, following a 26.7% increase for the year 2008, which highlights a healthy performance when taking into consideration the severe downward pressures regional banks are facing on their earning levels. As pinpointed later in this report, the growth, both in terms of size and earnings, is not being achieved to the detriment of the sector's financial standings as liquidity, capitalization and asset quality indicators have remained high, supporting the Lebanese banking sector's soundness in the context of robust growth.

The Lebanese banking sector manages a large asset base domestically and efforts towards regional expansion started in the early 2000s

More than USD 115 bn of assets managed domestically along with an active deployment on the regional front

The 53 active commercial banks at the end of 2009 employed approximately 19,300 individuals in 885 branches throughout the country, and managed USD 115.3 bn in assets nationwide. Following a relative saturation of potential growth domestically and in order to add to the existing European subsidiaries of large Lebanese banks, regional expansion efforts were intensified starting in the early 2000s. The expansion into regional markets with under-developed banking systems offered Lebanese banks long-term growth potential as well as a diversified revenue stream and allowed them to expand away from the uncertain domestic political conditions, thus mitigating the Lebanese country risk. More recently and within the context of a slowdown in regional economies, the deployment of Lebanese banks in neighboring countries has temporarily slowed as witnessed by a diminishing rate of new branch additions, but should rapidly resume as plans to enter new international markets for new growth opportunities and further branch-network deployments are currently in the pipeline.

Regulations and landscape

Regulations

Banks and other financial institutions fall under the jurisdiction of the Central Bank (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 BDL's 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's shareholders' equity. Moreover, banks can only lend up to 50% of the value of stocks and up to 60% of the value of any 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 bank's equity provided the product is capital guaranteed with the approval of the Central Bank. Investment in derivative instruments is not allowed except for hedging purposes and after specific approval from the Central Bank.

- **Reserves requirements**
  In terms of required reserves on Lebanese pound (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.

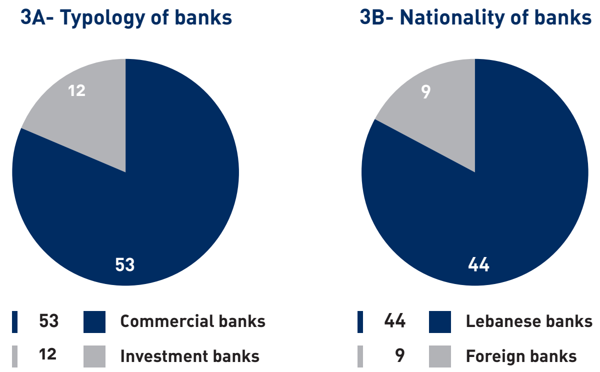
Sector landscape

Commercial bank domestic assets soared in 2009 despite the number of commercial banks remaining unchanged

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

As at year-end 2009, 65 banks were operational in Lebanon including 12 investment banks and 53 commercial banks, which suggests that the number of commercial banks has remained unchanged compared to 2008; meanwhile, over the same period, domestic assets of Lebanese commercial banks grew by 22.3 %, moving from USD 99.3 bn at end-2008 to USD 115.3 bn by end-2009. In parallel, commercial banks have increased the number of local branches from 861 by year-end 2008 to 885 branches by end 2009. In terms of activity, out of the 53 commercial banks, 44 are Lebanese and nine are foreign. Foreign representation is significant, whether through foreign banks maintaining their branches in Lebanon or holding equity stakes in several local banks.

Figure 3: Nationality and typology of banks in Lebanon as at end 2009



Source: BDL

Deployment in 31 countries outside Lebanon

> **17 Lebanese banking groups are currently deployed in 31 countries outside Lebanon**

In addition to their historical presence in Europe, major Lebanese banking groups started focusing their expansion efforts on the Middle East and North Africa in the first half of the past decade and more specifically in markets with under-developed banking systems (Syria, Iraq, Egypt, Sudan etc.), to mitigate limited domestic growth opportunities. Several banking groups have successfully expanded abroad. The latest figures provided by the ABL reveal that 17 Lebanese banking groups have embarked on an international expansion. With deployment in 31 countries outside Lebanon and most importantly across Europe and the MENA region, these banking groups currently operate around 193 branches abroad either directly or through a subsidiary. Taking into account the results from international operations, it should be noted that Lebanese Banks' held an asset base of USD 138.6 bn at the end of 2009 and generated USD 1,426.5 mn in net profit. Going forward and given that regional expansion is still a priority for Lebanese banks, we expect international operations to remain a key driver for Lebanese banks' performance in terms of balance sheet and earnings growth.

The Lebanese banking sector is relatively crowded and still has room for more consolidation going forward

> **From a highly fragmented market, the sector moved to a somewhat consolidated environment**

The Lebanese banking sector witnessed several transformations over the past decade moving from a highly fragmented market to a somewhat consolidated environment following a wave of consolidation in the sector starting in the mid-nineties that was encouraged by the Central Bank. Looking ahead we believe that although the Lebanese banking sector has consolidated to a certain degree, it still has room for more given the relatively high number of commercial banks operating on the domestic market (53 commercial banks at the end of 2009 servicing a population of 3.9 mn). With fragmentation remaining a key characteristic, the Lebanese banking sector still appears overbanked relative to many of its emerging market peers. One reason why the Lebanese banking industry is expected to witness more consolidation is that with the restrictions set by the Central Bank regarding the yearly opening of new branches, the acquisition of peers becomes a natural catalyst for cash-rich Lebanese banks seeking new growth opportunities to channel their excess liquidity, boost their franchise, obtain balance sheet strength and benefit from synergies and economies of scale. Moreover, the strict application of the Basel II capital requirements is likely to boost the acquisition of those local banks struggling to meet capital adequacy regulations by well-capitalized large banking groups. Additionally, many of the banks are small and family owned and might feel pressure to consolidate due to decreasing competitiveness and viability. Nonetheless, currently large banks may have little appetite to acquire smaller ones as their capacity to grow organically on the local market might be perceived as less costly and as their focus remains on expanding their international operations.

> **“ The existing potential for further consolidation may be hindered by the large banks small appetite for inorganic expansion**

- **12 largest banks controlled 85.5% of the sector’s consolidated assets at the end of 2009**

While the market remains fragmented, concentration at the top end of the scale has began to emerge. Among the 53 commercial banks that operated in Lebanon at the end of 2009, 12 banks (known as Alfa banks) held a deposit base in excess of USD 2 bn. As pinpointed in the table below, the figures provided by Bankdata Financial Services regarding Alfa banks show that those 12 banks accumulated assets, deposits and loans equivalent to USD 118 bn, USD 98 bn and USD 28 bn respectively at the end of 2009 and generated USD 1,289 mn in net profits for the year including results from international operations. At these levels, Alfa banks controlled 85.5%, 86.1% and 83.5% respectively of the banking sector’s total asset base, deposit base and loan portfolio at the end of 2009 and generated 90.4 % of the sector’s earnings for the year.

