# Lebanon Banking Sector Report

August 2009

## A SUCCESSFUL STORY OF RESILIENCE UNSCATHED BY GLOBAL TURMOIL

- The Lebanese banking sector has demonstrated a significant resilience to the ongoing Global Financial Crisis, adding to its successive episodes of noticeable resilience of the past few years.
- Measured by total assets, Lebanese banks activity grew by US$ 13.0 billion in 2008, the equivalent of 13%, driven by customer deposits which accumulated US$ 11.0 billion as outlined by consolidated banking statistics provided by Bankdata Financial Services, a trend that was extended even further over the first half of 2009 as per preliminary Central Bank statistics.
- The growth in banking activity clearly highlights the strong confidence in the Lebanese banking sector within the context of perfect capital mobility across borders and with capital increasingly fleeing to the most immune banks and financial institutions around the World.
- With respect to profitability, net profits reported a considerable growth of 26.7% in 2008, maintaining a 6-year trend of consecutive positive double-digit annual earning growth rates for Lebanon's banking industry despite the impact of the global financial crisis on the banks earning power around the globe.
- Activity and bottom line growth were not realized at the detriment of the risk profile of the Lebanese banking industry. Lebanese banks maintained very high liquidity levels in a period where liquidity is key to comfort depositors at large. Primary liquidity stood at 51.5% at end-2008, against an average of 28% for the MENA region, 34% for emerging markets and 30% globally.
- Asset quality was also reinforced, with the ratio of net doubtful loans to gross loans continuing its decline and reporting its lowest level in a decade, reaching a mere 1.4% in 2008.
- Moreover, Lebanese banks continue to enjoy a good capital adequacy level, as the consolidated Basle II ratio stood at circa 12.2% for the Lebanese banking sector, quite above the 8% benchmark.
- The reasons why the Lebanese banking industry was relatively insulated from the global financial crisis are actually numerous, of which the regulatory and supervisory regime, the conservative practices of Lebanese banks (highly liquid deposit-rich banks with low leverage), in addition to structural economic factors such as the recurrence and non-speculative nature of capital inflows towards Lebanon supported by a large pool of offshore savings around the Globe.
- Looking ahead, the continuing diversification of bank activities by geographic location and markets of presence in a MENA region characterized with large pent-up growth potential despite temporary setbacks, should provide an additional support to the Lebanese banking risk diversification profile and reinforce further its immunity against adverse individual market developments.
- Finally, for the Lebanese resilience to be sustained in the long term, drastic structural reforms need to take place in an attempt to ensure a soft-landing scenario for Lebanon's public finance conditions that represent the major vulnerability factor for Lebanon. It is then that we can say that Lebanon could be a unique model of immunity serving as a viable example to a number of countries in the region, in the emerging countries arena and across the Globe at large.

**The Lebanon Banking Sector Report can be accessed via Internet at the following web address: http://www.banqueaudi.com**

CONTENTS




**Bank Audi sal - Audi Saradar Group**
Group Research Department
Bank Audi Plaza, Bab Idriss
Riad El Solh - Beirut - Lebanon
P.O.Box: 11 - 2560
Tel : (961-1) 994000
Telefax : (961-1) 985622
Swift : AUDBLBBX
e-mail : research@banqueaudi.com


Bank Audi sal
Audi Saradar Group

There is no single doubt today that the most critical development in our recent contemporary history is the spread of the World financial crisis that had entered a very serious phase by the end of the third quarter of 2008. Lingering hopes that the damage could be contained to a handful of financial institutions that made bad bets on mortgages have indeed evaporated. New fault lines emerged beyond the original problem i.e troubled subprime mortgages. There has been also a growing sense of wariness about the health of financial sectors around the World at large.

It is thus quite important for us to spare some time to try to overview the current international financial crisis and its impact on Lebanon's economy and banking system. The first part of this study would be dedicated to discuss the background of the global financial crisis and its spillover effects, while the second part would be dedicated to analyze the performance of the Lebanese economy during the crisis era and the third part would address at length the Lebanese banking system resilience per se, leaving the fourth part for the various reasons behind Lebanon's banking sector resilience to the severely contagious financial woes, and the fifth and last part to concluding remarks on such a resilience.

## 1. The background of the global financial crisis

As spillovers of the subprime crisis extended to the entire financial system, global financial markets have faced their worst crisis since the great crash of the 1920s. Some of the big World financial institutions have been hit very hard by the ongoing credit crunch, too much to bear. In mid-September 2008, global investment bank Lehman Brothers filed for bankruptcy, following Bear Stearns' evaporation in March, while Merrill Lynch, having lost billions of US Dollars, was wholly acquired by Bank of America and Washington Mutual was bought by JP Morgan. Worldwide insurance giant AIG was reported to have sought a consistent emergency loan to face financial difficulties. A total of 26 US banks were reported to have failed in 2008, followed by 64 other banks in the first seven months of 2009, the largest number ever. Likewise, a number of European financial institutions came under pressure over the weeks and months that followed the crisis outburst within a scary global contagion environment.

