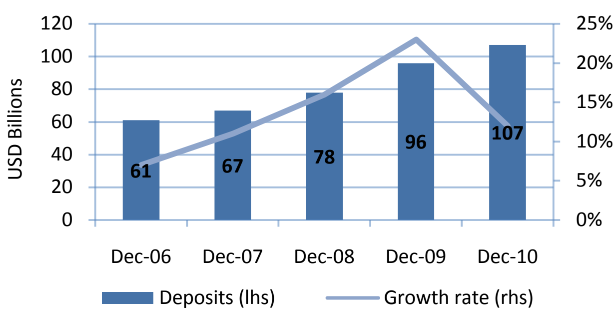
THE LEBANESE BANKING SECTOR: August 2011

The performance of the Lebanese banking activity is dependent on the influx of deposits and is correlated to the economic situation which is itself highly sensitive to the political and security climate which prevails locally and regionally. The financial soundness of the sector remains solid in terms of profitability, liquidity, capitalization and asset quality and the long-term growth potential is encouraging, despite the political and security developments in Lebanon and the region. It is expected that regulators will maintain close supervision of the industry, preserving its strength and its compliance with international standards and safeguarding its reputation as a "safe haven", which along with structural factors of attractiveness (banking secrecy, relatively attractive interest rates on deposits) would allow Lebanese banks to continue ensuring their role of supporting the private sector and financing the government debt.

Strong performance of Lebanese banks in 2010, bolstered by solid economic conditions

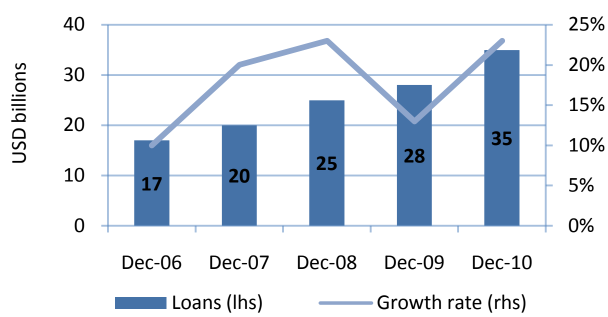
While the global financial and banking system was recovering, the Lebanese banking sector, backbone of the Lebanese economy, continued to grow vigorously in 2010, favored by good economic developments as indicated by a real growth of the Lebanese economy at 7.5% in 2010 according to the International Monetary Fund (IMF) estimates and a surplus of USD 3.3 billion in the balance of payments for that year. The growth of assets and deposits in Lebanese banks, strongly correlated to the fact that deposits represent more than 80% of the sector's assets, reached 12% in 2010 for both indicators. The fact that the pace of growth of assets and deposits in 2010 was lower than in 2009, can be mainly attributed to the normalization of international capital flows that had found refuge in Lebanese banks in the aftermath of the global financial crisis in 2008. At year end 2010, assets and deposits reached USD 129 billion and USD 107 billion respectively, highlighting once again the important size of the banking sector relative to that of the local economy with ratios of banks' assets / GDP and banks' deposits / GDP at around 328% and 273% respectively at the end of 2010. The analysis of deposits in Lebanese banks at the end of 2010 reveals that the movement of de-dollarization initiated in 2008 continued in 2010 as dollarization of deposits declined from 65% at end 2009 to a record of 63% in late 2010, evidencing an increased confidence in Lebanese pound throughout the year. As for credit dollarization, it remained very high at around 80%. Total credits to the private sector reached USD 35 billion at the end of 2010 representing a growth rate of 23% during the year which was favored by a large demand for loans fueled by good economic conditions and by the incentives of the Central Bank and the flexibility of Lebanese banks due to their ample levels of liquidity.

Figure 1: Deposits of residents and non-residents in commercial banks



Source : Banque du Liban

Figure 2: Loans to residents and non-residents

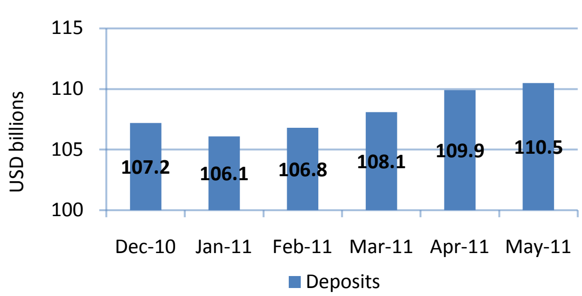


Source : Banque du Liban

∎ Slowdown in banking activity in 2011 in light of political tensions locally and turbulences in some regional countries

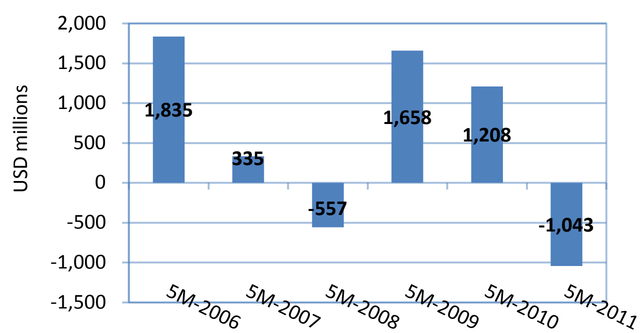
During the first five months of 2011, banking activity has been less dynamic as it was affected on one side by the slowdown in the local economy in light of a decline in confidence due to the local political impasse and persistent altercations and on another by the Lebanese Canadian Bank (LCB) affair which was accused by the U.S. Treasury Department of money laundering. In parallel, political and security problems that have been shaking the MENA region since the beginning of 2011 are additional factors for the deceleration of Lebanese banks' activities, since they are slowing capital flows into Lebanon and leading Lebanese banking groups deployed in turbulent countries to manage their operations carefully and freezing their expansion plans focusing on safeguarding the quality of their assets. It should be noted that tensions on the Lebanese political scene have prevented the Lebanese economy and the Lebanese banking sector to take advantage of regional instability as during the global financial crisis. In parallel to the expected slowdown of the Lebanese economy as shown by estimates of real GDP growth at 2.5% for 2011 according to the IMF (compared to 8.5% for 2009 and 7.5% for 2010) and a deterioration in the external position of Lebanon as indicated by a deficit in the balance of payments of USD 1,043 million over the first 5 months of 2011 (compared with a surplus of USD 1,658 million for the corresponding period in 2009 and a surplus of USD 1,208 million for the corresponding period in 2010), banks witnessed a deposit growth of 3% over the first 5 months of 2011 which declined slightly compared to 4% during the same period of the previous year. As for the slowdown in lending activity of commercial banks, it was more evident as loans were up 7% in the first 5 months of 2011, against 11% during the same period in 2010. A movement of conversion to dollar deposits characterized the first five months of 2011 and resulted in an increase in the dollarization of deposits to 66.4% at the end of May 2011, well above the de-dollarization historical record of 63% reached in 2010.