Table 1: Alpha banks' key figures 2009 (domestic and international operations)

USD mn	Assets Volume	Assets %	Customer Deposits Volume	Customer Deposits %	Loans & advances Volume	Loans & advances %
Bank Audi	26,489	22.4%	22,986	23.4%	6,747	23.8%
Blom Bank	20,719	17.5%	17,968	18.3%	4,021	14.2%
Byblos Bank	13,577	11.5%	10,285	10.5%	3,196	11.3%
Fransabank	10,799	9.1%	9,013	9.2%	2,309	8.1%
BankMed	10,585	8.9%	8,183	8.3%	3,134	11.1%
Banque Libano Francaise	7,553	6.4%	6,342	6.5%	2,261	8.0%
Banque of Beirut	6,969	5.9%	4,909	5.0%	1,797	6.3%
Credit Libanais	5,486	4.6%	4,822	4.9%	1,290	4.6%
Lebanese Canadian Bank	5,202	4.4%	4,434	4.5%	1,269	4.5%
SGBL	4,764	4.0%	3,648	3.7%	1,350	4.8%
BBAC	3,743	3.2%	3,287	3.3%	680	2.4%
IBL Bank	2,624	2.2%	2,375	2.4%	281	1.0%
Total Alfa Banks	**118,510**		**98,254**		**28,333**	

Source: Bankdata Financial Services

USD mn	Shareholders' equity Volume	Shareholders' equity %	Net income Volume	Net income %
Bank Audi	2,185	21.0%	289	22.4%
Blom Bank	1,707	16.4%	293	22.7%
Byblos Bank	1,302	12.5%	146	11.3%
Fransabank	1,057	10.2%	104	8.1%
BankMed	1,142	11.0%	91	7.0%
Banque Libano Francaise	594	5.7%	67	5.2%
Banque of Beirut	787	7.6%	76	5.9%
Credit Libanais	423	4.1%	52	4.0%
Lebanese Canadian Bank	357	3.4%	35	2.7%
SGBL	361	3.5%	70	5.4%
BBAC	287	2.8%	37	2.9%
IBL Bank	193	1.9%	28	2.2%
Total Alfa Banks	**10,396**		**1,289**	

Source: Bankdata Financial Services

More specifically, it should be noted that three undisputable leaders currently dominate the sector, namely Bank Audi, Blom Bank and Byblos Bank. The market share analysis highlights that Bank Audi is the largest bank in terms of assets, deposits, loans and shareholders' equity and the second largest in terms of net profit. Blom Bank is the leading bank in profitability and the second largest in Lebanon by assets, deposits, loans and shareholders' equity. Byblos Bank is the third largest player in terms of assets, deposits, loans, shareholders' equity and net profit. The top three Lebanese banks' are continuing to sustain their leading position among their peers in the group. In fact, together, the three banks controlled 51.3% of the Alfa banks' total assets in 2009 with 22.4% being held by Bank Audi, 17.5% by Blom Bank and 11.5% by Byblos Bank. Moreover, the three banks together generated 56.5% of the Alfa group's total earnings in 2009, including a contribution of 22.7%, 22.4% and 11.3% from Blom Bank, Bank Audi and Byblos Bank respectively. On a broader level, Bank Audi, Blom Bank and Byblos Bank together controlled 43.9% and 51.1% of the sector consolidated assets and earnings in 2009.

> **“In 2009, Bank Audi, Blom Bank and Byblos Bank controlled 43.9% and 51.1% of the sector's assets and earnings respectively**

Growth trends and drivers

The Lebanese banking sector continued its pattern of exceptional performance in 2009, as all major indicators witnessed a robust evolution. The balance sheet activity of commercial banks demonstrated strong growth throughout the year via the substantial rise in deposits and healthy growth in lending activity. At the same time, the sector reported a solid increase in its earnings despite the ongoing global and regional financial crisis.

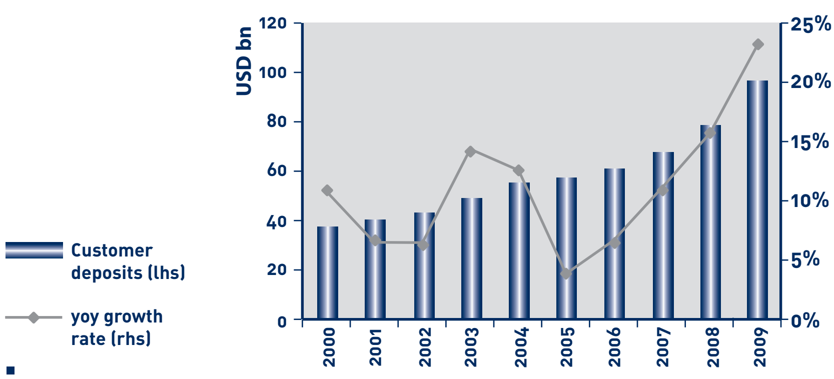
Assets & deposits growth and breakdown of deposits

Strong asset base expansion driven by unprecedented deposit inflows to the sector

With the liabilities of Lebanese commercial banks being mainly composed of customer deposits (which accounted for 83% of the total balance sheet at end 2009), sector growth has always been driven by inflows of deposits. Between 2000 and 2009, domestic assets of commercial banks posted a CAGR of 12.3% driven by the strong growth in deposits over the same period. In 2009, as a direct reflection of continuous large liquidity inflows into the country, domestic assets of commercial banks increased by USD 21 bn to reach USD 115.3 bn by the end of the year. Compared to the USD 94.3 bn attained over the same period of 2008, this represents a 22.3 % increase. This high level of asset growth continued to be driven by customer deposits which accounted for 83.1% of the asset base of commercial banks in 2009, compared to 82.5% at the end of 2008. Lebanese commercial banks mobilized strong deposit inflows throughout 2009 as evidenced by a 23.1% growth in customer deposits, the equivalent of a USD 18 bn addition. It should be noted that this surge in customer deposits surpassed the previous year's record to reach a new historical high of USD 95.8 bn from local operations.

> **Domestic assets of commercial banks grew by 22.3% in 2009 on the back of a 23.1% growth in customer deposits**

Figure 4: Customer deposits growth over the period 2000-2009



Note: Figures related to domestic operations of commercial banks
Source: BDL

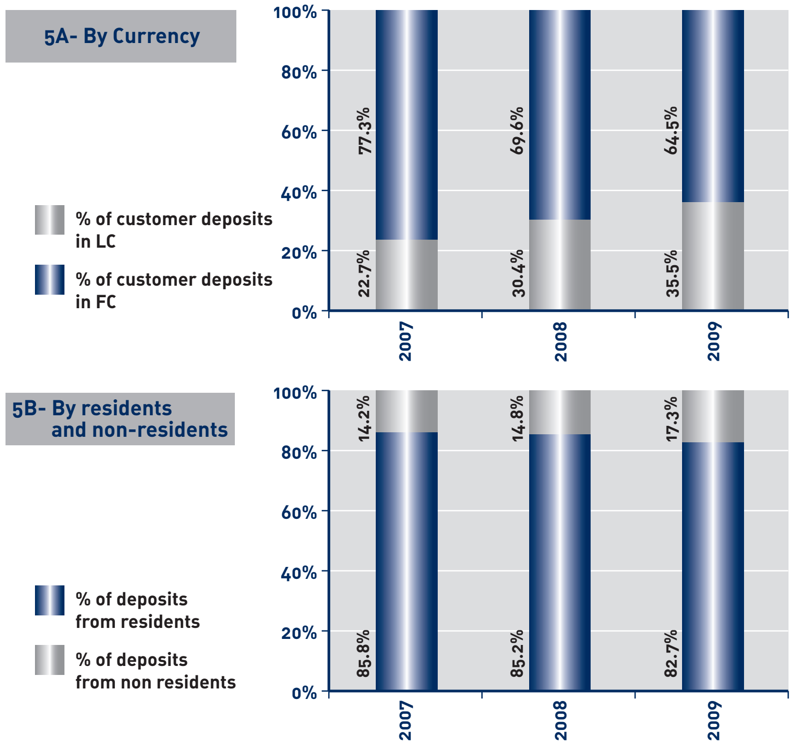
Declining deposit dollarization

Taking a closer look at the increase in deposits, its should be noted that LBP customer deposits saw a remarkable increase relative to deposits in Foreign Currencies (FC) by the end of 2009, suggesting that the liquidity that flowed into the Lebanese banking sector was mainly triggered by deposits in LBP. The latter recorded a 43.8% surge in 2009 (equivalent to USD 10.4 bn), compared to 14.1% for foreign currency deposits (equivalent to USD 7.6 bn). This development demonstrates that the de-dollarization trend continued in 2009 driven by the spread in favor of the local currency and the rising confidence of depositors in the Lebanese pound and the Lebanese economy. The breakdown of deposits by currency at end 2009

> **Dollarization rate of deposits dropped from 69.6% in 2008 to 64.5% 2009, pinpointing a renewed confidence in the LBP and the economy as a whole**

revealed that deposits in Lebanese pounds accounted for 35.5% of the total deposit base, whereas deposits in foreign currencies contributed 64.5% of total deposits, suggesting that the dollarization rate of deposits has been steadily declining since 2006 to reach its lowest level of the decade by the end of 2009.