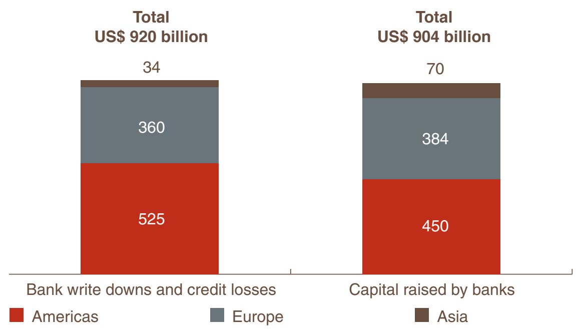
These unexpected and simultaneous developments sent shockwaves through the financial system in the four corners of the globe, while major Central Banks reacted by pumping trillions to markets to help alleviate the effects of the growing crisis, a step seen as essential in calming markets as concerns that more such institutions would collapse. More recently, a number of States around the World, particularly in Europe and the United States, have adopted massive bailout efforts consisting of buying shares in financial institutions to enhance their capital bases or acquiring mortgages and assets from banks to improve their liquidity status, thus providing new policy signals for international markets at large.

What are the roots of the problem? Let us start by the identification of this contagious disease before discussing its spillovers. It is actually called "deleveraging", or the unwinding of debt as the World's largest Central Bank and Treasury officials chose to name it. During the credit boom of the current decade, both financial institutions and households took on too much debt. Between 2002 and 2006, household borrowing in the United States grew at an average annual rate of 11%, far outpacing overall economic growth. Borrowing by financial institutions in parallel grew by a significant 10% annualized growth rate. Now many of those borrowers can't pay back the loans, a problem that is exacerbated by the collapse in housing prices in the US. They need to reduce their dependence on borrowed money, a painful and drawn-out process that can choke off credit and economic growth.

At least three things need to happen to bring the deleveraging process to an end, and they're very hard to do at once. Financial institutions and others need to fess up to their mistakes by selling or writing down the value of distressed assets they bought with borrowed money. They need to pay off debt. Finally, they need to rebuild their capital cushions, which have been eroded by losses on those distressed assets. But many of the distressed assets are hard to value and there are few if any buyers. Deleveraging also feeds on itself in a way that can create a downward spiral: Trying to sell assets pushes down the assets' prices, which makes them harder to sell and leads firms to try to sell more assets. That, in turn, suppresses these firms' share prices and makes it harder for them to sell new shares to raise capital, thus leading to a self-feeding loop or a "financial accelerator."

Deleveraging started with securities tied to subprime mortgages, where defaults started rising rapidly in 2006. But the deleveraging process has then spread well beyond, to commercial real estate and auto loans and to the short-term commitments on which investment banks rely to fund themselves. It is estimated that in the past year or so, financial institutions around the world have already written down US$ 920 billion worth of assets and raised US$ 904 billion worth of capital. But that doesn't appear to be enough. Every time financial firms and investors suggest that they've written assets down enough and raised sufficient new capital, a new wave of selling triggers a reevaluation, propelling the crisis into new territory.

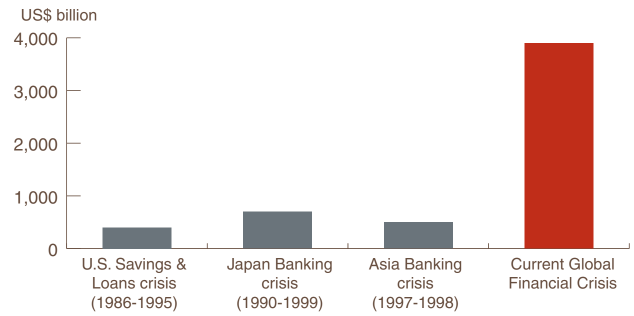
*The Global Financial Crisis in figures (as of April 2009)*




*Sources: Institute of International Finance, Bank Audi's Research Department*

Debt-driven financial traumas have a long history, from the Great Depression in 1930 to the Savings & Loans crisis in the late 1980s to the Asian financial crisis of the late 1990s. Neither economists nor policy makers have easy solutions. This crisis has been even more complicated this time by innovative financial instruments that financial markets created and distributed. They're making it harder for officials and executives to know where the next set of risks is hiding and also contributing to the crisis spreading impact. In the early stages of this crisis, regulators saw that their rules didn't fit the rapidly changing financial system they were asked to oversee. Investment banks, at the core of the crisis, weren't as closely monitored by the Securities and Exchange Commission as commercial banks were by their regulators. As of April 2009, the IMF estimated global financial sector losses at US$ 4 trillion, exceeding by far the losses incurred in any previous financial crisis in the World.

***IMF Global Financial Stability Report (April 2009)***
***Financial Sector Losses***




*Sources: IMF, Bank Audi's Research Department*

As credit is tightening for consumers and business, the financial crisis is impacting the real economy, shrinking growth at large. Credit crunch indeed freezes hiring and expansion. When businesses and individuals can't get loans, job growth and economic expansion stall. The U.S. economy contracted at least in the final quarter of 2008 and the first quarter of 2009, meeting a classic definition of a recession, i.e two consecutive quarters of negative real GDP growth. Worldwide, the global economists' optimistic scenario is a couple of years of recession or painfully slow economy growth. Most recent IMF growth estimates and forecasts suggest a drop in global real GDP growth from 5.2% in 2007 to 3.2% in 2008, -1.3% in 2009 and 1.9% in 2010, confirming the global recessionary trap scenario, one of the worst in almost a century.