Figure 3: Deposits of residents and non-residents in commercial banks



Source : Banque Du Liban

Figure 4: Balance of payments – First five months of the year



Source : Banque Du Liban

∎ Maintained soundness in terms of profitability, liquidity, capitalization and asset quality

In order to maintain their level of profitability, Lebanese banks have been throughout 2010 alleviating the pressures on their interest margins through the control of interest rates offered on deposits. According to statistics from the Association of Banks in Lebanon (ABL), interest rates on deposits in local currency and dollars have followed a downward trend in 2010 reaching 5.69% and 2.80% respectively at the end of 2010 against 6.81% and 3.10% respectively at the end of 2009. In the first five months of 2011, interest rates on deposits in local currency continued to decline, albeit slightly, from 5.69% in December 2010 to 5.64% in May 2011 while interest rates on dollar deposits have gained back a few points from 2.80% at the end of 2010 to 2.83% in May 2011. Consequently interest margins in Lebanese Pounds and Dollars have expanded, reaching 1.57% and 1.62% respectively in May 2011 well above their level at the end of 2009 (1.11% and 1.48% respectively). This trend of widening interest margins in 2010 was accompanied by an improvement in cost-efficiencies (cost-to-income ratio at 47.2% in 2010 against 51.6% in 2009), which boosted the profitability of Lebanese banks which net profits (excluding international branches) amounted to USD 1,642 million for 2010, representing an increase of 37% relatively to 2009. In terms of liquidity, Lebanese banks boast significant flexibility with a loans-to-deposits ratio of 33% at the end of 2010 reflecting a high and comfortable level of liquidity by international standards. As for the capitalization of the sector it has strengthened as indicated by a Capital Adequacy Ratio (according to Basel II) moving from 12.5% in 2009 to 13.4% in 2010. Asset quality is sound as indicated by a ratio of net NPLs / net loans standing at 2.1% and a coverage ratio of these NPLs at 63.4%.

Table 1 : Key ratios

	End 2010	End 2009
Dollarization of deposits	63.2%	64.5%
Capital Adequacy Ratio – Basel II (CAR II)	13.4%	12.5%
Loans-to-deposits (private sector)	33%	30%
Net NPLs/Net loans	2.1%	3.1% *
NPLs coverage	63.4%	61.3% *
Exposure to sovereign risk	54%	56%
Interest margins (LBP)	1.59%	1.11%
Interest margins (USD)	1.67%	1.48%
Cost-to-income	47.2%	51.6%
Return on assets (ROA)	1.3%	1.1%
Return on equity (ROE)	18.8%	15.5%

**End of 2008*

Source: Banque Du Liban, Association des Banques du Liban

■ The year 2011 should see vigilance and consolidation

The rest of the year 2011 should see vigilance and consolidation. The Lebanese banking sector should continue to demonstrate its ability to offset the impacts stemming from the slowing economy and the Lebanese political impasse as well as from the encountered difficulties in some turbulent regional countries (Syria and Egypt) and from the blemished image of Lebanese banks following the Lebanese Canadian Bank affair.

First, the orientation of economic growth in the first half of the year and the political crisis on the local scene suggest that growth of banks will remain moderate throughout 2011 and that the risk of deterioration of the political and security situation in Lebanon and the region remains the main risk that threatens the economy and the banking sector. This risk is further amplified by the high exposure of banks to the sovereign. Yet, the growth prospects of Lebanese banks are positive in terms of profitability given the easing pressures on interest margins that followed the decline in interest rates on deposits and the continuous improvement in terms of cost-efficiencies, in a context of moderate balance sheet growth.

Second, some regional countries like Syria and Egypt where Lebanese banks operate and which are perceived as pockets of growth for the Lebanese banking sector, have recently become high-risk markets due to the political and security unrest. It is quite likely that the Lebanese banking groups deployed in the region maintain a cautious approach in these countries in the short-term, by freezing their expansion plans while closely monitoring the quality of their assets. It should be noted that the growth prospects for the medium and long term in these countries are full of opportunities. Improved visibility will enable Lebanese banks to resume their expansionary strategy, in order to take advantage of the growth potential offered by these markets.

As for the vigilance of regulatory authorities, notably the Central Bank, it represents a guarantee of safety just like the recent renewal of the mandate of Riad Salameh at the head of the Central Bank for six years. With its strict supervision of the sector, the Central Bank led by its governor was able to support the stability and confidence in the Lebanese pound and the banking sector shielding it from exogenous shocks. It is expected that efforts in terms of promoting good governance and fighting money laundering will be intensified in order to safeguard the image of Lebanese banks.

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