PART 4

THE LEBANESE BANKING SECTOR IN 2017

04

I- INTRODUCTION

1-1

In 2017, the Lebanese banking sector continued to face challenges, most notably in November after the Prime Minister' resignation, so the sector was able, in coordination with the monetary and supervisory authorities, to cross the stage and maintain monetary stability with the least possible negative repercussions. In the coming period, the sector will bear, due to the Law 64 and its implementing decrees, fiscal charges rare or impossible to find in similar quality and size in the world, knowing that the banking sector is one of the most contributor in tax revenues to the government thanks to the transparency it enjoys.

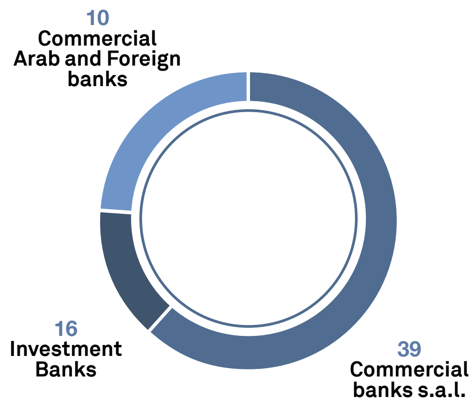
1-2

In 2017, Lebanese banks continued to focus on asset quality and capital safeguarding and enhancement. They also remained in full compliance with international laws on combating money laundering and terrorist financing, risk management and good governance, and the ones governing correspondent banks and Common Report Standard in order to protect Lebanon from any international financial isolation and keep people's deposits and investors' contributions away from any sanctions, despite the risks surrounding the country. Banks have broadened the implementation of international standards in terms of social responsibility and have been active in the process of restructuring an advanced IT infrastructure. They have effective and precautionary measures to protect against e-piracy and cyber- attacks, more efficient solutions to protect Internet access addresses, and modern safeguards for the command system.

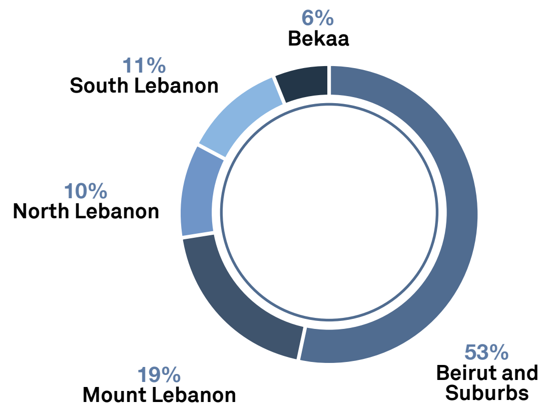
1-3

By the end of 2017, the number of banks operating in Lebanon was 65, distributed among 49 commercial (of which 10 Arab and foreign banks) and 16 investment banks. There are also 12 representative offices for foreign banks in Lebanon. Banks operating in Lebanon have correspondent relationships with 183 banks in 82 cities around the world that facilitate financial transactions with other countries and vice versa. The difficult operating conditions surrounding the banks, the increasing cost of complying with international laws and the capitalization requirements prompted foreign banks to reconsider their presence in Lebanon and urged some small and medium-sized Lebanese banks to seek consolidation. A number of new shareholders with good credibility, individuals and international financial institutions joined the capital of a number of Lebanese banks as part of their expansion plans and their intention to attain higher levels that help to take advantage of greater opportunities.