Figure 5: Breakdown of customer deposits



Source: BDL

> **Non-resident deposits increased substantially over 2009 (+44%), clearly highlighting the confidence boost**

Renewed confidence saw non-resident deposits increase substantially

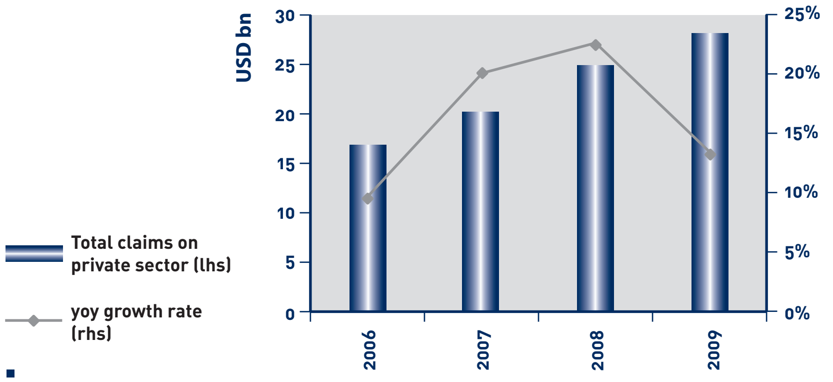
Furthermore, deposits stemming from the non-resident private sector proved to be the category that witnessed the most substantial increase over 2009 (+44%), whereas customer deposits funded by residents grew by 19.5% over the same period. Consequently, the share of non-resident deposits grew from 14.8% at end 2008 to 17.3% at end 2009, clearly highlighting the confidence boost from the regained political stability and the high yields offered on deposits relative to international rates. Despite this progression in non-resident deposits relative to resident deposits, it should be noted that the fact that the deposit base of commercial banks remains mainly funded by residents provides a further stability factor since this category of depositors has proven to be less inclined to withdraw funding during times of political unrest.

Lending activity and loans breakdown

Healthy lending activity, yet below previous year's performance

During the first half of the past decade, the performance of Lebanese commercial banks was weak on the lending activity front as a result of relative inertia from the private sector as well as the banks' conservative lending practices in order to preserve a sound asset quality. Between 2000 and 2006 Lebanese commercial banks' lending to the resident private sector registered a CAGR of 0.63%. Since 2007 lending has been on an upward trajectory supported by stronger economic growth and the steadier political and security situation, as illustrated by a 20% and 22.6% yoy growth in total loans to the private sector for 2007 and 2008 respectively.

Figure 6: Claims on private sector growth over the period 2006-2009



Note: Figures related to domestic operations of commercial banks
Source: BDL

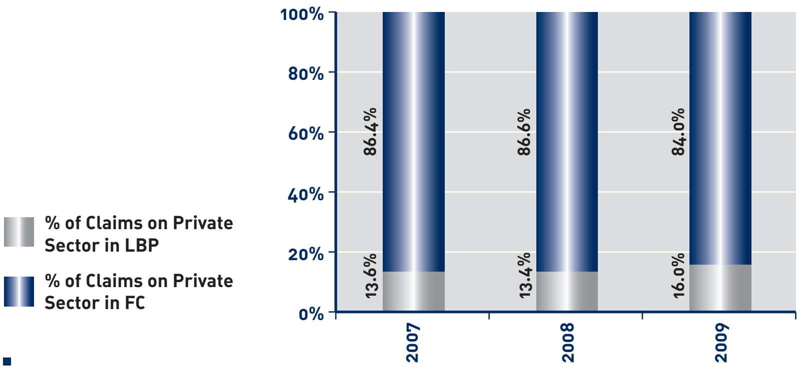
> **Loans' growth stood at 13.3% in 2009**

Over 2009, Lebanese commercial banks' lending activity remained healthy. Loans to the private sector from commercial banks reached USD 28.4 bn for 2009 compared to USD 25 bn in 2008, translating into a 13.3 % increase. Going forward, we believe that the growth in loans should further accelerate starting in 2010 on the back of the banking sector's high liquidity levels along with an expected surge in demand from the private sector in the context of improved local macroeconomic conditions. Moreover, we expect the lending activity to be spurred by the Lebanese banks' operations in neighboring countries and by the expected reforms relating to infrastructure projects and privatization efforts.

Encouraging measures to reduce the high dollarization rate of lending

The analysis of loans by various components shows that the dollarization rate remained high at 84% percent in 2009. In an effort to encourage lending in LBP, the Central Bank has issued new circulars which aim at reducing the cost of lending in this currency. In this regard, a circular issued in 2009 lowered the reserve requirements which Lebanese banks were previously required to keep at the Central Bank at zero percent interest, thus allowing banks to lend in LBP at more attractive rates on certain categories of loans.

Figure 7: Currency breakdown of loans

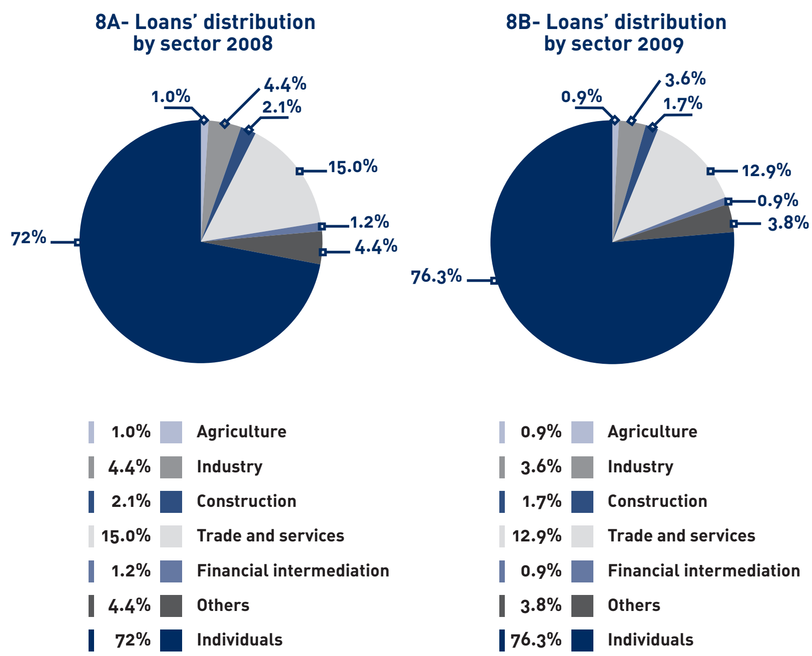


Source: BDL

More than 70% of loans to individuals, with limited exposure to housing loans

Based on data provided by the Central Bank, the figures below, which depict the loans' breakdown by sector for 2008 and 2009, show that the bulk of the loan book for Lebanese commercial banks and financial institutions is made up of individual loans. The figures indicate that loans to the private sector include 72% and 76% of individual loans in 2008 and 2009 respectively. As for corporate loans, it is worth noting that the trade and services sectors are the largest beneficiaries, with 15% and 13% of total loans outstanding being allocated to these sectors in 2008 and 2009 respectively.

