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RESEARCH

Bank Industry Risk Analysis: Lebanese Banks Plant Cedars Abroad While Resisting The Political Impasse

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Major Rating Factors

Strengths

- Sustained resilience to the volatile political and constrained economic environment
- Strong liquidity and funding: deposits have proven resilient, but are ultimately sensitive to a deterioration in confidence
- Supportive authorities with a good track record of crisis management

Weaknesses

- High direct exposure to the sovereign
- Limited earnings diversification, despite increased geographic expansion
- Weak, although improving, asset quality at the system level

1. Executive Summary

Standard & Poor's Ratings Services considers that the main impediment for Lebanese banks remains their high direct exposure to the risks inherent in operating in the Republic of Lebanon. The country was downgraded to 'CCC+/Stable/C' on Jan. 31, 2008, to reflect the current political impasse there. The Lebanese government's high indebtedness, fiscal deficit, and fragile political stability pose a serious threat to any bank in the system. Although Lebanon has never defaulted, the banking system, which has proven highly resilient thus far, would suffer dramatically from an unwinding of public finances. Consequently, the three rated Lebanese banks' (Bank Audi SAL - Audi Saradar Group, Bankmed, s.a.l., and Blom Bank sal) exposure to sovereign risk is paramount and impinges significantly on the ratings on the banks. These ratings are supported, however, by steady growth in business and profits, improvements in loan quality, and good management.

In the longer term, the ratings on both the sovereign and the banks could be raised if the pressure on both the political and economic front is alleviated through the combination of a consensual political decision leading to the appointment of a president and the formation of a cabinet, as well as a demonstrated capacity to advance on the program of economic reforms pledged at the Paris III conference. Conversely, the ratings could be lowered should civil unrest break out or the political impasse cause protracted policy inertia.

Prior to the current political conundrum, the July-August 2006 conflict between Hezbollah and Israel followed the assassination of the former Prime Minister Rafik Hariri in early 2005. Despite subsequent increased pressure in an already volatile environment, resilience was once again strong, however. Dollarization of deposits (that is, the preferred use of U.S. dollars for deposits) and the outflow of foreign currency funds reached their peak following both critical events. However, the coordinated and well-prepared crisis management by the Banque du Liban (BDL), the Banking Control Commission (BCC), and the banking community helped to promptly restore confidence, thus avoiding devaluation of the Lebanese pound (LB£) and the risk of the financial system becoming illiquid.

Several specific features make Lebanese banks unique in the Middle East:

- First, the banking sector's assets represent about 3.5x the country's GDP. Deposits made by both residents and nonresidents (the latter attracted by the high returns available and drawn by longstanding family and community

ties) are driving banking activities, leaving the whole sector vulnerable to a deterioration in confidence. As the banks' loan leverage is very low, surplus liquidity is mostly channeled into government securities. Direct exposure to the sovereign (including deposits at the BDL) is therefore high, at LB£62.7 trillion ($41.7 billion, at LB£1,503.1 to $1) at Sept. 30, 2007 (about 6.9x their equity base). This also reflects the retail banking market's limited scale, although local banks are further foraying into this segment.

- Second, Lebanese banks are heavily dollarized (usually about 65%), and even more in times of crisis (about 70% since year-end 2006).
- Third, Lebanon is overbanked. Since competition is tense, and the Basel II implementation does not favor excessive holding of non-investment-grade government debt, consolidation may be under way as small banking institutions struggle to keep up.

With an awareness that using their balance sheets to fund the government's financing needs is unsustainable, larger banks are favoring geographic expansion to deploy their liquidity having little use for it locally. The BCC is supporting this trend and has paved the way for new activities, such as Islamic finance. If the drive for geographic expansion proves successful in dramatically reducing Lebanese banks' dependency on government debt, the ratings on the banks may improve in the long term.

Asset quality is strengthening at a sustained pace, driven by the authorities' proactive attitude. Banks have also been attempting to clean up their loan books through write-offs and more active recovery. Nonperforming loan (NPL) ratios are still relatively high, however, at 8.5% at year-end 2007, when interests in suspense (IIS) are excluded. At about 68%, coverage by provisions is satisfactory.

2. Economic Risk

Volatility of the business cycle: Structural economic constraints need to be addressed by an overhaul of the public finances

Despite a liberal and open business environment, economic competitiveness suffers from severe structural economic constraints. These include:

- The damaged infrastructure and underinvestment inherited from the civil war and subsequent crises;
- High real wages;
- Tariff barriers;
- Cumbersome tax; and
- The commercial law environment.

Domestic private sector investment is constrained by limited access to long-term financing, as interest rates remain high and large fiscal imbalances continue to monopolize banks' balance sheets.

Lebanon's small and open economy is predominantly biased toward the service sectors (about 75% of economic activity), notably driven by tourism and an oversized banking sector. Total banking assets account for about 3.5x GDP ($24.2 billion in 2007); one of the highest among rated sovereigns. This notably signals the role of the substantial net income of the 12 million-13 million-strong expatriate population in the domestic economy. The government's short-term financing needs are therefore met by the banking sector's robust liquidity, ensured by the satisfactory inflow of resident and nonresident deposits during relatively calm periods (about 1% compounded monthly growth rate at such times). Other economic sectors are, in descending order of significance, industry, construction, and agriculture.

Economic growth prospects: Political stability and urgent economic reforms are key to recovery

The July-August 2006 conflict with Israel severely damaged Lebanon's infrastructure, as well as interrupting commerce and weakening productive capacity there. As a result, efforts to restore confidence in the region were hindered. Despite ongoing efforts to repair infrastructure, subsequent political disputes have continued to undermine confidence and have impinged on the recovery of the Lebanese economy. Such disputes have intensified in recent weeks, as deep divisions between the government under prime minister Fouad Siniora and the Hezbollah opposition over the design of the political landscape have resulted in an inability to elect a new president following the departure of Emile Lahoud in late-November, 2007.

We expect economic growth to remain constrained in the short term, rising to 2.4% in 2008 from an estimated 2% in 2007, owing to the debilitating political stand-off and constrained policy-making capacity, which have undermined confidence in the country, above all in the key tourism and financial services sectors. Government finances will remain precarious--the delivery of donor support pledged under Paris III has been below expectations, and the funding of the substantial government deficit will continue to depend on the banking sector's capacity to lend to the government.

The rejuvenation of Lebanon's credit standing, as well as that of its financial sector, will depend on the achievement of political stability. The ratings could be raised in the event of a consensual political decision leading to the appointment of a president and the formation of a cabinet, as well as a demonstrated capacity to advance on the program of economic reforms pledged at the Paris III conference.

B. Systemic risks

Political risk: Lebanon's divisive political system has reached yet another crossroads

There is no quick fix to the current political stand-off that calls into question the fragile political contract that has prevailed since the end of the 15-year civil war in 1990. The situation is further complicated by the active involvement of a range of external powers with opposing goals. The political situation poses two main threats to public finances: first, the near-term risk that depositors, concerned by developments, will move funds offshore, taking away from the banking sector's capacity to lend to the government; second, a protracted stand-off over the longer term will inevitably delay essential economic reforms.

After the Paris III agreement...