**IMF Global Output Growth Outlook as of April 22, 2009**

| In percent | 2007a | 2008a | 2009f | 2010f |
|---|---|---|---|---|
| World output | 5.2 | 3.2 | -1.3 | 1.9 |
| Advanced economies | 2.7 | 0.9 | -3.8 | 0.0 |
| United States | 2.0 | 1.1 | -2.8 | 0.0 |
| Euro area | 2.7 | 0.9 | -4.2 | -0.4 |
| Japan | 2.4 | -0.6 | -6.2 | 0.5 |
| United Kingdom | 3.0 | 0.7 | -4.1 | -0.4 |
| Other advanced economies | 4.7 | 1.6 | -4.1 | 0.6 |
| Emerging and developing economies | 8.3 | 6.1 | 1.6 | 4.0 |
| Africa | 6.2 | 5.2 | 2.0 | 3.9 |
| Central and eastern Europe | 5.4 | 2.9 | -3.7 | 0.8 |
| Commonwealth of Independant States | 8.6 | 5.5 | -5.1 | 1.2 |
| Developing Asia | 10.6 | 7.7 | 4.8 | 6.1 |
| Middle East | 6.3 | 5.9 | 2.5 | 3.5 |
| Western Hemisphere | 5.7 | 4.2 | -1.5 | 1.6 |

*Source: IMF - World Economic Oultlook*

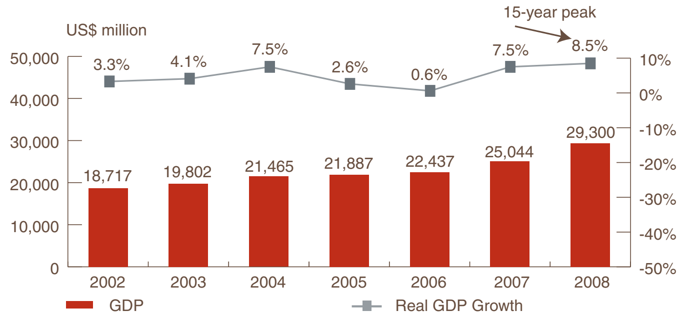
## 2. The Lebanese economic performance during the global crisis

Within this context, one has to wonder if our local economy is immune to a crisis of such a magnitude. Let us thus look at the performance of the Lebanese economy during the crisis era, and more specifically over the past year.

In the middle of one of the most acute financial crisis that hit the World, Lebanon has been performing paradoxically well, reporting one of the best annual performances in the past two decades. Real GDP growth is estimated to have recorded 8.5%, its highest level since 1994, i.e since the early post-war reconstruction years. Real sector indicators were indeed all on the rise in 2008, confirming the buoyant performance. Among such indicators, we mention the number of passengers at the Airport which increased by 21% in 2008, the number of tourists which rose by 31%, exports which grew by 24%, construction permits which increased by 30%, cleared checks which grew by 37% and tax-free purchases which jumped by 56% year-on-year. Nominal imports, which represent 55% of aggregate demand in Lebanon and which steadily represent a reflection of demand in both its investment and consumption components, rose by 37% over the past year.



***Lebanon's GDP and Real GDP Growth rate (IMF)***




*Sources: IMF, Bank Audi's Research Department*

It is widely believed that while the short term economic prospects of the country might be mildly affected by the global woes, they should remain on a positive path on the overall. Prospects for 2009 still look promising, as a result of the successful completion of parliamentary elections, the normalization at the level of domestic politico-security conditions, the signals of a very flourishing touristic season in summer with hotel reservations at close to peak levels and the significantly growing number of Lebanese non-residents expected to visit their homeland. All this, within the context of relatively appeasing global conditions, raised recent real GDP growth forecasts to around 6% for the year 2009, by far outpacing regional growth expected at 2.5% by the International Monetary Fund and global growth expected at -1.3% according to the same IMF forecasts.

When the global financial crisis burst last year, there were fears that the Lebanese economy, typically an open economy with strong linkages to the outside World, could be hit by the crisis. Some considered that the crisis transmission channels might be related to a possible decline in remittances from Lebanese residing abroad and experiencing a cut in income or even job losses in the hosting Arab and Western countries. Few suggested that the real economic slowdown that Lebanon's major foreign trade partners are witnessing might also impact Lebanese exports' volume or price competiveness in general. Others argued that Lebanon's foreign direct investments might dwindle on lower liquidity in the region in the aftermath of the nosedive in oil prices and the slide of regional financial markets.

However, empirical performance since the beginning of 2009 suggests that the effects of such transmission channels were very mild. Indeed, Lebanese exports managed to almost maintain in the first half of 2009 their high level reported over the similar period of the previous year, as these exports consist more of necessity products rather than luxury and durable goods which demand could be negatively impacted by the global financial crisis. Second, it looks like capital inflows into the country have not been affected at all by the external environment, as Lebanon's balance of payments registered a record high 6-month surplus of US$ 2.1 billion and capital inflows rose by a buoyant 46% year-on-year. Third, foreign direct investments did not report a contraction, as mirrored by a number of real sector indicators, especially imports of investment goods, which have posted a 22.7% rise in the first six months of 2009 relative to the corresponding period of the previous year.

Most importantly, it looks like the continuing domestic growth factors, which benefitted significantly from improved political and security conditions in the country with favorable impact on household consumption and business confidence, are offsetting any adverse external spillover, maintaining economic growth at quite a satisfactory level. As such, Lebanon has certainly firmly avoided falling into a recessionary trap and is certainly not expected to register any negative output growth rate in the foreseen future such as the ones being projected for many economies around the world.