Figure 8: Distribution of loans by sector 2008 and 2009



Source: BDL

The exposure of the Lebanese banks' loan portfolio to the property sector totaled USD 10.1 bn at the end of 2009

Taking a closer look at the exposure of Lebanese banks to the property sector, it should be noted that loans for construction, housing and rent totaled USD 10.1 bn at the end of 2009 up from USD 8.3 bn in 2008, a 21.5% increase, whereas total loans to the private sector recorded growth of 13.3% over the same period. This substantial increase in the exposure of Lebanese banks to the property sector when taking into consideration the catalytic role real estate played in the global financial collapse could give rise to concern. However, we believe the risk to be considerably mitigated by the non-speculative nature of the local real estate market and by the marginal size of this exposure when taking into consideration the large asset base of the banking sector. Moreover, the practices of regulatory authorities have been conservative and precautions are being taken to shield Lebanese banks from any deterioration of their asset quality should there be any burst in the housing bubble. One of the main regulations that should be cited in this respect is the 60% limit imposed on developers with regard to the leverage of their projects.

Profits: growth, revenue segmentation and profitability drivers

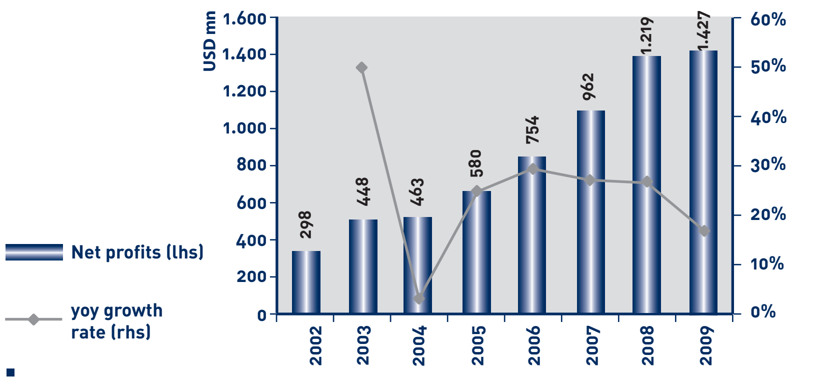
Profits' growth

Regular growth in profits across an eight-year track

Boosted by an improvement in cost efficiency levels as well as the positive impact of regional expansion along with strong balance sheet growth, Lebanese banks have reported regular growth in profits across an eight-year track. The consolidated net profits of the Lebanese banking sector recorded a 25.1% CAGR over 2002-2009, which translated into total earnings moving from USD 298 mn in 2002 to USD 1,427 mn in 2009.

Lebanese banks generated USD 1,427 mn in net profits from their consolidated operations in 2009, which represents a 17% increase relative to 2008

Figure 9: Lebanese banking sector consolidated net profits



Source: Bilanbanques

Despite the narrowing spread environment and as a direct reflection of major balance sheet expansion, the figures reveal that the Lebanese banking sector continued to report steady growth in its earnings over 2009, as witnessed by an increase of 17% in the consolidated earnings of Lebanese banks.

More specifically and according to the annual report released by the ABL, Lebanese banks generated USD 1,197 mn in net profits from their domestic operations in 2009 compared to USD 1,067 mn in 2008, which represents a 12.1% increase following a 25.6% increase in 2008. This deceleration in the growth of net profits can be mainly attributed to pressures on the interest margin since the decline on yields on uses of

> **Net-interest income accounts for the bulk of the Lebanese banks' operating revenues**

funds was not matched by a similar drop in cost of funds. In fact, the net interest margin dropped from 1.97% in 2008 to 1.68% in 2009.

Looking ahead, we believe a key driver for earnings growth will be the international operations of Lebanese banks as well as the ability to preserve their profitability levels by sustaining a high balance sheet growth within an environment characterized by tightening interest margins.

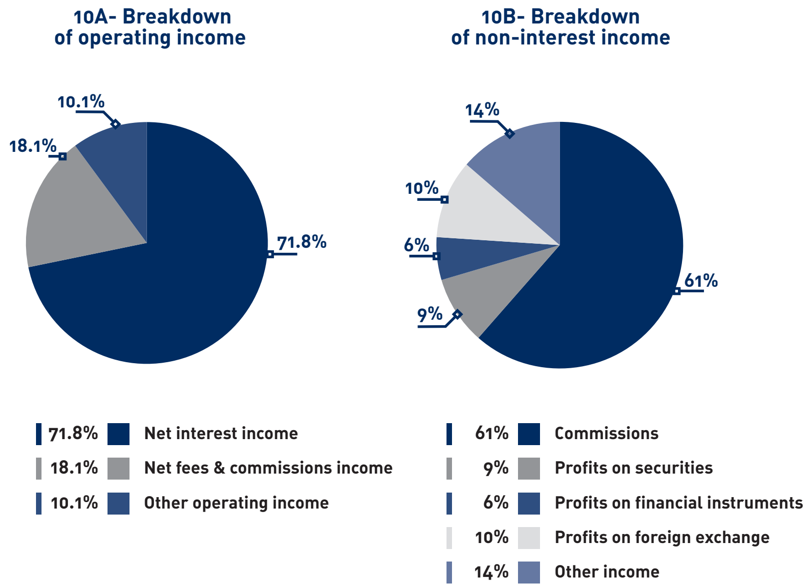
In order to further analyze the profitability of the Lebanese banking sector, we present what we believe to be the key issues. We highlight the segmentation of revenues by taking into consideration the major components: net interest income, fees & commissions and trading & investment income. We also run an analysis revolving around the key profitability drivers namely cost-efficiency levels and, most importantly, interest spreads.

– Segmentation of revenues

Interest income accounts for the bulk of total banking income

Starting in the late nineties, large banks started diversifying earnings by covering a large spectrum of banking services (investment & private banking, capital markets, insurance), thus decreasing their reliance on traditional banking (retail & commercial banking). Also, it should be noted that most of the banks are currently focusing their efforts on diversifying their revenue streams. However, taking into account the sector as a whole, the profitability of Lebanese banks is mainly driven by net interest income, implying a close correlation between the performance of the banks and the interest spread between the cost of funding and the yields on uses of funds. Taking a closer look at the sector's income segmentation, it is worth noting that the net interest income accounted for 71.8% of the total operating income in 2008, which mirrors a high contribution of interest income to the sector's income from operations.

Figure 10: Breakdown of operating income and non-interest income for 2008



Source: Bilanbanques

> **Going forward, business line diversification and capital markets recovery are expected to boost the non-interest income**

Non-interest income expected to gain ground

The non-interest income segment remains underdeveloped but should gradually increase in the coming years as capital markets recover and investment banking activities prosper driven by the economy recovery and the geographical expansion of large banks in neighboring countries. Moreover, Lebanese banks are seeking to reduce their sensitivity to interest rates and we believe they will focus their efforts on increasing the non-interest income component of their revenue stream. We expect Lebanese banks to establish or reinforce their private banking, investment banking, brokerage and asset management activities with a view to increasing their non-interest contributions.