LEBANESE BANKING SECTOR STRUCTURE END 2017



GEOGRAPHICAL DISTRIBUTION OF COMMERCIAL BANKS BRANCHES OPERATING IN LEBANON END 2017

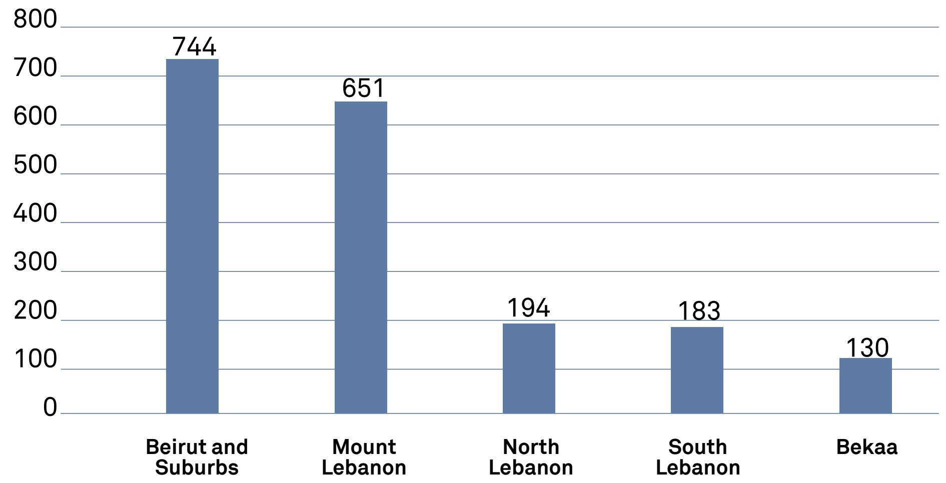


Source: BDL

1-4

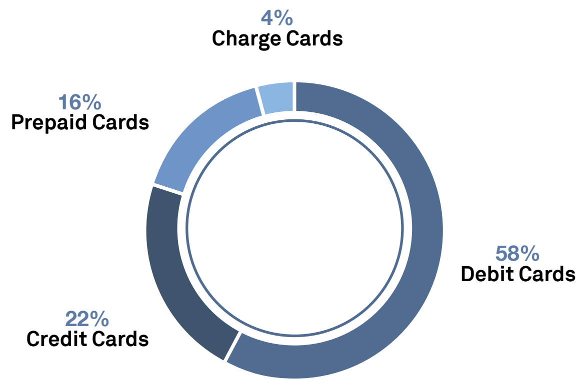
Lebanese banks manage a delicate balance between their external and internal expansion, taking into account regional geopolitical trends and political and economic situation in Lebanon. At the domestic level, banks are strengthening their role in enhancing financial inclusion and facilitating the Lebanese people's dealings with them by diversifying the loan portfolio for individuals and companies through offering retail and credit programs according to market requirements, and transferring payments through banking channels. This explains the spread of branches and ATMs in the domestic market and the diversity of payment cards. The network of bank branches reached 1,086 branches in Lebanon, of which 1,065 branches for commercial banks. The number of ATMs placed at customer service reached 1,902, and the total number of high-security payment and credit cards in circulation was approximately 2.6 million at the end of 2017.

GEOGRAPHICAL DISTRIBUTION OF ATMs IN LEBANON END 2017



Source: BDL

CARDS DISTRIBUTION END 2017



Source: BDL

1-5

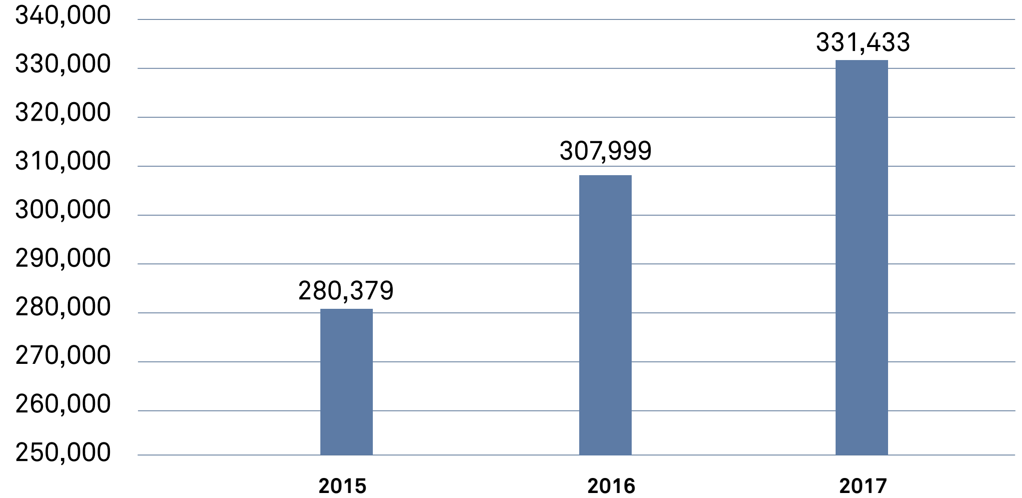
The openness to abroad markets represents a challenge for the monetary authorities, which see it as a necessity because the size of the banking sector is becoming greater than the size of the national economy, provided that this expansion is to be carried out in a disciplinary manner and under a follow-up from concerned authorities to enhance its good view abroad. The volume of external activity of banks is estimated at about $ 34 billion. However, the banks that have expanded in some countries are facing difficulties due to negative developments that put pressure on the banking activity. They are caused either by the prevailing situation in a certain country or by the decisions of the local monetary authorities that affect the work of the Lebanese banks. We note that 18 Lebanese banks are present abroad (through a subsidiary bank, branch or representative office).