## 3. The Lebanese banking sector resilience to the global crisis

Within this environment, Lebanon's banking sector has witnessed in fact over the past year one of its best performances ever, unscathed by the global financial turmoil. Between December 2007 and December 2008, banks assets grew by US$ 13.0 billion, the equivalent of 13%, driven by customer deposits which accumulated US$ 11.0 billion over the period, a trend that was extended even further over the first half of 2009, as per preliminary Central Bank statistics. The growth in banking activity clearly highlights the strong confidence in the Lebanese banking sector within the context of perfect capital mobility across borders and with capital fleeing to the most immune banks and financial institutions across the World. Capital inflows towards Lebanon amounted to above US$ 16 billion in 2008, up by 48% relative to the previous year, leaving a large balance of payments surplus of US$ 3.5 billion, a record high for Lebanon.

Indeed, measured by the aggregation of Lebanon's banking sector assets, total activity grew from US$ 101.1 billion in 2007 to US$ 114.1 billion in 2008, 44% higher than the average annual growth reported over the past five years. The main activity drive remains customer deposits. The latter's growth in 2008 was 53% higher than the average growth reported over the previous five years. As a result of the significant growth in bank activity outpacing that of the country's nominal output, bank deposits to GDP reached a new record high of 315%, outlining the significant activity size relative to the size of the domestic economy. The 2008 results actually consolidate the growth reported since 2002, with average annual asset growth of 12.6% and average annual deposit growth of 12.5% over the past six years.

Based on data for consolidated and domestic activity (Lebanon and abroad), it looks like the growth driver was domestic much more than foreign over the past year. Indeed, the share of abroad in consolidated assets of the banking system has dropped from 15.9% in 2007 to 15.1% in 2008 and that of abroad in customer deposits has fallen from 10.9% to 10.0%. In fact, total deposits outside Lebanon accounted for a mere 4.1% of consolidated deposit growth, while the remaining 95.9% was accounted for by domestic deposits. This is a further proof of the resilience of Lebanon itself to the global crisis, attracting inflows to its domestic banking sector.

Within the context of significant conversions from FX holdings to LP holdings as a result of growing confidence in the national currency, the growth in deposits was accounted for to the extent of 83.3% by LP deposits, leading to a considerable drop in dollarization. LP deposits actually grew by US$ 9,187 million, while FX deposits rose by a mere US$ 1,845 million in the year 2008. This actually led to a drop in dollarization by 7.5% from 79.5% in December 2007 to 72.0% in December 2008, its lowest level since 2004.

The year 2008 also witnessed a significant growth in lending activity. The latter was triggered by the improvement in domestic economic conditions on one hand and dynamic regional corporate banking policies lending out of Lebanon to regional corporates or to Lebanese corporates with regional activity on the other hand. As a matter of fact, total loans grew by US$ 5,854 million, i.e three times their average growth of the past five years. With bank lending growing at a higher rate than deposits (24.9% versus 13.6%), the consolidated loans to deposits ratio rose from 28.9% in 2007 to 31.8% in 2008.

**Growth Rates of Lebanese Banks**

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | Var 08/07 |
|---|---|---|---|---|---|---|---|---|
| Assets | 8.7% | 13.3% | 14.6% | 6.8% | 12.8% | 15.0% | 12.9% | -2.1% |
| Loans to customers | -5.3% | -3.0% | 7.1% | 8.2% | 14.6% | 30.7% | 24.9% | -5.8% |
| Deposits from customers | 7.5% | 14.7% | 13.4% | 6.2% | 11.7% | 16.0% | 13.6% | -2.4% |
| Shareholders' equity | 11.7% | 12.2% | 13.0% | 25.3% | 27.4% | 11.5% | 14.6% | 3.1% |
| Total L/C openings of the year | 11.6% | 16.1% | 48.6% | 0.1% | 15.7% | 42.2% | 53.6% | 11.4% |
| Net profits for the year | -13.3% | 50.5% | 3.4% | 25.3% | 29.8% | 27.2% | 26.7% | -0.5% |

*Source: Bankdata Financial Services wll*

Still, lending is highly dollarized to the extent of 90% in 2008, with lending dollarization almost unchanged from its 2007 level despite the reported important dedollarization at the funding side. Lebanon is actually facing these days a golden opportunity resulting from the structural changes in the deposit base at large. The opportunity, at the same time a challenge, is mainly tied to the possibility of resorting to local currency financing of the State and the economy at large, instead of US Dollar financing, as a result of the important conversions of US Dollar holdings into Lebanese pounds and that are estimated at US$ 8 billion in 2008. As these conversions go on, markets are witnessing increasing local currency liquidity that should be channeled to finance the private and public sectors. The local currency financing of the public sector, as an alternative to foreign currency financing, would reduce foreign currency public debt to GDP that represents the main vulnerability indicator in Lebanon, especially amidst the current international financial crisis. In parallel, the local currency financing of the private sector would restore the role of the Lebanese pound as a standard of deferred payment, after it had gradually regained its roles as a medium of exchange, unit of account and store of value.

at large has been increasingly suffering from the setbacks created by the global financial crisis. By the date of the finalization of this report, a large number of countries' regulators in the region have had to introduce liquidity support facilities for banks in an aim to alleviate the tightening of liquidity conditions or even had to guarantee bank deposits (KSA, Bahrain, Oman and Kuwait), while others had to directly intervene in banks' capital through the acquisition of shares in distressed banks (Qatar, UAE and Bahrain). Also, while Lebanese banks managed to report a positive growth in their consolidated net earnings over the past year, a large number of regional banks have witnessed net losses or contracting profitability as a result of the nosedive on regional equity markets and growing provisioning requirements for banks in the region, a trend that is likely to accentuate further in the year ahead within the foreseen downturn in almost all economies of the region.