The Paris II international donor conference, which took place in 2002, resulted in public finances improving in the short term ($4.4 billion in commitments). Economic reforms were soon mired, however, by political intrigue and subsequent political developments, such as the assassination of Mr. Hariri and the 2006 conflict, both of which caused public finances to deteriorate once more. A third international donor conference--Paris III--took place in January 2007. Beirut's European, U.S., and Arab Gulf allies pledged a total of about $7.6 billion to help Lebanon recover from the 2006 war and support the economic reform process. Of this, about $4.7 billion was pledged to the government--with a large proportion earmarked for specific projects rather than unconditional budgetary support or debt relief. Nevertheless, the timely release of these funds is important, as they should help compensate for the estimated cumulative $4.5 billion fiscal deficit over 2006-2010, and alleviate pressure on government debt servicing. Owing partly to the political deadlock, inflows pledged on the back of the Paris III conference have been released well below the targeted level for 2007, and prospects for 2008 will be subject to progress made in the political arena.

Despite the slow release of Paris III funds, the likelihood of continued strong support from Arab Gulf countries mitigates the risk of default. By providing liquidity when needed, Gulf states have signalled their continued commitment to Lebanon's political stability, as well as their willingness to act as a quasi-lender of last resort to the Lebanese economy and banking system.

Monetary stability and investment environment: Confidence in the peg persists

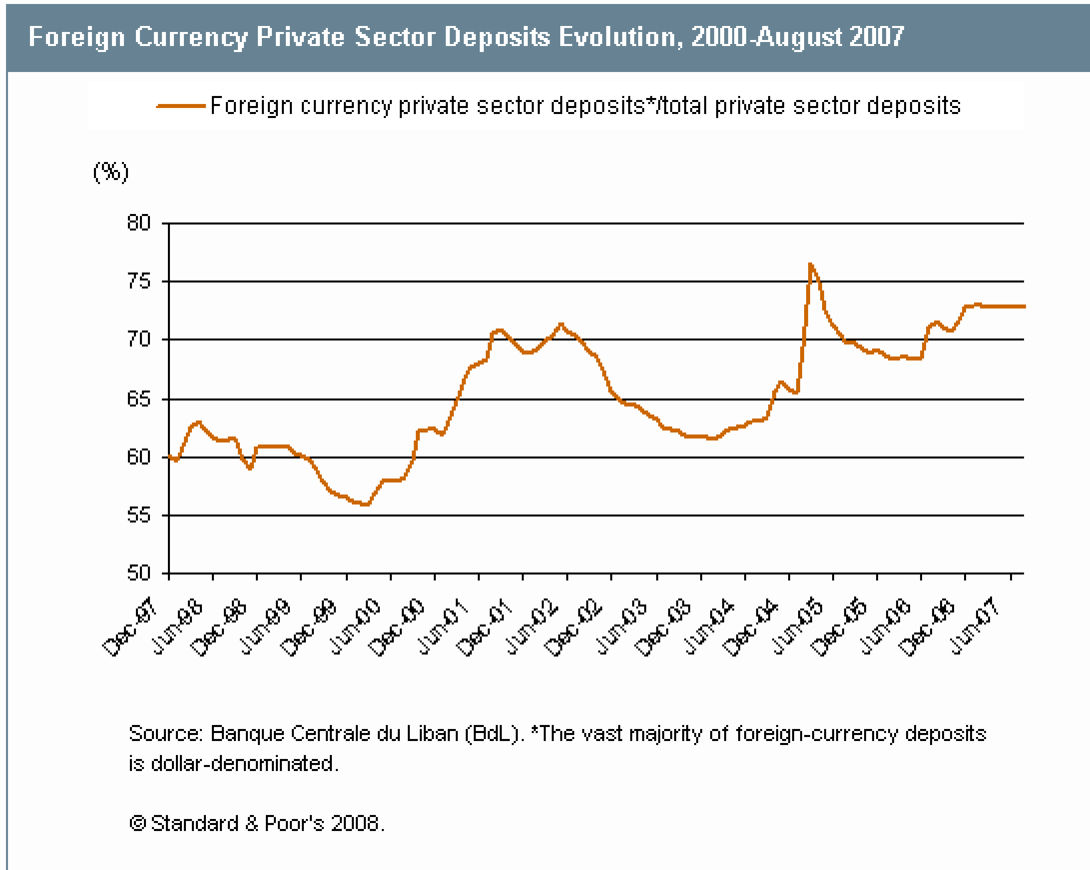
Throughout the various political and economic crises, several key factors have allowed the maintenance of a fixed exchange-rate regime:

- Strong commitment to the peg;
- The dollarized nature of private sector credits;
- A strong and resilient financial sector;
- Sizable foreign exchange reserves at the BDL;
- The absence of a foreign exchange forward market;
- The restriction on banks' foreign exchange positions; and
- The support of the Lebanese diaspora.

In the event of a sharp devaluation, depending on its intensity and suddenness, loan quality would be affected and would trigger higher provisioning requirements. Furthermore, economic conditions would likely prove very sluggish, as business confidence would collapse and the diaspora would be likely to slow transfers.

Dollarization of deposits in Lebanon is high (about 70%) and usually increases in times of political stress, thus limiting the potential level of outflows (see chart 1). Following each recent crisis, the BDL has significantly improved its reserve position, enabling it to meet all foreign exchange demands and to instill confidence in the financial system.

Chart 1



Source: Banque Centrale du Liban (BdL). *The vast majority of foreign-currency deposits is dollar-denominated.

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The conflict with Israel has resulted in shortages that have increased pricing pressure. In addition, inflation remained high in 2007 compared with historical levels because of the falling dollar and rising global commodity and food prices. Imported inflation is expected to keep the CPI (consumer price index) relatively high in 2008, at above 5%. With little demand-side pressure, however, prices should ease from 2009.

Current treasury management is prudent and underpins confidence, but structural reforms are crucial

The fiscal outturn in 2007 was better than the targets established under the Emergency Post-Conflict Assistance program (EPCA) approved in April by the International Monetary Fund, at the request of the Lebanese government. The primary surplus of 3% of GDP helped reduce the country's indebtedness to 171% of GDP in 2007 from 178% in 2007. The EPCA is viewed positively as it paves the way for more far-reaching reforms, offers a valuable anchor for policymaking, and could help strengthen the government's hand with regard to reform vis-à-vis domestic opponents.

Economic reforms are nevertheless crucial for the reduction of the huge stock of debt that severely constrains fiscal flexibility. Privatization of the two state-owned GSM mobile phone licences would be a major step forward--a measure that is awaiting the formation of a national unity government. Further reforms are still required, including the reform of Electricité du Liban, adjustments to state gasoline subsidies, and a range of tax and fiscal accountability measures. However, provided the political situation remains contained, rollover risks are likely to be manageable in the short term owing to the expected continued--albeit increasingly reluctant--support from commercial banks.