II- BANKING ACTIVITY

2-1

At the end of 2017, total assets of commercial banks operating in Lebanon reached LBP 331,433 billion (the equivalent of USD 219.9 billion) compared to LBP 307,999 billion (USD 204.3 billion) at the end of 2016. Hence, total assets rose by 7.6% in 2017 and by an equivalent of USD 15.6 billion compared to a 9.9% growth or USD 18.3 billion in 2016. This slowdown came in the light of the political developments that took place and the difference in the nature and size of the financial engineering operations carried out by the Banque du Liban between 2017 and 2016.

TOTAL ASSETS / LIABILITIES OF COMMERCIAL BANKS OPERATING IN LEBANON - END OF PERIOD - BILLION LBP



Source: BDL

2-2

The table below shows the evolution of the main liabilities' items of commercial banks, in absolute value and percent of the total. The comparison between the end of 2016 and 2017 shows a decrease in resident private sector deposits share (from 62.9% at end 2016 to 60.7% at end 2017) and non-resident private sector share (from 16.6% to 16.0%) against an increase in "other liabilities" share (from 6.5% to 9.2% respectively). Note that these liabilities have been increasing since May 2016 in particular as a result of the financial operations carried out by the Banque du Liban with the banks in the mentioned year, which continued to rise in 2017, especially in the last quarter, and also for the same reason. "Other liabilities" item includes generally loans granted by the Banque du Liban to banks and interbank operations between the bank branches in Lebanon and abroad and other liabilities, and it constitutes an additional source of funding besides deposits and capital accounts.

COMMERCIAL BANKS LIABILITIES AT THE END OF THE PERIOD (BILLION LBP AND %)

	2015		2016		2017	
	Value	%	Value	%	Value	%
Resident private sector deposits	180,489	64.4	193,765	62.9	201,263	60.7
Public sector deposits	5,074	1.8	5,956	1.9	6,484	2.0
Non-resident private sector deposits	48,026	17.1	51,196	16.6	52,998	16.0
Non-resident financial sector deposits	9,864	3.5	9,467	3.1	11,278	3.4
Capital accounts	25,131	9.0	27,497	8.9	28,831	8.7
Other liabilities	11,795	4.2	20,118	6.5	30,579	9.2
Total	**280,379**	**100.0**	**307,999**	**100.0**	**331,433**	**100.0**

Source: BDL

2-3

Total deposits remain the primary source for the activity of commercial banks operating in Lebanon representing 78.7% of total liabilities at the end of 2017 (81.4% at the end of 2016). In addition to deposits, banks include their own resources represented in capital accounts and other resources from the market when needed. The expansion of the total assets of commercial banks operating in Lebanon relies to a great extent on the growth in deposits of resident and non-resident private sector which are fed by the flow of funds from abroad and the lending activity to the economy. Banks also seek to increase their medium and long-term resources through the issuance of certificates of deposits, preferred shares and subordinated debt obligations and get credit lines from Arab and international institutions, organizations and funds. However, total resources outside deposits and capital accounts are still modest requiring the development of the capital markets. It should be noted that the interest rate policy adopted in November 2017 and in subsequent months extended the length of deposits in Lebanese pound at banks from about 40 days to 125 days, which also helps manage liquidity.

Deposits

2-4

At the end of 2017, the total deposits' base, which includes deposits of resident and non-resident private sector and deposits of some institutions of the public sector, reached LBP 260,745 billion (the equivalent of USD 173 billion), in comparison to LBP 250,918 billion (USD 166.4 billion) at the end of 2016. So these deposits increased by 3.9% with a value of USD 6.6 billion in 2017 following a higher increase of 7.4% i.e USD 11.4 billion in 2016. This slowdown is due to the political crisis that arose in November 2017, which resulted in a limited exit of deposits, on one hand, and to the different nature of the financial operations carried out by the Banque du Liban in 2016 and 2017, as mentioned above, on the other hand.

2-5

At the end of 2017, the share of the resident private sector represented 77.2% out of total deposits, compared to 20.3% and 2.5% for non-resident private sector and public sector shares respectively. It should be noted that deposits include certificates of deposits issued by banks. The majority of bank deposits are term accounts (more than 80%). The average maturity of deposits in Lebanese pound is currently 4 months according to the monetary authorities. The deposits growth in 2017 resulted from resident deposits increase representing 76.3% similar to the preceding year (76.6%).