In Lebanon, the growth in bank profits at a pace higher than that of assets and equity in 2008 actually led to a rise in return ratios in a period where regional and international banks have reported a decline in such ratios

## Currency Structure of Lebanese Banks

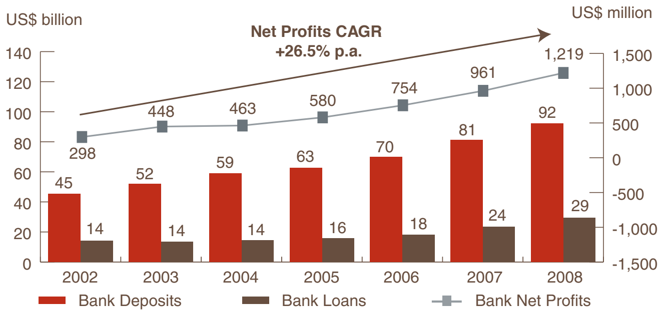
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | Var 08/07 |
|---|---|---|---|---|---|---|---|---|
| FC assets/Total assets | 68.0% | 64.3% | 67.8% | 70.4% | 74.4% | 77.5% | 71.6% | -5.9% |
| FC loans/Total loans | 85.4% | 88.6% | 87.7% | 88.0% | 89.0% | 90.1% | 90.0% | -0.1% |
| FC deposits/Total deposits | 69.7% | 65.4% | 68.4% | 71.8% | 76.5% | 79.5% | 72.0% | -7.5% |
| FC Tbs/Total Tbs | 39.1% | 44.8% | 52.6% | 51.0% | 50.5% | 51.8% | 42.9% | -8.9% |

*Source: Bankdata Financial Services wll*

With respect to profitability, the year 2008 was a significantly rewarding year for the Lebanese banking sector as a whole despite the impact of the global financial crisis on the banks earning power around the globe. The banking sector's net profits reported a considerable growth of 26.7% in 2008, maintaining a 6-year trend of consecutive positive annual earning growth rates for the industry at large (CAGR of 27% for the period 2002-2008). The major banking challenge for the year ahead is to maintain the positive growth in earnings within the context of an expected drop in Lebanese banks spreads following the significant contraction of international interest rates over the past year.

across the board. Return on assets reported a rise of 0.1% in Lebanon in 2008 to reach 1.1%, and return on equity reported a rise of 1.4% to reach 13.2%. The latter has benefited from a relative improvement in asset utilization, a slight rise in the net operating margin within the context of an almost stable leverage factor in 2008. While the absolute levels of Lebanese banks return ratios remain below international benchmarks, the 2008 dynamics were definitely to the advantage of the Lebanese banking sector as all broad regional return ratios had reported a net contraction during the year as a result of the crisis impact on banks bottom lines.

## *Major Lebanese Banking Sector Aggregates*




*Source: Bankdata Financial Services wll*

## Evolution of Return Ratios of Lebanese Banks

| | 2007 | 2008 | 08/07 |
|---|---|---|---|
| Yield on earning assets | 6.9% | 6.7% | -0.3% |
| - Cost of earning assets | 4.8% | 4.3% | -0.5% |
| = Interest margin | 2.1% | 2.3% | 0.2% |
| x Average interest earnings/ Average assets | 94.2% | 94.5% | 0.3% |
| = Spread | 2.0% | 2.2% | 0.2% |
| o.w. in LL | 2.1% | 2.1% | 0.0% |
| o.w. in FX | 1.9% | 2.2% | 0.3% |
| + Non interest income/Average assets | 0.9% | 0.9% | 0.0% |
| = Asset utilization | 2.8% | 3.1% | 0.3% |
| x Net operating margin | 36.3% | 36.6% | 0.3% |
| **= ROAA** | **1.0%** | **1.1%** | **0.1%** |
| x Leverage | 11.6 | 11.7 | 0.1 |
| **= ROAE** | **11.8%** | **13.2%** | **1.4%** |

*Source: Bankdata Financial Services wll*

It is worth mentioning that such a Lebanese banking resilience to turmoil comes in a period where the Middle Eastern region

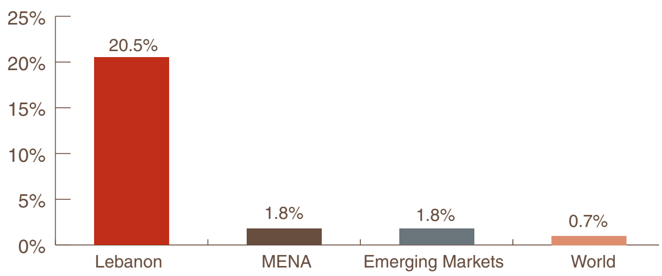
It is finally important to mention that the global financial crisis which had obviously a negative impact on asset quality of banks across the World within the context of the acute economic downturn generating credit defaults, did not leave its imprints on the Lebanese banks asset quality at all in 2008. On the contrary, the ratio of net doubtful loans to gross loans continued its decline, reporting its lowest level in more than a decade, reaching a mere 1.4%, down from 2.1% in 2007. In parallel, doubtful loans continue to be well provisioned at around 87.4%, one of the sound levels in peer markets at large.