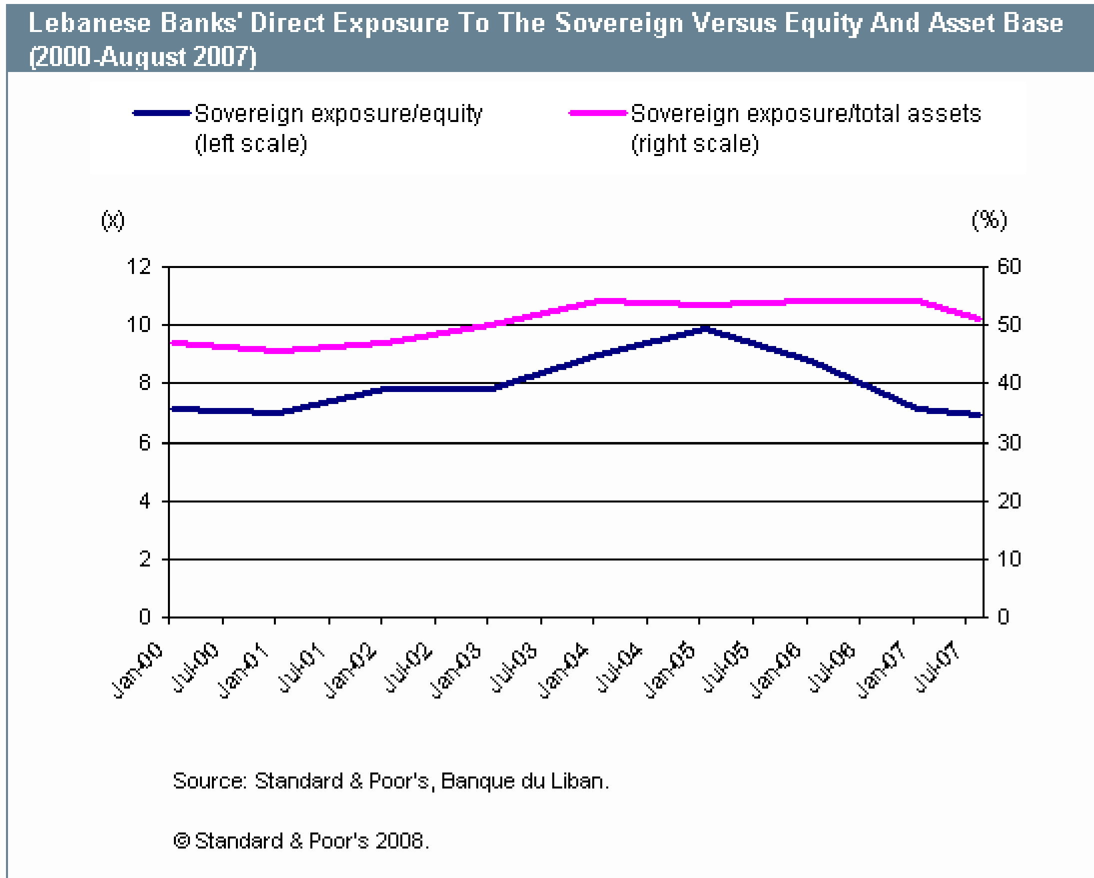
C. Leverage in the economy and credit risk

Lebanese banks are too tied to government financing for any realistic delineation between them and the sovereign

Banks in Lebanon provide the bulk of both private sector and government financing. They hold more than 50% of total sovereign debt, underlining their interdependence with the government. Given the risky environment and a lack of domestic alternatives, the banks have tended to channel higher liquidity into government paper and deposits at the BDL, together standing at an exceptionally high LB£62.7 trillion at Sept. 30, 2007, about 6.9x their equity base, or 51.0% of total banking assets (central government accounts for about 27% of total bank assets, while certificates of deposit account for a further

24%). In recent months, Lebanese banks have indicated they are becoming less willing to lend to the government because of the political situation and stalled economic reform program. Standard & Poor's considers that this stance will be hard to implement as banks are not in a position to allow the sovereign to default, given the implications for their own balance sheets (see chart 2).

Chart 2



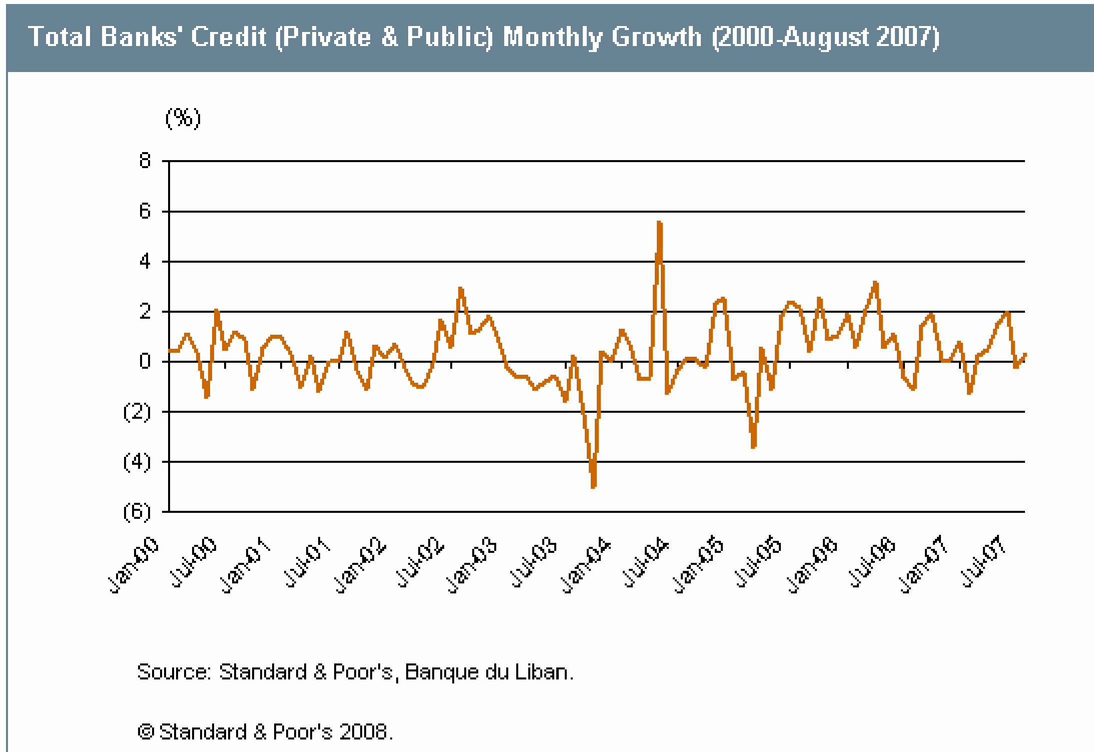
High direct exposure to the sovereign implies:

- Investments in Lebanese Treasury bills (T-bills) generally make up almost all banks' LB£ liquidity. A local currency default would therefore be disastrous for them, depriving them of the liquidity necessary to meet the inevitable run on their LB£ deposits. This, in turn, would drastically undermine confidence in both the central government and the banking system. Banks are therefore the government's most significant contingent liability, but its direct capacity to support the sector is limited.
- Funding longer-term government paper with short-term deposits creates maturity mismatches, which could potentially lead to negative spreads should interest rates be increased to support the currency or to compensate depositors for the added risk of retaining LB£. If this scenario were to occur, we expect major banks to gain through a flight to quality, as smaller institutions could not hold deposit rates down as a trade-off for being "safe havens" for client funds.
- Lending to the private sector is crowded out, owing to the wide differential in yields between government paper and corporate loans. This hinders the development of banks' franchise value.