More than 60% of the banks' non interest income is derived from commissions

As depicted by the above pie chart representing the non-interest income breakdown for 2008, commissions continued to provide Lebanese banks with the bulk of their non interest income stream, with 61% of the sector's operating income being derived from this source.

Profitability drivers

Besides the balance sheet growth and the contribution of non-interest income to earnings, interest spreads are an essential driver behind the banks' profitability bearing in mind that the net interest income is the largest component of sector earnings. Another factor that helps higher profitability is the cost-efficiency level.

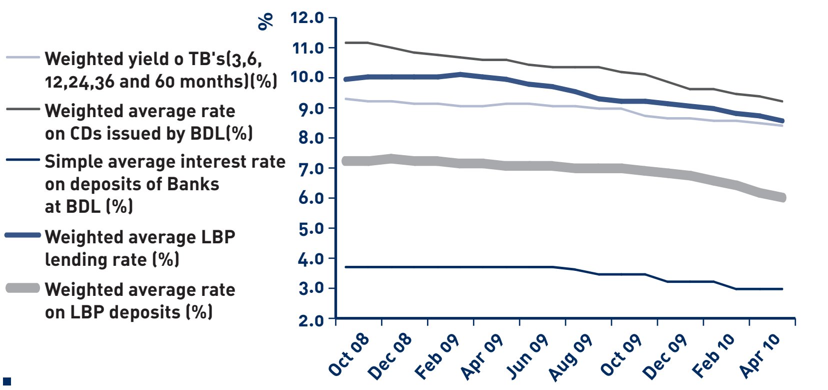
Interest spreads

Interest spreads in LBP

On the local currency front, it is important to mention that the majority of interest-earning assets are allocated to Lebanese treasury bills, certificates of deposit (CDs) and deposits at the Central Bank; this makes the interest spread in LBP largely dependent on the difference between the yield on Lebanese pound treasury bills (T-bills) and the cost of customer deposits in LBP.

In 2009, as a result of lower yields on T-bills issued by the Ministry of Finance and CDs issued by the Central Bank (following an improved sovereign rating) and in the context of a substantial increase in LBP liquidity levels, interest rates on LBP deposits gradually decreased as evidenced by the weighted average rate on LBP deposits reaching 6.81% in December 2009 against 7.26% in December 2008 and 7.40% in December 2007.

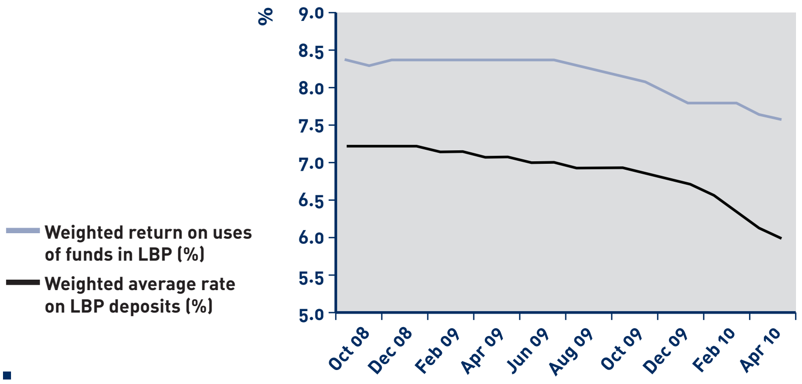
Figure 11: Yields on T-bills, rate on CDs, rate on LBP deposits at BDL, LBP lending rate vs. rate on LBP deposits



Source: ABL

Besides the decrease in rates on LBP deposits, lending rates on LBP have been falling steadily since 2007. The average rate on lending in LBP fell from 10.03% at the beginning of 2009 to 8.55% in May 2010. One of the main reasons behind the decline in the LBP lending rate resides in the lifting of reserve requirements on certain categories of loans which translated into a decrease in the rates of some LBP loans thereby making them more appetizing for borrowers.

Figure 12: Weighted average use of funds in LBP vs. weighted average cost of funds in LBP



Source: ABL

> **Interest spreads on LBP tightened over 2009 as a result of a faster decline in LC treasury yields compared with LBP deposits**

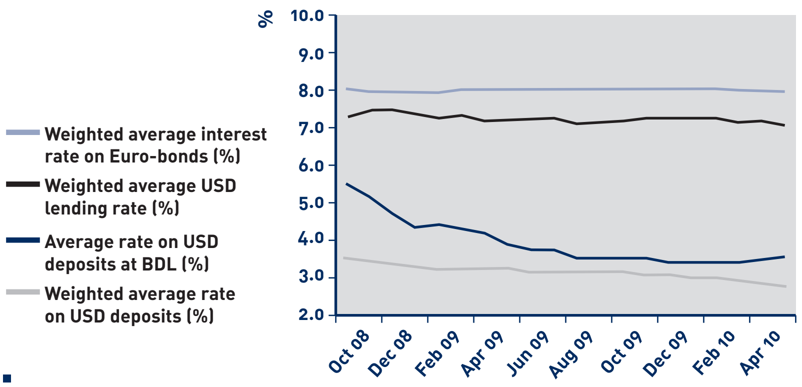
More generally, the interest spread on LBP tightened over 2009 translating into pressure on the banking sector's net interest income. In fact, interest spread on LBP declined from 1.20% in January 2009 to 1.17% in December 2009. This can be mainly attributed to a faster decline in local currency treasury yields compared with local currency deposits.

Since the beginning of 2010, the pressure on bank interest margins eased as the interest spread in local currency increased from 1.14% in January 2010 to 1.59% in May 2010 following a substantial decrease in the cost of funding. In fact, Lebanese banks have been cutting the rates on LBP deposits since the beginning of 2010 in an effort to offset the declining local currency asset yield and with a view to maintaining their margins.

Foreign currency spreads

On the foreign currency side, a high proportion of the liquidity is allocated to interbank placements and towards lending to the private sector, which makes the interest spread highly correlated to the difference between interest paid on USD customer deposits on the one hand and the Libor as well as yields offered on Lebanese government Eurobonds on the other.

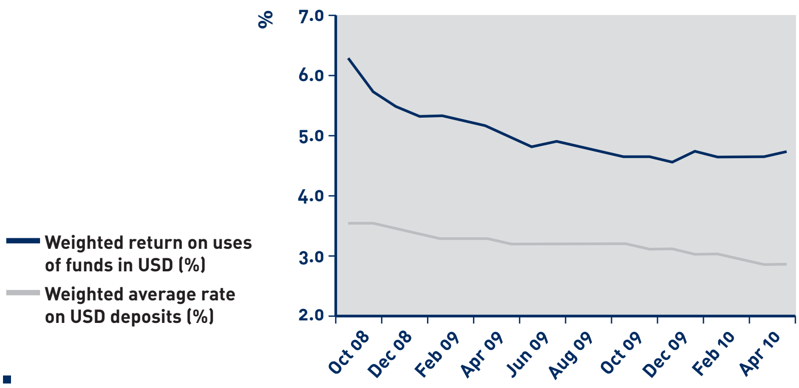
Figure 13: Eurobonds yields, USD lending rates, rates on USD deposits at BDL deposits vs. USD deposits



Source: ABL

The declining trend in the average rate on USD lending that began in 2007 continued in 2009 to reach 7.27% in December 2009 against 7.51% in December 2008 and 8.02% in December 2007. At the same time, USD deposit rates pursued the same downward trend as those on LBP deposits yet at a slower pace, within a context of plummeting international rates and a low Libor translating into pressure on interbank deposit rates. Figures demonstrate that the average rate on USD deposits reached 3.1% in December 2009, down from 3.55% in October 2008.