## 4. The factors underlying Lebanon's banking sector resilience

The reasons why Lebanon was relatively insulated from the global financial crisis are various, ranging from the regulatory and supervisory regime to the conservative practices of Lebanese banks and to structural economic factors such as the recurrence and non-speculative nature of capital inflows towards Lebanon supported by a large pool of offshore savings around the Globe.

At the macro level, the Lebanese banking system benefits from a stable deposit base supported by recurrent capital inflows, the bulk of which is constituted of remittances from a large pool of Diasporas all over the World. With annual remittances of close to US$ 6 billion, Lebanon has the highest ratio for remittances per capita in the World. Such remittances, which have been sustainably growing year after year over the past decades, are not likely to receive a significant hit as a result of the current crisis, and are expected to remain in the worst circumstances above 15% of Lebanon's GDP. These remittances, which empirically proved to be non-volatile in nature, originate from a large pool of Diasporas well diversified by sector of activity and country of residence around the globe.

*Remittances/GDP (Year 2008)*




*Sources: World Bank, IMF, Bank Audi's Research Department*

At the regulatory level, Lebanese banks are very well regulated by international standards. The financial industry is well supervised by the Central Bank and the Banking Control Commission, which imposes significant regulatory measures for risk management and control. The limited exposure to derivatives and structured products has indeed avoided the accumulation of portfolios of toxic assets on the Lebanese banks' balance sheets. The Central Bank prevents banks from investing freely in structured products as per recent circulars issued prior to the eruption of the global financial crisis. As a result, the subprime crisis did not reach Lebanese banks as they have no positions and thus no losses in subprime instruments. Moreover, banks are not allowed to lend for the acquisition of shares by more than 50% of the investment value and they are not allowed to lend to real estate investments for more than 60% of the project cost. Notwithstanding the banks' bond investments which are restricted to "investment grade" bonds and which should not exceed at anytime 50% of their shareholders' equity.

It is important to mention that Lebanon's banks do not have large housing exposures, while keeping in mind that such exposures were at the origin of the subprime crisis. Total housing loans are close to US$ 1.9 billion, or less than 2% of the domestic assets of banks in Lebanon. In addition, real estate prices have witnessed considerable hikes over the past few years, contrary to the downward trend reported in the United States and Europe and which had accelerated the crisis. Notwithstanding the fact that the securitization of these loans is practically non-existent in Lebanon.

Moreover, bank lending has always been covered by a significant amount of collaterals. Such a high collateralization is linked to the conservative nature of lending policies and practices at Lebanese banks. According to Central Bank statistics for 2008, total advances against guarantees amount to 76% of the aggregate loan portfolio of the banking industry. More specifically, local banks ask any investor seeking a loan for a real estate project to provide collateral worth at least twice the amount of the desired loan.

In addition, Lebanese banks have very high liquidity levels in a period where liquidity is key to comfort depositors at large. Primary liquidity stood at 51.5% at end-2008, against an average of 28% for the MENA region, 34% for emerging markets and 30% globally. Particularly, primary liquidity in foreign currency as a percentage of customer deposits in foreign currency, considered to be the most important liquidity measure in a highly dollarized environment, stood at 54.2% by end-December 2008. Although declining relatively in 2008, it remains one of the highest levels in the World and by far exceeding regional and international benchmarks. Still, it is worth mentioning that the ratio of placements in foreign banks as a percentage of customer deposits reported a

### Asset Quality of Lebanese Banks

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | Var 08/07 |
|---|---|---|---|---|---|---|---|---|
| Doubtful loans/Gross loans | 21.8% | 24.3% | 21.7% | 20.8% | 18.7% | 13.9% | 10.7% | -3.2% |
| Substandard loans + doubtful loans/Gross loans | 26.7% | 29.9% | 26.1% | 24.2% | 21.3% | 15.7% | 12.0% | -3.7% |
| Net doubtful loans/Gross loans | 4.2% | 5.2% | 4.0% | 3.5% | 2.9% | 2.1% | 1.4% | -0.8% |
| Loan loss reserves on doubtful loans/Doubtful loans | 76.5% | 73.8% | 76.4% | 79.0% | 81.1% | 84.7% | 87.4% | 2.6% |
| Net doubtful loans/Equity | 23.0% | 25.0% | 18.7% | 13.7% | 9.8% | 6.6% | 4.5% | -2.1% |

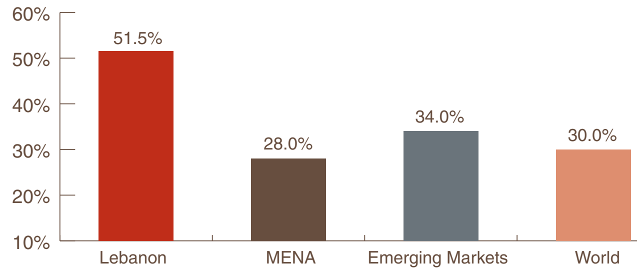
*Source: Bankdata Financial Services wll* noticeable decline of 7.4% in 2008 to reach 26.8%, partly compensated by a rise in the share of placements at BDL as a percentage of customer deposits by 2.2% to reach 27.4% at end-2008.