Credit growth in Lebanon is subject to the political environment that regularly hampers the strong financing opportunities available

Crises tend to trigger a negative trend in lending, followed by periods of recovery (see chart 3). In anticipation of the November 2007 presidential elections, credit growth was virtually put on hold. Domestic capital markets offer limited alternatives for channeling surplus liquidity.

Chart 3



Lebanese banks' loan leverage is very low--22.9% at Aug. 31, 2007--as a consequence of the banks' high direct exposure to the sovereign. This mitigates any concerns about systemwide concentration risk--in terms of industry, single name, or geographic exposures. Concentration does exist, however, as domestic lending opportunities are limited in terms of names and sectors, and because geographic expansion has, until recently, been relatively well distributed geographically.

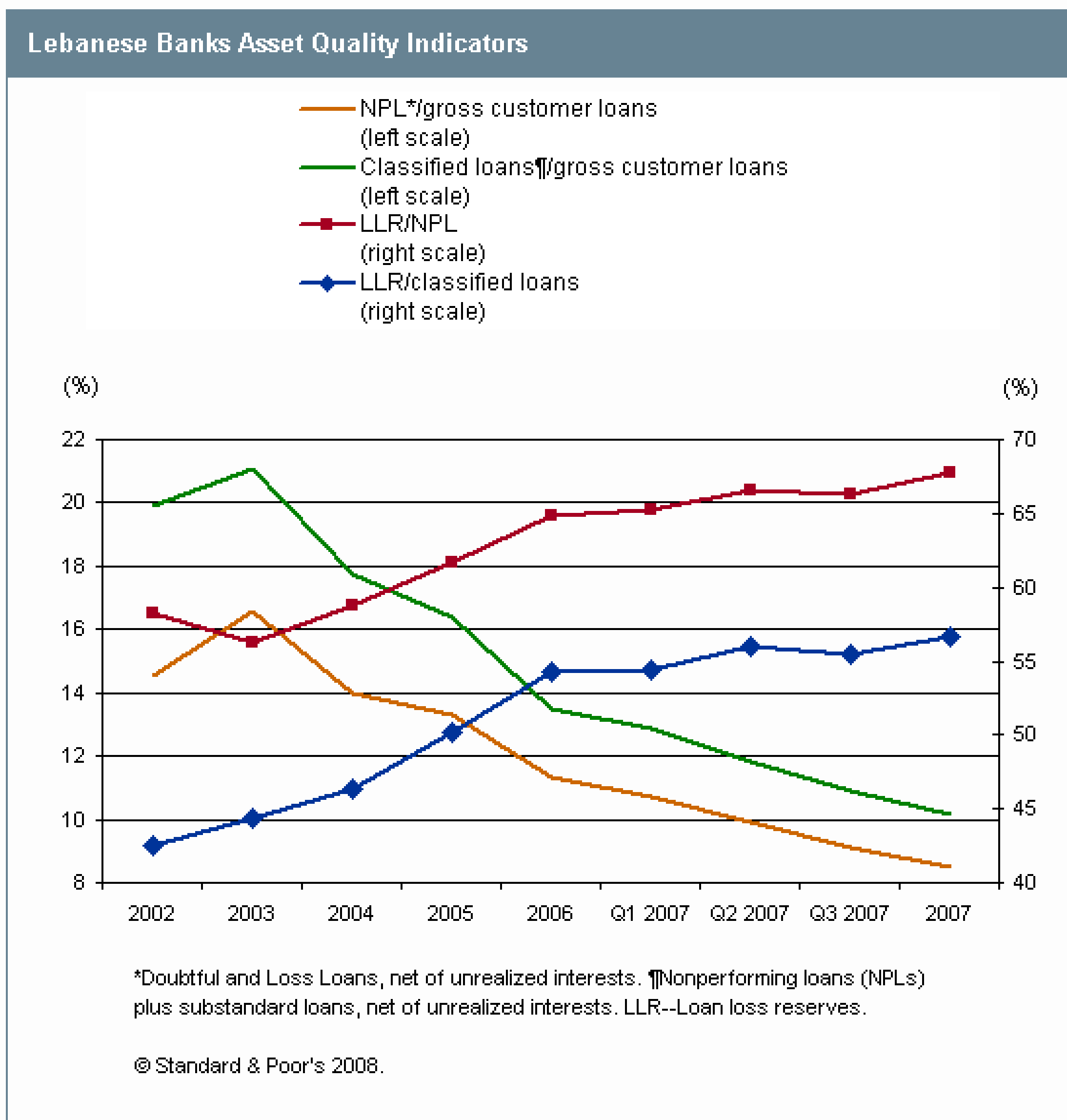
Banks' loan portfolios are generally skewed toward the services and financial institutions sectors. The construction sector accounts for almost 20% of outstanding loans, potentially exposing banks to a real estate market downturn, further complicated by the banks' preference for taking real estate as collateral. The safer retail-banking book is developing and now accounts for about 30% of banks' loans, providing an increased cushion in a volatile environment.

In time, geographic diversification should reduce the concentration on higher risk sectors in the domestic economy such as services, contractors, and tourism. Moving away from sovereign exposure should also lessen short-term volatility, but the process will take time and will depend on a steady reduction in the government debt stock.

Asset quality has strengthened following brief economic momentum..

Excluding IIS from gross loans, the Lebanese banking system has relatively high NPLs amounting to $1.7 billion at year-end 2007, or an NPL ratio of 8.5% (see chart 4). Given the low loan leverage, however, NPLs net of provisions represent less than 8% of Lebanese banks' equity base.

Chart 4



The 2006 conflict did not trigger any significant deterioration in asset quality because it was short and mainly affected banks' dollar liquidity. The authorities still intervened, however, to avoid any drifting in asset quality (see chart 5). Since 2002, NPL ratios have been trending down and provision coverage has been more satisfactory, at 68%. NPLs can partly be attributed to the 15-year civil war ending in 1990, but are also due to the banks' corporate banking bias, where credit risk is traditionally high. We expect the cost of risk to remain high in the medium term, despite the increasing proportion of retail lending in credit portfolios, active debt management by larger banks, and potential small banks' consolidation into more risk-management-effective institutions.

Chart 5
Impact Of The 2006 Crisis And Subsequent Follow-Up By The Banque du Liban

The Banque du Liban (BDL) is very closely involved in the classification of the banks' loan portfolios, and considers current provisioning levels adequate. Up until 2002, when coverage of nonperforming loans (NPLs) by loan loss reserves had been constantly declining, we considered the provisioning trend to be an additional cause for concern, particularly as it was at a time when the economy was still struggling to recover. Banks were expected to increase their level of protection in this context, but profitability was not sufficient to allow for conservative enough provisioning.

Toward the end of 2003, the BDL issued a circular setting, a mechanism that encourages banks to gradually settle their NPL portfolio as it stood in June 2003.