Figure 14: Weighted average use of funds in USD vs. weighted average cost of funds in USD



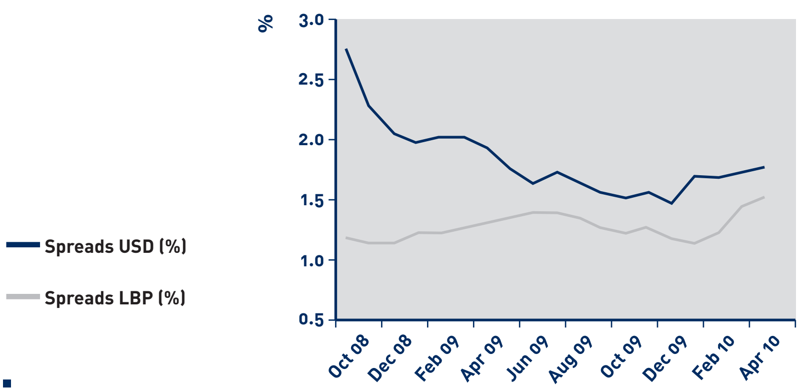
Source: ABL

Interest spreads in USD felt from 2.07% in December 2008 to 1.48% in December 2009 as a result of a limited re-pricing of USD deposits compared with a fast decline in FC asset yields

As a result of a limited re-pricing of USD deposits compared with a fast decline in foreign currency asset yields, spreads in USD narrowed in 2009 falling from 2.07% in December 2008 to 1.48% in December 2009, putting pressure on the interest income of Lebanese banks. However, this trend was reversed over the first five months of 2010 as USD interest spreads picked up slightly, moving to 1.88% in May 2010 from 1.68% in January 2010. This can mainly be attributed to the fact that Lebanese banks continued to cut their costs on USD funds even more radically than in 2009 as evidenced by the rate on USD deposits falling from 3.10% in December 2009 to 2.85% in May 2010.

The below graph clearly highlights the widening trend in interest spreads from October 2008 till May 2010.

Figure 15: Spreads USD vs. Spreads LBP



Source: ABL

> **The cost-to-income ratio for Alfa banks has decreased from 51.8% in 2008 to 49.8% in 2009, suggesting a further rise in cost efficiency**

Going forward, we believe that the upward trend in the interest spread that was initiated from the beginning of 2010 is unlikely to be sustained given the low level of the Libor, the decrease in CDs and Eurobonds yields and lending, and given the fact that Lebanese banks are unlikely to further reduce their cost of funding to prevent any capital flight as international interest rates regain momentum.

Moreover, and as evidenced by the figure above, spreads on LBP have traditionally been lower than those on USD, which has provided little incentive for commercial banks to attract depositors in LBP. However, it should be noted that with the ongoing de-dollarization of deposits within the context of regained confidence in the Lebanese banking sector and the Lebanese economy as a whole, it appears that depositors are taking advantage of the interest differential between LBP deposits and USD denominated deposits.

Operating efficiency

Improvement in cost-efficiency over the past few years

The overall cost-efficiency of the banking sector has been gradually improving over the past few years as banks have managed to gradually decrease the cost-to-income ratio. This relevant indicator of management efficiency reached 52.64% in 2008 down from 54.89% in 2006. Moreover, Alfa banks witnessed a decline in their cost-to-income ratio from 51.83% in 2008 to 49.79% in 2009.

This improvement in the cost-efficiency levels of the top Lebanese banks as well as of the banking sector on a broader level suggests that the yearly rise in net operating income has been surpassing the annual growth of total expenses. One of the main reasons behind this improvement is that Lebanese banks are putting greater effort into cost-control measures within a context of high income growth, which has paid off given the significant reduction of their cost-to-income ratio. Also it should be noted that cost-efficiency over 2009 was spurred by some setbacks on the regional expansion front which alleviated pressure on the expenses front.

Sector financial standings

Despite the substantial growth that was recorded by Lebanese banks in 2009, their financial soundness remained intact and they continued to exhibit high-quality financial indicators. Banks maintained high core liquidity levels and continued to boast a good capital adequacy level buffering the banking sector from the effects of the global crisis. Moreover, Lebanese banks succeeded in maintaining a sound asset quality as witnessed by declining non performing loan (NPL) ratios and high provisioning levels as well as adequate return ratios.

Capitalization

Strong capital position and full compliance to the criteria of Basel II

Lebanese banks have traditionally operated with significantly high capital ratios. Moreover, banks have further strengthened their capital base during the past years by issuing common and preferred shares and injecting a substantial part of their earnings in reserves.

Looking at the figures, it should be noted that the capital accounts of Lebanese commercial banks have been witnessing steady growth in recent years, increasing by 13.4% and 11.9% in 2008 and 2009 respectively to reach USD 7.9 bn by the end of 2009. However, the equity-to-assets ratio slightly declined in 2009 to reach 6.9% down from 7.5% in 2008 as a result of the exceptional growth in assets over 2009.

“Lebanese banks are solidly capitalized, their CAR stood at 12.5% in 2009 according to Basel II, significantly above the required 8%

In its annual report for 2009, the ABL indicates that the Lebanese banking sector boasts a capital adequacy ratio in excess of 20% according to Basel I and about 12.5% on a Basel II basis, significantly above the 8% requirement set by the Basel committee.

The overall robust capitalization of the sector was boosted by the risk management of Lebanese banks themselves and the prudent restrictions that were set by the BDL regarding high risk investments in an aim to shield the sector from any deterioration of its capitalization level.

Liquidity

Outstanding liquidity levels by regional and global benchmarks

One of the main reasons behind the attractiveness of the Lebanese banking sector amid the global financial turmoil is its abundant structural level of liquidity both in local and foreign currencies. The high levels of liquidity enjoyed by Lebanese banks exceed regional and global benchmarks by far and buffer the banking industry in times of financial distress and global downturn.

These high levels of liquidity can be attributed to Lebanese banks enjoying a large deposit base accounting for 83.1% of the total balance sheet. Furthermore, the loans-to-deposits ratio, an essential indicator of liquidity, is particularly low in Lebanon. With the unprecedented level of deposits that flowed into the sector in 2009, the loans-to-deposits ratio for Lebanese commercial banks further decreased from 32.2% in December 2008 to 29.6% in December 2009, compared to an average of 75% for MENA banks in 2008.

“Lebanese banks boast very high liquidity levels as witnessed by customer deposits accounting for 83% of the total balance sheet and the loans-to-deposits ratio standing at 29.6% in 2009

"**Unscathed asset quality despite lending growth's acceleration**

Asset quality

Stringent regulations set by the Central Bank and prudent risk management by banks translate to intact asset quality

Historically, maintaining an adequate level of asset quality has been a challenge for Lebanese banks given the difficult economic and political situation of their domestic environment. More recently and at a time when banks across the region are witnessing pressure on their asset quality and despite the acceleration in lending growth starting 2007, the overall quality of the Lebanese banking sector's portfolio has remained high.

Moreover, the sector is witnessing a net improvement in the overall quality of its loan book as evidenced by the NPL (substandard + doubtful)/gross loans ratio steadily declining to reach 12% in 2008 down from 15.7% in 2007 according to Bilanbanques 2009. In addition, the provision coverage (LLP/NPL) crossed 80% in 2008 up from 78% a year earlier, sustaining the improvement in the overall asset quality of the sector.