## Liquidity of Lebanese Banks

| | 2007 | 2008 | Var 08/07 |
|---|---|---|---|
| **Liquidity in LL** | | | |
| **Loans to deposits** | **13.9%** | **11.4%** | **-2.6%** |
| **Total liquid assets / deposits** | **112.6%** | **107.5%** | **-5.1%** |
| o.w. Cash, BDL & CDs/Deposits | 41.7% | 42.0% | 0.3% |
| o.w. Banks/Deposits | 3.5% | 2.5% | -0.9% |
| o.w. Tbs/Deposits | 67.2% | 62.6% | -4.6% |
| **Liquidity in FX** | | | |
| **Loans to deposits** | **32.8%** | **39.8%** | **7.0%** |
| **Primary liquidity/Deposits** | **59.5%** | **54.2%** | **-5.2%** |
| o.w. BDL/Deposits | 25.2% | 27.4% | 2.2% |
| o.w. Banks/Deposits | 34.3% | 26.8% | -7.4% |
| BDL/Primary liquidity | 42.4% | 50.5% | 8.2% |
| Subsidiaries/Primary liquidity | 5.0% | 4.3% | -0.7% |
| Banks/Primary liquidity | 52.7% | 45.2% | -7.5% |
| Net primary liquidity/Deposits | 51.4% | 45.9% | -5.5% |

*Source: Bankdata Financial Services wll*

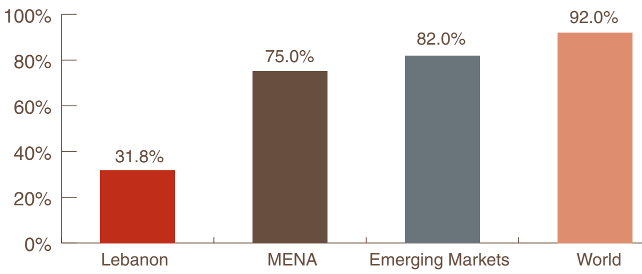
*Primary Liquidity/Deposits (Year 2008)*




*Sources: Central Banks, IMF, Bank Audi's Research Department*

While it is true that lending to the private sector represents close to the size of the domestic economy in Lebanon, such a lending is constrained to a small portion of the large bank resources, with deposits to GDP standing at 315.1% in Lebanon, against 62.0% for the region, 74.3% for emerging markets and 93.4% for the global average. As such, loans to deposits stand at a mere 32% in Lebanon, one of the lowest ratios around the Globe, which represents by itself an important buffer in a period of deleveraging across the World. Such a low ratio also provides banks with important flexibility at a time where most banking sectors in the region and in the World have loans to deposits ratios approaching 100% limiting their loan extension capability.

*Loans/Deposits (Year 2008)*

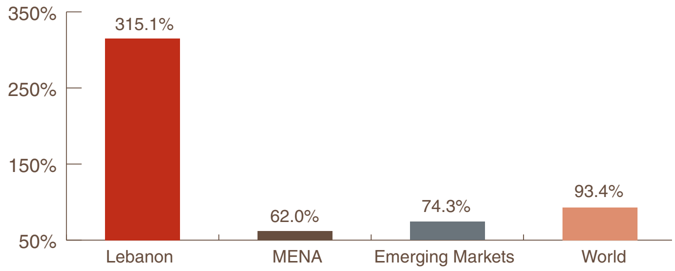



*Sources: Central Banks, IMF, Bank Audi's Research Department*

In parallel, Lebanese banks have a good capital adequacy level, i.e an acceptable leverage level in a period where the recent crisis has underlined the threat of excessive indebtedness on behalf of banks. The capital adequacy Basle 1 ratio stood at 22.4% in Lebanon, against 14.5% for the region, 15.4% for emerging markets and 14.8% for the global average. While it is true that the Lebanese Basle 1 ratio is overstated as a result of the zero-risk weighting allocated to Lebanese Treasury bills leading to a relatively low ratio of risk weighted assets to total assets of merely 35% at end-2008, it is important to mention that the Basle II average is estimated at circa 12.2% for the Lebanese banking sector, quite above the 8% benchmark.



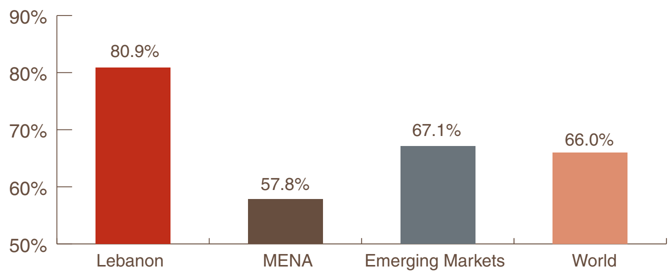
*Deposits/GDP (Year 2008)*




*Sources: Central Banks, IMF, Bank Audi's Research Department*

More importantly, Lebanese banks are all considered deposit-rich banks where the deposit base constitutes 81% of their total funding at large, against 58% for the MENA region, 67% for emerging markets and 66% for the global average at large. It is important to bear in mind that the deposit rich profile of banks pays in tough times such as the one the World is currently passing by as customer deposits represent a much more stable funding franchise than all other sources of market debt funding.