Following the July-August conflict in 2006, the BDL took several steps such as relaxing the deadline to complete the settlement of this portfolio (and including the NPL caused by the summer crisis). These initiatives eventually resulted in reducing the NPL portfolio of June 2003 by half at year-end 2007.

In addition, and in the context of Lebanon, IFRS39 (paragraph 8) allows for collective provisions in stressed circumstances. Given the recurrent and quasi-permanent stressed conditions, the BDL has requested that banks set aside some additional collective, as well as general provisions, for a total amount of about $160 million, equivalent to the net impact on NPLs that the war was responsible for.

According to intermediary circular No. 138 dated May 24, 2007, and starting September 2007, all NPLs will be net of unearned interests, which will be recorded off balance sheet.

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Banking Industry Country Risk Assessment (BICRA) group 9, with high gross problematic assets (GPA)

Standard & Poor's analyzes the broad environment in which banks operate, including the economic, regulatory, and legal contexts, factoring inherent strengths and weaknesses into the individual bank ratings. This is captured by a BICRA score, which reflects the strengths and weaknesses of a country's banking system relative to those in other countries. This score is an integral part of estimating the potential depth or damage of a crisis. BICRAs classify countries into 10 groupings, the strongest being group 1. Lebanon is classified within group 9, along with Costa Rica, Guatemala, Nigeria, and Vietnam.

For all banking systems analyzed, we estimate the potential level of GPA--expressed as percentage of domestic private-sector credit--that could result in the 12 months following a reasonable worst-case economic downturn. GPAs are defined as assets 90 days or more past due. We estimate that GPAs in Lebanon's banking system could rise into the 25%-40% range. Other countries, such as India, Morocco, Poland, and Turkey are in the same range.

3. Industry Risk

A. Competitive dynamics

A small and still overbanked market; domestic capital markets still in their infancy

The Lebanese banking system is larger and more open than peers', with $81.9 billion of total assets at Sept. 30, 2007. The sector comprises 64 commercial banks, including 11 specialized institutions and four Islamic banks. We consider that Lebanon is overbanked, given its population of four million, a leveraged private sector, and a financially strained public sector. In light of this, we consider that further rationalization will be required over the medium term.

The five largest banks accounted for more than 60% of the sector's assets at year-end 2007, with a fair degree of concentration. No single bank overwhelmingly dominates the market, however.

Financial services, with the exception of insurance, are almost wholly intermediated by banks, since nonbank financial services providers are scarce. This is a positive factor supporting the ratings on Lebanese banks and we do not foresee any imminent threat to this key franchise.

In the Lebanese market, listed companies are limited, volumes of transactions are low, and both domestic and foreign participations are far from thriving. There is virtually no domestic bond market apart from an oversized eurobond sovereign paper market. To raise capital, fund growth, and safeguard historical shareholders' positions, several Lebanese banks have resorted to issuing preference shares.

Competition, the implementation of Basel II starting gradually from 2008, and the indirect effect of the current protracted political situation should further reduce the number of players in the Lebanese banking sector.

The BDL supports the domestic merger trend, which has been taking place since the 1990s, as it reinforces the resilience of the banking system. It has, however, taken a laissez-faire approach toward this, but has made it clear that it does not favor major banks' aggregation, which we consider sensible from a policy perspective.

As competition increases and the banking system coalesces around the larger players, smaller banks--often family-owned ones--might struggle to compete in terms of products and services, and might be unable to provide the necessary banking coverage to meet the needs of the Lebanese economy and population. Nevertheless, consolidation is somewhat impeded by the high prices that bank shareholders are demanding for control. Despite the gloomy environment curbing domestic opportunities, we expect the consolidation trend to continue in the medium term.

The authorities are pushing toward more effective banking supervision and prudent risk management to maintain the much-needed confidence in the local banking system. As part of Basel II implementation, and given the current ratings on the sovereign, government debt will be risk weighted at 150% (instead of 100% for a "B-" rating category), leaving smaller competitors struggling to keep up with capital requirements and the risk monitoring-related costs. The largest banks in the country should remain adequately capitalized and above the regulatory requirements, as some of them have already increased their capital. Yet, the recent sovereign downgrade means that fewer funds than had originally been planned may be allocated to overseas expansion. Small banks may thus become fair game for larger domestic banks, and even for foreign players lured by the prospect of using Lebanon as a platform to service neighboring markets.

Islamic banking: Strong interest and prospects, but still a marginal segment

There are currently four fully fledged Islamic banks in Lebanon, licensed under a dedicated legal framework passed in April 2004. Their business model mostly focuses on consumer finance (see table 1). Specialization might increase through size and neighboring markets' servicing (Syria and Jordan), where demand is larger. To finance their domestic branch network expansion and prepare for geographic diversification, Islamic banks have recently undergone or plan capital increases. Operating in an untapped and underdeveloped market, and relying on parental support in terms of risk management and capital support, Islamic banks should not be part of the consolidation trend.

Table 1

Lebanese Islamic Banks--A Snapshot As At Dec. 31, 2007

Bank	Rating	Date of launch	Parent	Parent rating*	Branches	Assets (mil. $)	Deposits (mil. $)	Reported equity (mil. $)
Albaraka Bank Lebanon	N.R.	1992	Albaraka Banking Group (B.S.C.)	BBB-/Stable/A-3	6	162	123.6	18.3
Arab Finance House	N.R.	2003	Qatar Islamic Bank	N.R.	4	219.3	107.5	61.2
Lebanese-Islamic Bank	N.R.	2006	Credit Libanais	N.R.	1	38	8.7	18.3
BLOM Development Bank	N.R.	2006	Blom Bank sal	CCC+/Stable/--	1	40.4	9.6	19.9
Total					12	459.7	249.4	117.7

Source: Standard & Poor's, Lebanon's Banking Control Commission. Branches: Number of operational branches. Deposits include restricted investment accounts (recorded off balance sheet). N.R.--Not rated. Ratings as at March 17, 2008.

The BDL is not adverse to the development of Islamic banking in Lebanon, and provides support through tailor-made regulation and ongoing amendments. Furthermore, it targets a market share of about 5%-10% in the medium term, which we consider aggressive and ambitious (unless existing conventional players convert their operations). There is a clear willingness to fully integrate Islamic banks into the Lebanese financial system.

Conventional Lebanese banks demonstrate a genuine interest in developing Islamic banking. The banks would have to create dedicated subsidiaries to satisfy BDL requirements, but could use this segment to increase their competitive edge and accompany regional plans.

Most Lebanese banks are owned, or have been owned, by families

In general terms, family ownership can be considered a negative rating factor, because families are often unable to support institutions in times of need, and are unwilling to see any dilution of their ownership interest. In the region, however,

individual owners are often very wealthy and able to support their business interests. In Lebanon, the BDL views family ownership positively because it guarantees banks' conservatism. Although retaining their family links, several banks, such as Bank Audi SAL - Audi Saradar Group, have listed part of their share capital on the Beirut and international stock exchanges.

A number of international financial institutions are represented in Lebanon or are involved in joint ventures with Lebanese partners. About one-half of the 64 commercial banks active in Lebanon have majority foreign ownership.