The figures released by the ABL highlight that the asset quality has been improving in the past few years as suggested by the net problem loans to net total loans decreasing from 6.8% in 2006, to 3.1% in 2008, to less than 3% in the first half of 2009. Simultaneously, the same source indicates that the level of provisioning has been rising as demonstrated by the provisions against problem loans to problem loans ratio standing at 61.8% by mid-2009 up from 60% in 2008 and 54.4% in 2006.

It should be noted that the asset quality has been enhanced by the Lebanese banks' conservative lending policies and practices as well as by the Central Bank's regulations that shielded Lebanese banks from investing in structured products and limited their housing and real estate lending exposures. In this regard, it is worth mentioning that the real estate exposure of the Lebanese banking sector is very contained relative to its global and regional peers, which further mitigates its credit risk. Going forward, we do not foresee any relevant risk of deterioration of the asset quality associated with strong retail lending in the short to medium term, given the prudent risk management of Lebanese banks in this regard.

"**As a result of low margins and a relative high cost structure, the Lebanese banks' return ratios are moderate**

Return ratios

Moderate return ratios

With regard to profitability, the year 2009 was considerably rewarding as demonstrated by a 19.29% increase in the consolidated earnings of the Alfa banks. However, those banks exhibited stable return ratios given the fact that this considerable growth in earnings was matched by a nearly equivalent progression in average assets (+17.77%) and in average shareholders' equity (+20.18%). Their return on average assets ratio (ROAA) and the return on average equity ratio (ROAE) stood at 1.18% and 13.85% respectively in 2008 and moved to 1.20% and 13.75% in 2009.

Figures released by the ABL for 2009 reveal that the ROAE from the domestic operations of Lebanese banks registered a slight increase from 15.40% in 2008 to 15.49% in 2009 while their ROAA decreased slightly to reach 1.09% in 2009 down from 1.16% in 2008.

On a broader level, the consolidated figures of the banking sector in 2008 indicate that the ROAA and the ROAE stood at 1.1% and 13.2% respectively. At these levels, the returns of the Lebanese banking sector appear to be moderate relative to the equity of banks and in comparison to the average assets as a result of low interest margins and relative high cost structure.

Key risks

The main vulnerability of the Lebanese banking sector resides in its high exposure to sovereign debt

High exposure to the sovereign

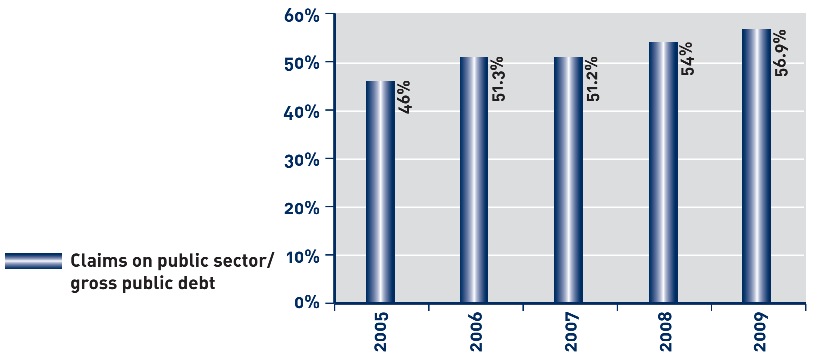
Due to an imbalance in expenditures and revenues, which is a direct reflection of the surge in public expenditure related to reconstruction, poor tax collections and the absence of any fiscal adjustment efforts, Lebanon's large debt burden continued to rise throughout 2009, as it reached USD 51.1 bn by the end of the year compared to USD 47 bn in 2008, translating into an increase of 8.7%. Despite a net decrease in the debt-to-GDP ratio over the past few years driven by stronger economic growth, Lebanon's debt burden remains among the highest in the world with a debt to GDP ratio standing at 152% at the end of 2009.

With their high level of liquidity, Lebanese banks have traditionally acted as the backbone of the economy, providing funding to the country's sovereign debt, and played a key role in financing the government's fiscal deficit. The domestic banking system (including the Central Bank) holds the bulk of government papers.

Lebanese banks held USD 29.1 bn in claims on the public sector as of December 2009, with the majority in treasury bills from the Ministry of Finance. The graph below depicts that local commercial banks held 57% of the gross public debt by the end of 2009 with the gross public debt standing at USD 51.1 bn. In this regard, it should be noted that the exposure to the sovereign is a way for Lebanese banks to channel their excess liquidity, which is becoming even more sensitive within a context of increasing liquidity in local currency following the vast conversion of deposits from USD to LBP and relative low demand for lending in local currency, which creates a mutual reliance between the government and banks.

By the end of 2009, Lebanese commercial banks held 57% of the gross public debt

Figure 16: Percentage of government debt held by Lebanese commercial banks

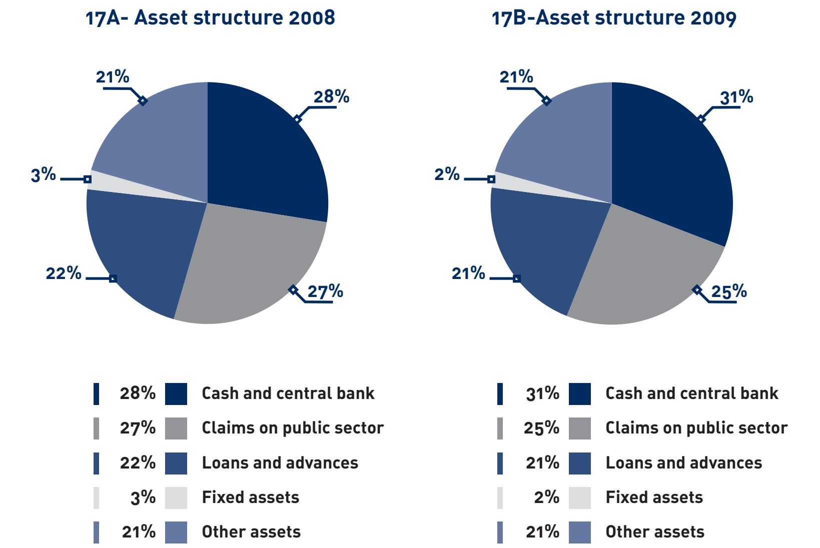


Source: BDL

The balance sheet structure of Lebanese commercial banks shows that their asset base is dominated by claims over the public sector, accounting for 25% of the total. Also deposits with the Central Bank are a major constituent of total assets accounting for a 31% share (including certificates of deposits). More generally, the asset allocation reflects the large exposure to sovereign risk, as 56% of commercial bank assets are made up of government securities and Central Bank paper.

The asset allocation for 2009 reflects that 56% of commercial banks' assets are made up of Government securities and Central Bank paper

Figure 17: Lebanese commercial banks asset structure in 2008 and 2009



Source: BDL

The main vulnerability of the Lebanese banking sector resides in its high exposure to sovereign debt. Given this high exposure, careful risk management remains critical in order to maintain the confidence of depositors in the Lebanese banking sector while serious fiscal measures to reduce the structural imbalances seem unavoidable to insure the long-term financial immunity of the country.

Political challenges lying ahead

Despite the relative stability that prevailed in Lebanon in 2009, political instability continues to be a key risk in the country since Lebanon remains exposed to political and security shocks. Any rise in political uncertainty could adversely affect economic and financial conditions and may have a negative impact on levels of confidence among investors and depositors. However, this risk is mitigated by the sector's proven immunity in times of crisis and its track record in managing deposit outflows and pressure on reserves fairly quickly. The most recent episodes that illustrated this ability were during the aftermath of the Hariri assassination in 2005 and the war between Israel and Hezbollah in July 2006.