*Deposits/Assets (Year 2008)*




*Sources: Central Banks, IMF, Bank Audi's Research Department*

Furthermore, Lebanese banks have a positive external position, i.e the Lebanese financial sector is a net lender to the outside World. Net foreign assets in Lebanon are positive, as foreign assets exceed foreign liabilities by US$ 4 billion as per

### Capitalization of Lebanese Banks

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | Var 08/07 |
|---|---|---|---|---|---|---|---|---|
| Capital adequacy (as per Basel I requirements) | 20.6% | 23.0% | 21.4% | 23.6% | 25.5% | 22.0% | 22.4% | 0.4% |
| Capital adequacy (as per Basel II requirements) | - | - | - | - | - | 12.7% | 12.2% | -0.4% |
| Equity to assets | 6.8% | 6.7% | 6.6% | 7.8% | 8.8% | 8.5% | 8.6% | 0.1% |
| Leverage | 13.8 | 13.9 | 14.1 | 11.9 | 10.4 | 11.8 | 11.6 | -0.2 |
| Internal capital generation | 5.5% | 9.1% | 8.4% | 9.5% | 10.2% | 9.8% | 11.9% | 2.1% |

*Source: Bankdata Financial Services wll*

Central Bank statistics for year-end 2008. In other words, the domestic Lebanese banking sector is not indebted to the outside World in a period where deleveraging is causing a liquidation of the placements of some international financial institutions to offset their losses on the assets side. Within the same context, the market rests primarily on Lebanese investors and depositors, while non-resident deposits represent a mere 15% of the total deposit base according to the same Central Bank statistics. It is also worth mentioning that the foreign assets of Lebanese banks consist mainly of well diversified placements in highly rated OECD commercial or universal deposit-rich banks that were relatively less exposed to the crisis.

## 5. Concluding remarks

In the midst of one of the worst financial crisis shaking depositor confidence, hitting investment attractiveness and depressing economic activity worldwide, there is paradoxically a successful story that emerges unscathed by the unfavorable external environment: It is that of Lebanon's resilient banking sector that persistently and stoutly faces any type of internal or external turmoil at large.

Based on standard models, experience from other countries, and derived rules of thumb, many observers may argue that the Lebanese banking sector could have undergone a prelude of a turmoil a long time ago. All things considered, the episodes of severe financial pressures in 2005 and 2006 that were both triggered by exogenous shocks, had the ingredients of a perfect storm, yet Lebanon weathered them seemingly without much lasting damage. In the aftermath of such episodes came the recent global financial crisis which almost did not leave any imprints on the country's financial sector because of the wide perception of strong resilience as outlined throughout this study.

Could Lebanon be an atypical model from which, despite main vulnerabilities, one can extract lessons to other emerging markets to follow? A recent IMF report tried to analyze Lebanon's ability to manage financial pressures following severe shocks despite its large debt overhang and significant external vulnerabilities. IMF findings revolve around the fact that despite such vulnerabilities, investors and depositors are comforted first and foremost by the perception of an implicit guarantee from donors, but also by Lebanon's track record of zero default and the country's large liquidity cushion.

The IMF study stresses that local banks play a key role in maintaining stability. On one side, they hold the bulk of government paper and have no incentive to liquidate their position abruptly even during severe crisis as this would be self-defeating. On the other side, they mobilize strong and continuous deposit inflows from a dedicated customer base that provides the necessary net financing for the government and the balance of payments at large. The IMF analysis argues that Lebanon's banking system is an attractive destination for deposits. The main sources of deposits are the large and wealthy Lebanese Diaspora, Arab investors in the region and Lebanese residents at large. The IMF adds that the banking system is well regulated, exhibits good financial sector soundness indicators, offers bank secrecy, enjoys high core liquidity levels, while depositors have never lost money from bank failures.

While Lebanon is certainly unique in many aspects, it holds interesting lessons for other countries. First and foremost, Lebanon's experience could be interpreted as validating the notion that markets recognize good behavior and are willing to give countries more leeway if they never defaulted in the past. Second, a strong local banking system that intermediates inflows can be a contributor to market stability. Third, building on special circumstances to cultivate a dedicated investor and depositor base helps insulate to some degree financing flows from general market trends.

Finally, although the recent global financial crisis revolves around excessive private sector indebtedness rather than sovereign indebtedness, the demonstrated Lebanese resilience is not equivalent to financial immunity. For the Lebanese resilience to crises to last in the long term, drastic structural reforms need to take place in an attempt to ensure a soft-landing scenario for Lebanon's public finance conditions that remain worrisome and where the main vulnerability lies. Such reforms are becoming increasingly urgent in a period where Lebanon's public sector can count relatively less on international assistance and foreign support because of the wealth contraction phenomenon observed around the Globe as a result of the international financial crisis. Following the recent improvement in the political climate in the country, it is now time to launch such long awaited structural reforms that should ensure a gradual reduction of sovereign indebtedness and public deficit levels to fundamentally sustainable levels with respect to the size of the national economy. It is actually then that we can comfortably say that Lebanon and its financial sector could be a unique model of immunity serving as a viable example to a large number of countries in the region, in the emerging countries arena and across the Globe at large.