Profitability: Despite the high exposure to government paper, Lebanese banks' profitability has proven resilient

Given the difficult economic and political environment, which results in banks regularly supporting public finances, the banking system has not been able to gradually replace government paper with higher yielding assets in the form of domestic and international loans. Interest income received from government paper therefore remains the driver of profitability, with net interest margin largely shaping financial results.

Future generation and diversification of earnings looks promising. Retail lending is slowly picking up, potentially bringing earnings diversification away from government paper and corporate banking. International operations are still small contributors to overall revenues, with top-tier banks being the exception. This should change going forward, however, owing to the authorities' support for geographic expansion. Noninterest revenues, notably the fee income component, have yet to become a significant contributor. Lebanese banks have the ability and product base to boost noninterest revenues. Assuming a fairly rapid economic recovery, sustained improvements in profitability and quality of earnings can be expected in the medium term.

B. Operating environment

Expansion abroad may be an alternative to deploying high liquidity

The largest banks currently operate subsidiaries abroad, enhancing their creditworthiness by providing diversification in economies not correlated to Lebanon. These subsidiaries have provided an offshore haven during crises, enabling banks to continue servicing key clients. Banks are perusing neighboring markets, which will:

- Compensate for lost domestic investment and growth opportunities incurred by a quasi-permanent stressed environment; and
- Naturally increase earning and credit diversification out of pure domestic sovereign risk, thus improving their resilience to shocks.

The BDL remains very hands-on and grants permission for banks to invest overseas on a case-by-case basis. The BDL issued a circular setting specific requirements for Lebanese banks to ensure they closely manage and monitor their related entities abroad, including their performance, risks, and management. Therefore, the BDL puts emphasis on banks enhancing their risk-management capabilities--clearly favoring banks that display adequate capital and a strong management track record--and close cooperation with the regulators of the targeted countries. Once the BDL is confident that banks are able to manage their overseas exposures adequately, the remaining constraints should ease.

Venturing into new markets and business lines should remain a cherry-picking process

Lebanon's larger banks tend to choose the fast-growing underbanked neighboring countries to venture into. They can thus deploy their expertise quickly and swiftly there--which is at a much higher level than regional peers' due to their longer track record and experience of stressed environments. Egypt, Jordan, and Syria are naturally attracting their attention, although Iraq, North African, and Gulf countries are also on the map (see table 3). Nevertheless, Lebanese banks will experience the same difficulties as local players, namely the lack of sufficient trained local experts and mounting competition.

Table 2

Major Latest Cross-Border Initiatives Of Lebanese Banks	
Iraq	Fransabank stated it wishes to go to Iraq, presumably in mid-2008. Byblos Bank opened a branch in Iraq. This is a first for a Lebanese bank in this country. Byblos was granted the licence in July 2006.
Sudan	Bank of Beirut bought 17.76% of Sudanese French Bank, the second-largest private bank in Sudan with about 18 branches and total assets of $395 million.
Armenia	Byblos bought Armenia's International Trade Bank in September 2007.
Syria	Strongly present in Syria, Lebanese banks take part in the local banking sector (private) development, although still constrained by the ownership limitations (49%), but expected to be raised in 2007/2008. Byblos own a 61% stake in newly

	formed Adonis Insurance Syria. Fransabank should add a representative office in Lybia in its international network.
Bahrain	Credit Libanais launched operations in Bahrain last October 2007 (one branch). Lebanese Canadian Bank holds a stake in AlSalam Bank, launched in 2006.
Saudi Arabia	BankMed and Banque Audi both secured an investment banking licence in 2006.
Egypt	BLOM Bank acquired Misr Romanian Bank in 2005.

Banks' performance and ratings might improve providing the regional political environment stabilizes

Despite demonstrated expertise in risk management--the legacy of a troubled history--and the support from the BDL, there will be a time lag before Lebanese banks' foreign operations effectively generate sufficient revenues and profits to offset their current dependence on the sovereign. Delineation from the country's sovereign risk--stemming from a successful foray into regional expansion--should only occur in the long term, providing the political environment stabilizes somewhat, and if a material part of the banks' assets and revenues are effectively held out of Lebanon.

In addition, we expect that regional expansion will inevitably slow down, since changes incurred will take time to effect and risk-management processes will need to be kept up to date. Furthermore, the BDL will only allow gradual and controlled expansion. Eventually, to sustain longer-term regional growth, banks may have to widen their capital base further.

C. Operating environment

Retail banking should spearhead increased diversification and sophistication of banks' business lines

The Lebanese banking system boasts about 830 domestic branches, or one per 4,800 inhabitants, a figure that is comparable with European countries with developed banking structures. Despite this branch density, the bulk of the population is also still only partially banked or completely unbanked, impeding any meaningful and profitable development in domestic retail-banking activity. In addition, the range and sophistication of retail-banking products have traditionally been relatively narrow and mainly restricted to deposits; this is slowly changing, however. Retail banking has become one of the key areas of development, and sustained growth is expected in this field, although from a low base.

Any potential run on retail deposits is mitigated by Lebanese banks' comfortable liquidity position

The total Lebanese banking system deposit base reached $71.5 billion at Sept. 30, 2007, and is mostly short term and dollar denominated. Customer deposits, largely fuelled by the diaspora ($5 billion-$6 billion of remittances yearly, or almost one-fourth of Lebanon's GDP), are still Lebanese banks' principal source of funding and vehicle for asset growth. They have remained quite stable despite recurrent political turmoil, clearly signposting strong confidence in the domestic banking market. The attractive yields offered by the banks and the BDL, the latter's commitment to safeguard the peg, and the sizable foreign currency reserves help to maintain the stability of deposits.

In addition, also as a result of generally quite conservative liquidity policies, top banks tend to be highly liquid, with cash and money-market placements in excess of 20%-30% of assets. A substantial part of the T-bill portfolio can be repoed with the BDL, although punitively high interest rates are usually charged to ensure that only banks in real need resort to this form of financing. Contingency plans are finally in place, aided by close communication with the BDL and the BCC, and have helped the banks weather the 2005 and 2006 crises.

D. Regulatory environment

BDL and BCC remain at the heart of the banking system

The legal basis for banking regulation is the Code of Money and Credit (1963) and the Code of Commerce (1942), with subsequent additions and amendments.

The BDL and the BCC, which are legally independent entities, carefully coordinate their activities, set out banking regulations, and supervise banking activity. The BDL is the main licensing and policy-making body for local banks and foreign institutions' branches. The BCC ensures banks' supervision and compliance to legislation and circulars. The supervisory approach is a blend of on- and off-site supervision, which includes regular follow-ups with bank managers. External auditors' reports are also analyzed.

The key to understanding Lebanon's role in middle eastern banking in the past is the Republic's 1956 Banking Secrecy Law, a key distinguishing feature. All banks established in Lebanon and all branches of foreign banks are subject to this law (see table 3).

Significant progress made in the prevention of money laundering has enabled Lebanon to be removed from the Financial Action Task Force (FATF) list of noncooperative countries and territories in 2001. A Special Investigation Commission (SIC) has been created in 2001 to receive and review suspicious transactions and is empowered to lift bank secrecy.