SWOT analysis

Strengths

- Buoyant economic conditions on the domestic scene
- Strong and large banking sector (over 3.5x GDP) supported by Diaspora deposits.
- Skilled management and high-quality workforce compared to other regional countries
- Stable exchange rate
- Strict and competent regulatory oversight set by the BDL
- Conservative practices and risk management of Lebanese banks
- Stringent regulations regarding lending exposure and exposure to “toxic assets”
- High and improving asset quality with limited exposure to real estate
- Strong capital ratios
- Ample levels of liquidity by regional and international benchmarks

Weaknesses

- Moderate return ratios of the Lebanese banking sector relative to the equity of banks and in comparison to average assets
- Unfavorable impact of low-yielding assets on the profitability of banks
- Pressure on net profit in a context of an environment of tightening interest spreads
- High reliance on net-interest income

Opportunities

- Encouraging growth outlook for the Lebanese economy and regained confidence to lead to strong capital flows
- Significant potential to expand lending activity from current levels
- Development of a regional platform with significant growth potential
- Benefits for the banking sector from potential reforms and privatizations
- Room for further consolidation, synergies and economies of scale
- Focus on cost-control initiatives

Threats

- Volatile domestic operating environment marked by persistent political instability and slow reforms
- High exposure to government securities and sovereign risk
- High level of public debt and risk of sovereign default
- Compression of spreads due to plummeting Libor and slower than anticipated reduction in cost of funds
- Potential pressure on the asset quality and higher provisioning costs in the context of rapid growth in the loan portfolio

Outlook

2009: another year of growth, resilience and financial soundness

In 2009, the Lebanese banking sector witnessed one of its best performances and remained insulated from recent market events in line with the overall positive achievements of the Lebanese economy. The sector recorded major growth both in size and in earnings boosted by its ability to accumulate deposits at a swift pace as well as increase its profit steadily, while preserving high liquidity and capitalization levels as well as an unimpaired asset quality.

"Stable outlook" and "low vulnerability" for the Lebanese banking sector and upgrades of bank ratings in 2009

> **Encouraging upgrades from Moody's and Fitch in 2010**

Within this context and despite the key risks that revolve around Lebanon's volatile operating environment and the banks' sizeable exposure to sovereign debt, rating agencies have upgraded their ratings on various Lebanese banks in conjunction with a sovereign upgrade as well as on the Lebanese banking sector as a whole. In March 2010, Moody's granted a stable outlook for the Lebanese banking system and upgraded the long-term foreign currency deposit ratings of Bank Audi, Blom Bank, Byblos Bank and Bank of Beirut (April 2010) from B2 to B1, following an upgrade of Lebanon's sovereign ratings from B2 to B1, citing the sustained improvement in the country's external liquidity position as well as the amelioration in the domestic political situation. Moreover, Fitch upgraded Lebanese Banks on Sovereign rating in April 2010, citing the consistent liquidity, capitalization and profitability of Lebanon's banking system as well its resilience to the effects of the global credit crunch and the international economic challenges. More recently, Moody's Investors Service released a special comment on Arab banks, in which the rating agency reiterated its stable outlook for the Lebanese banking sector, emphasizing the good performance of Lebanese banks. The report mentioned that the banking system has defied global trends since the second half of 2008 and noted the Central Bank's prudent regulations that have protected banks from the US sub-prime crisis as well as the system's high liquidity levels and the important source of funding from the Lebanese Diaspora. On the other hand, the high exposure of banks to sovereign debt is cited as a constraint that limits the banks' capacity to diversify their revenue sources. In June 2010 a risk assessment of 86 banking systems in advanced and emerging economies released by Fitch indicated that Lebanon's banking sector was among 26 banking systems that came in the 'low level of potential vulnerability' category on its Macro-prudential Indicator.

Encouraging performance over the first half of 2010

> **A healthy growth in deposits and a strong lending activity over the first five months of 2010 gives us some indications of the anticipated performance for 2010**

Over the first five months of 2010, the Lebanese banking sector and the economy as a whole performed remarkably well, which suggests that Lebanese banks are on the right track to achieve another successful year should the political climate remain stable. On the one hand, deposits reported healthy growth and customers continued to convert foreign currencies into LBP taking advantage of the spread in favor of local currency.Also, liquidity levels (which are at an all-time peak following the record inflow of deposits in 2009) are being translated into increased lending activity towards the private sector. In this regard, commercial banks issued USD 3.1 bn of additional loans to the private sector during the first five months of 2010, representing a 10.8% growth in loans over the period, significantly higher than the 4.1% growth in loans registered over the same period of 2008.

Positive growth perspectives for the rest of 2010

“High liquidity levels will most likely translate into more expansion domestically and regionally

Since Lebanese banks have attracted greater levels of liquidity, their growth perspectives appear to be encouraging and will most likely translate into yet more expansion on the buoyant domestic scene. Moreover, Lebanese banks could take advantage of a recovery in regional economies to generate more growth and earnings from their regional platform and intensify their efforts at regional expansion. On the other hand, income from non-interest sources will remain a key driver for earnings growth and is likely to be spurred by a focus on product diversification as well as by a recovery in market activities.

More generally, the banking sector performance will remain closely linked to economic parameters

“With spreads expected to remain under pressure, Lebanese Bank’s profitability will remain closely correlated to their balance sheet growth

Despite the slight pick-up in local and foreign currency interest spreads witnessed over the first five months of 2010, spreads are expected to remain under pressure in 2010 as a result of low-yielding assets. Consequently, the profitability of Lebanese banks will remain closely linked to their ability to grow their balance sheet substantially which in turn is largely correlated to the nominal growth of the local economy and to developments in the balance of payments. A large surplus of USD 1.21 bn in the balance of payments over the first five months of 2010 along with an expected healthy growth of 6% for Lebanon’s GDP according to the IMF provide further support to our belief that the banks’ balance sheet growth will remain broadly favorable over 2010. Looking ahead, economic developments should closely be monitored as any slowdown in GDP growth could hinder the Lebanese banking sector, bearing in mind that the banking sector and the Lebanese economy are highly interdependent.

The high exposure of the banks to sovereign debt remains the main area of concern and the solution resides on a macro-economic level

“The major challenge is still to reduce fiscal imbalances and reach a sustainable fiscal position

At present, the Lebanese banking sector is best described as financially sound, resilient and fast-growing and playing a key role in an economy where banks continue to dominate the financial system. However, it is currently benefiting from short-term factors and a prudent approach would be to focus on wider structural issues. In this regard, the main area of concern for the Lebanese banking sector remains the high exposure of the banks to sovereign debt. The key takeaway is that the risk of a banking crisis is significantly amplified by a highly levered public sector running a tremendous fiscal deficit. In light of the buoyant economy, efforts revolving around a fiscal strategy should be made on a macro-economic level to help reduce the fiscal imbalances and reach a sustainable fiscal position. Implementing the reform package presented at the Paris III conference, including privatization, a VAT increase as well as a reduction in unnecessary expenditures, constitutes necessary measures in the process of the reduction of the fiscal and debt burden.

The asset quality and the cost of funding should be closely monitored

Other challenges still lie ahead

Another area of concern revolves around the recent falling trend in rates on USD and LBP deposits. Lebanese banks should closely monitor this parameter to prevent any capital flight outside Lebanon as international rates regain momentum, given the fact that one the major attractiveness of the Lebanese banking sector resides in the high level of interest rates offered compared to global standard. Finally, Lebanese banks should pursue their prudent risk management to prevent any deterioration of their asset quality should the economic environment worsen.