2-6

In terms of the distribution of deposits by currency, those denominated in LBP decreased by 4.1% in 2017 compared to an 5.1% increase in the previous year, while deposits in foreign currencies increased by 8.4% following an 8.8% increase in the two periods respectively, indicating that there were conversions from the LBP to US dollar in 2017, which were concentrated in particular in November and to a lesser extent in the first months of the year 2018. Accordingly, the dollarization rate of the private sector deposits increased from 65.8% at the end of 2016 to 68.7% at the end of 2017, the highest level in ten years.

2-7

Bank deposits are concentrated in Beirut and its suburbs which attracted 68.4% of total deposits at the end of 2017, allocated to 47.7% of the total number of depositors, whereas 31.6% of the deposits belong to other regions and were allocated to 52.3% of depositors, indicating a difference in the average deposit value between Beirut & suburbs and the other regions.

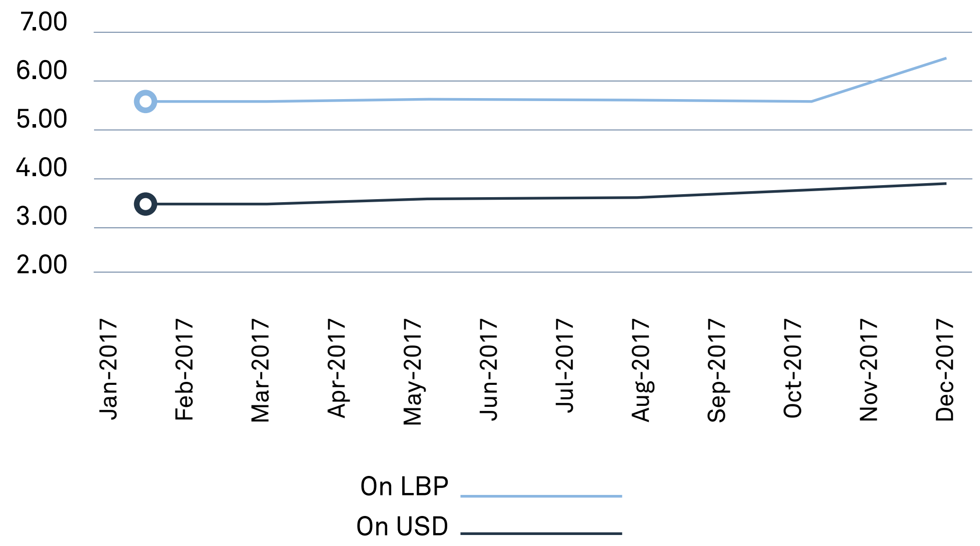
2-8

In parallel to the stability of interest rates on Treasury-bills in 2017 as in the previous year, the average interest rate on new or renewed deposits in LBP remained quasi-stable till October 2017. However, in the last two months of the mentioned year, the banks, in coordination with the Banque du Liban, have raised the interest rates on deposits in LBP when terms were extended, to discourage conversion. The average interest rate on deposits in LBP increased to 5.65% in 2017 compared to 5.56% in 2016, knowing that monthly average rose to 6.41% in December 2017 from 5.56% in October 2017. The average interest rate on new or renewed deposits in USD increased to 3.65% in 2017 from 3.34% in 2016 knowing that monthly average was 3.89% in December 2017. The interest rate on the dollar in the Beirut market came in parallel to the measures of the Banque du Liban, which encouraged attracting and keeping US dollar deposits, especially as the US interest rate rose. The Fed raised its benchmark interest rate by 0.75 basis points for the whole year 2017: 0.25 bps in each of March 15, June

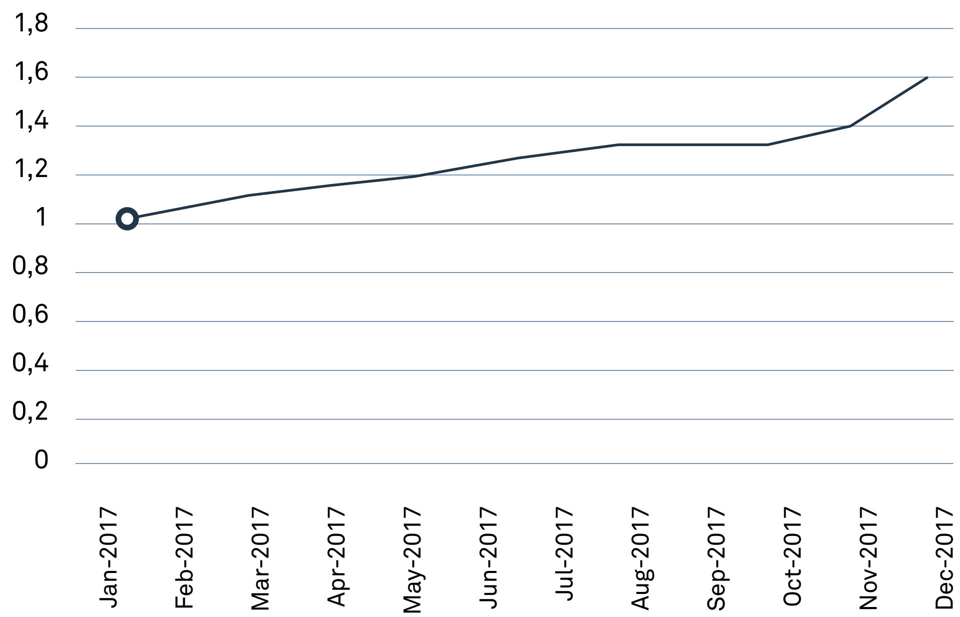
14 and December 13, after raising it by a quarter percentage point in December 2016 and by the same amount in December 2015.