Table 3

Main Regulatory Requirements Applicable To Banks In Lebanon

Requirements	Comments and details
Banking secrecy	It is an offence for any bank employee, including top management, to reveal their knowledge of clients' names, assets, or holdings to any individual, even those in authority, without the written authorization of the client. Banking secrecy does not apply, however, in cases of bankruptcy or litigation between the bank and client. Moreover, banks are permitted to communicate problem names among themselves to ensure the solidity of the banking system.
Reserve requirements	15% of Lebanese pound time deposits and 25% of Lebanese pound demand deposits (out of which 3% can be held in special Lebanese T-Bills) and 15% on foreign currency deposits must be held in the form of cash deposits with the Banque du Liban.
Capital adequacy	The minimum capital requirements for Lebanese banks was raised in two stages: to 10% by year end 2000, and 12% by year-end 2001. The average risk-adjusted capital ratio of Lebanese banks at the end of 2006 was about 24.7%. High regulatory ratios are largely due to the fact that the majority of the banks' assets are weighted at 0% (government securities in Lebanese pound) or 20%- 50%, although this is changing with the adoption of Basel 2.
Related-party transactions	Advances to related parties must not exceed 5% of shareholders' equity.
Credit limits	The single obligor limit is set at 20% of equity (excluding any revaluation reserve) for borrowers in Lebanon and countries rated 'A+' and above. As for other nonresidents, the limit per borrower is 10%, in addition to limits per country and per country rating. The total of all banking facilities that each exceed 15% of the bank's equity should not be greater than 8x the bank's equity.
Foreign exchange trading	The net trading forex position against the Lebanese pound is limited to ±1 of Tier 1 capital, and the position in foreign currency vis-a-vis other foreign currency is limited to 40% of Tier 1 capital. A structural foreign-exchange position of up to 60% of Lebanese pound-denominated Tier 1 capital is allowed.
Provisions for bad and doubtful debts	The 1998 directive that required banks to classify their loans into five categories was a step in the right direction, but the definition of nonperforming loans (NPLs) remain vague. NPLs are defined as those loans for which management has determined that the borrower is unable to meet their payment/repayment obligations, or where performance is otherwise unsatisfactory, unless the loans are adequately secured; that is, it is highly subjective. Moreover, the central bank does not stipulate required provisioning levels for the banks depending on the risk rating of the loan. This is left to management's judgement.
Provisions for general banking risk	Lebanese banks are required to withhold from their annual profits at least 0.2% and at most 0.3% of total risk-weighted assets and contra accounts for any eventual banking risks. This reserve for general banking risks must reach a cumulative percentage of 1.25% by 2008 and 2.0% by 2018. It is considered to be an integral part of shareholders' equity (Tier 1) and is not available for distribution of dividends.
International operations	Up to 2005, overseas operations were limited to 25% of equity. Last year, the total amount of exposures to overseas counterparts was allowed to go up to 25% of equity, a figure then increased to 100% of equity. BDL is currently working on a more fine-tuned approach, taking into consideration the credit rating of the country of destination. The limits are applicable to Lebanese banks' financial statements including operations in Lebanon and foreign branches, but excluding subsidiaries. Therefore, those limits should not be viewed as applied to consolidated group numbers. A Lebanese bank can expand abroad through sufficiently capitalized stand-alone subsidiaries, with or without full control.
Islamic banking	The law #575, dated Feb. 11, 2004, gives a dedicated framework to regulate the Islamic banking industry in Lebanon, which used to fall under the 'Law on fiducy'. Conventional banks operating in Lebanon may establish or take part in the establishment of Islamic banks and may hold shares in Islamic banks provided they obtain prior approval from the Central Council of the Banque du Liban. This means that conventional banks cannot open Islamic windows.

E. Crisis management

Lebanon's authorities are considered supportive of their banking system

Because the Lebanese authorities are dealing with a banking system that used to be the most developed regionally, and since they are familiar with banking stresses, they are very clear about their attitude toward troubled banks. The BDL's first point of action when dealing with troubled banks is the supervisory and monitoring work carried out by the BCC. Further action may then be taken by the BDL in several stages. Depending on the problem, the BDL may request that the bank's management (which, in Lebanon, will often include significant shareholders) increases provisions, improves risk controls, or injects extra capital. If these measures fail, the Higher Banking Council can enforce a number of measures to attempt to remedy the situation (see table 4). The bank in question could be forced either to merge with a stronger peer or to go into voluntary liquidation. The merger tool has been used regularly from the 1980s to the early 2000s.

Table 4

Lebanese Authorities' Intervention Track Record

BCC supervision: The Al-Madina case

2003	In July 2003, the BDL took control of Bank Al-Madina, a small Lebanese bank, accusing the shareholders and managers of embezzlement, misappropriation of funds, fraudulent practices, mismanagement, and failure to abide by standard accounting practices. The SIC ordered commercial banks operating in Lebanon to freeze the accounts and assets of 19 individuals (including the bank's chairman) and two related companies. The BDL also appointed a provisional general manager. These actions came after the BCC filed a report against the bank.

BDL direct intervention: Banque Libanaise pour le Commerce

2000-2005	Banque Libanaise pour le Commerce (subsequently renamed BLC Bank) also had to be rescued by the authorities. The bank suffered in the late 1990s from mismanagement and unauthorized loans to shareholders following its merger with the United Bank of Lebanon in 1999, which prompted the forced resignation of its then chairman. A group of Lebanese and Arab investors acquired control of the bank in 2000 and then discovered NPLs (about 60% of its loan portfolio) were higher than expected, leading to intervention by the BDL. In July 2002, it recapitalized the bank through a capital increase of $107 million, injecting another $40 million in June 2003, raising its stake in the bank further to about 95%. In November 2005, seven local and foreign bidders lined up to acquire BDL's stake in BLC Bank. The government-held Qatar Investment Authority (QIA, not rated) bought the stake for a total consideration of $235 million. QIA sold the institution to Fransabank in 2007 (although it kept its France- and Dubai-based branches). BLC should continue to operate as a single entity in the near future.

Past use of forced mergers

1987	Crédit Libanais sal (then controlled by the central bank) absorbed the fallout from Intrabank's bankruptcy.
1994	Crédit Libanais took over First Phoenician Bank.
1995	Crédit Libanais took over Capital Trust Bank in 1995.
2000	The BDL appointed a new general manager for Inaash Bank, subsequently took it over, and sold it to Société Générale de Banque au Liban, following potential violations of Article 152, which regulates lending to a bank's board members or their relatives .

BCC--The Banking Control Commission. BDL--Banque du Liban.

To ease pressure on the government's treasury, BDL's participation in the deposit guarantee fund should be transferred to banks

Established in 1967 as a joint venture between the authorities and all banks operating in Lebanon, the purpose of the National Deposit Guarantee Institution (NDGI) is to guarantee and protect depositors (up to a maximum of LB£5 million). Banks pay the institution a maximum annual fee of 0.15% of their credit accounts. The state, in turn, contributes an amount equal to that collected from the banks. Recourse to the fund has been used on several occasions, most notably following the collapse of Lebanon-based Intrabank in the late 1960s. The maximum amount guaranteed applies equally to the deposits of individuals and corporations. Although the BDL acknowledges the need to create a protective environment for small depositors, it is also unwilling to create moral hazard, stemming from the effective deposit insurance scheme nature of the fund, which in effect underwrites banks' mistakes. The expected full transfer to banks is expected to save around $500 million-$600 million, representing BDL's contribution to the $1 billion fund's capital.

Authorities' successful handling of the 2005 and 2006 crises signposted their readiness to maintain monetary, financial, and banking stability

Shortly after the 2005 crisis, regulatory authorities created a committee whose members included: the BDL, the BCC, and the Lebanese bankers' association. The committee's main focus was on monitoring banks' daily foreign-exchange positions, dollarization rates, dollar transfers out of the country, customer awareness, and back-up facilities. Two objectives were pursued: limiting and controlling customers' shift from Lebanese pound deposits to dollar deposits; and avoiding massive foreign-exchange transfers abroad. If unmonitored, both events could have resulted in a dollar liquidity crisis following a potential depletion of the central bank's foreign-exchange reserves. The committee successfully met its objectives, and the mechanism was once again employed during the 2006 summer crisis.

Dollar conversions and foreign-currency withdrawals from the BDL's reserves occurred in both crises; however, the latter were more limited in 2006 than in 2005. In both cases, the bulk of the transfers found their way to Lebanese banks' foreign subsidiaries, and the BDL fully reconstituted its foreign-exchange reserves. The difference between the two crises is that in 2006, the BDL did not issue any bonds to help fund the cost of the crisis, since banks absorbed this financial shock with greater ease. Such coordinated crisis management efforts demonstrated the Lebanese banking system's resilience to political and liquidity issues--as long as the sovereign's creditworthiness is not at stake in any way.

F. Accounting policies and transparency: Adequate

Lebanese banks have conformed to International Accounting Standards since 1998. We consider the transparency of accounts and the level of disclosure required of Lebanese banks as satisfactory and far superior to requirements in North Africa and Egypt. Table 5 summarizes Lebanese banks' main accounting specificities.

Table 5

Main Banks' Accounting Characteristics In Use In Lebanon	
Income recognition	Banks use the historical cost convention and the accrual method for income recognition, although interest on doubtful and classified loans is generally recorded as unrealized until the date of collection.
Financial statements	Despite the high level of dollarization in the banking business, all financial statements are required to be produced in Lebanese pounds, although bank statements separate out local and foreign currency items.
Foreign currency translation	Accounts in foreign currencies are translated into Lebanese pounds at the year-end market exchange rates as fixed by the Banque du Liban, and any differences are recorded in the profit and loss statement. Transactions in foreign currencies, including revenues and expenses, are translated during the year into Lebanese pounds at the rates of exchange prevailing on the transaction dates.
Loans and advances	Loans and advances are shown net of unrealized interest and provisions for doubtful debts.

Table 6

Loan Classification	
Normal A	Outstanding debts in which the clients normally respect the conditions of the financings.
Normal B	Outstanding debts with incomplete documents.
Follow-up	Deterioration in borrowers' profits or cash flows leading to frequent excesses over facility limits.
Below normal	Delay in payments of up to three months. Banks are required to establish a restructuring program on a case-by-case basis. The bank should review the debt after a specified period of time so as to establish the status of the client and to suggest remedies. During this period, all profits and commissions should be treated as unrealized until the debt is collected and associated extraordinary risks are removed. Late payment penalties on installments for a period that exceeds 90 days should also be considered as unrealized.
Doubtful debts	Delay in payment of up to six months. Profits and commissions should be considered as unrealized. Partial provision should be made.
Loss debts	These are the debts which are not expected to be repaid even with judicial processes. Profits and commissions should be considered as unrealized. The bank is required to form a provision for the entire debt. In the case of bankruptcy, profits and commissions should not be calculated.

Appendix 1: Basic Data On The Lebanese Banking System At Feb. 25, 2008

Number of banks:

At Dec. 31, 2007, there were 64 commercial institutions, including 11 specialized institutions and four Islamic banks.

System deposits:

LB£108.2 trillion at Sept. 30, 2007

Deposits per capita:

Deposits with Lebanese residents totaled LB£27.2 million per capita at Sept. 30, 2007.

Banking Regulator

The Banque du Liban, headed by Mr. Riad Salame, Governor.

Appendix 2: Sovereign Ratings On The Republic Of Lebanon (At Jan. 31, 2008)

Credit analysts:

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Rationale

On Jan. 31, 2008, Standard & Poor's Ratings Services lowered its long-term sovereign credit ratings on the Republic of Lebanon to 'CCC+' from 'B-', and removed them from CreditWatch with negative implications, where they were placed on Nov. 25, 2007. The outlook is stable. The short-term ratings were affirmed at 'C' and the transfer and convertibility assessment was affirmed at 'B+'.

The ratings on Lebanon were lowered as a result of the political impasse that has raised tensions within Lebanon, and for

which no easy resolution appears in sight. This stand-off has increased political instability, which could shake confidence in the financial sector, thereby compromising domestic banks' ability to lend to the government, and could delay reforms crucial for putting Lebanese public finances on a more sustainable path.

That said, several factors continue to support Lebanon's creditworthiness. The fiscal outturn in 2007—-a primary surplus of above 3% of GDP--was better than the IMF had targeted in its Emergency Post-Conflict Assistance program (EPCA), and the ratio of debt to GDP declined. Resident banks, which are by far the government's largest creditor, have continued to buy government debt despite their stated threats to desist unless the political confrontation is resolved and economic reform launched in earnest. Incremental bank funding of government deficits is still possible because, thus far, confidence in the currency and in the banking system has proven resilient to the political difficulties. This confidence is underpinned by prudent treasury management, with a fiscal buffer averaging $1 billion in 2007. There remains a strong possibility that foreign supporters of the Siniora government, primarily from among Gulf Arab countries, will step in to provide further financial aid. Moreover, the authorities met most of the targets set for 2007 under the EPCA program--largely preparatory steps for more far-reaching reform.

Nevertheless, these supporting factors threaten to be eclipsed by the political crisis. Despite a stated consensus that the head of the army, Michel Suleiman, should become the next president, deep divisions between the ruling March 14th coalition and the opposition (comprising primarily Hizbullah and the Free Patriotic Movement of former army general Michel Aoun), and between their respective external supporters, are preventing his election and the formation of a proposed national unity government. Consequently, the risk of instability has in our view increased, and with it the risk of capital flight. This would put pressure on the Lebanese pound's peg to the dollar and undermine the banks' capacity to lend to the government.

A protracted stand-off between the factions might also delay the passage of the most important economic reforms promised at the Paris III donor conference held in January 2007. These reforms are an essential starting point to redress precarious public finances, with general government debt remaining above 170% of GDP. These include the privatization of the state-owned GSM mobile phone networks, which has already been postponed until May, and an overhaul of the state-owned electricity company Electricité de Liban.

Outlook

The stable outlook balances Lebanon's political and fiscal pressures against the likelihood of third-party support and the country's economic resilience. The ratings will be lowered should civil unrest break out or if the political deadlock causes protracted policy inertia. The ratings could be raised in the event of the election of a president and the formation of a cabinet by consensus accompanied by some success in advancing the program of economic reforms pledged at the Paris III conference.

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