This reference rate was equivalent to 1.50-1.75% at the time of writing this report (after a quarter-point increase in March 21 2018).

DEPOSIT INTEREST RATES IN BEIRUT MARKET (%)



LIBOR 3 MONTH ON USD (%)



Source: BDL

Capital accounts

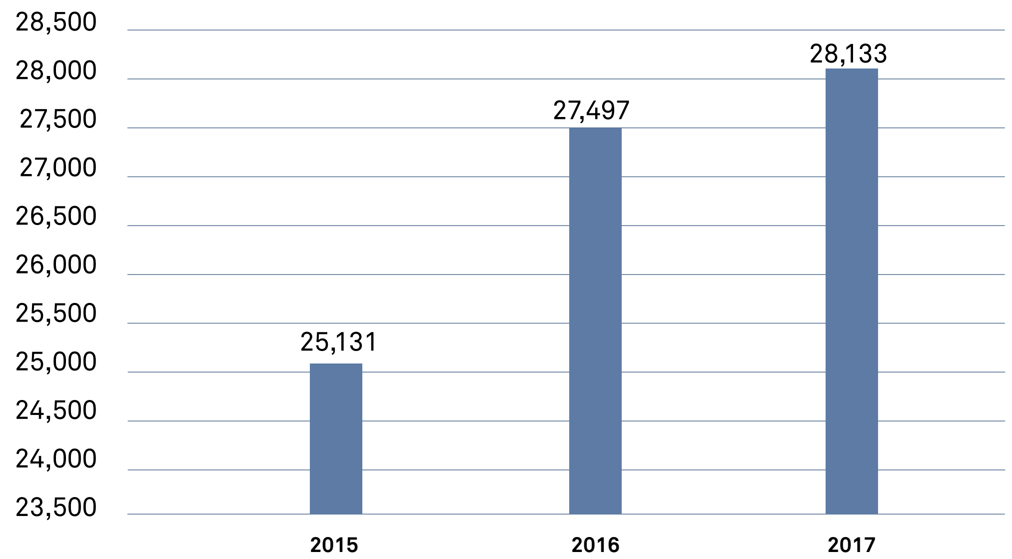
2-9

Capital accounts of commercial banks operating in Lebanon continued to increase in parallel to the assets growth, reaching LBP 28,831 billion (the equivalent of USD 19.1 billion) at the end of 2017 from LBP 27,497 billion (the equivalent of USD 18.2 billion) at the end of 2016, hence registering an increase of 4.9% in 2017 following a higher increase of 9.4% in the previous year. At the end of December 2017, capital accounts represented 8.7% of the consolidated balance sheet (around 8.9% at the end of 2016) and 31.7% of total claims on private sector (31.9% at the end of 2016. These ratios are considered good compared to their peers in numerous European advanced countries banking sectors. In addition to the deposits base sufficient to provide the financing needs of the public and private sectors, the banking sector has also, even limited, the ability of attracting more financial resources due to the confidence of investors in Lebanon and the region in this sector, despite the prevailing economic situation and the difficult regional scene throwing its weight on Lebanon. At end September 2017, the solvency Basel III ratio was 15.77% according to BDL.

2-10

Banks' Capital is crucial to protect a bank from various risks and to increase confidence in its sustainability as well as to protect bank customers, employees, shareholders, and the economy in general. Capital provides additional elements of strength and flexibility in implementing the internal and external expansion in terms of networks and business. So banks expand their capital base, constituted from the new capital attracted from investors in Lebanon and abroad through the issuance of common and preferred shares classified as core capital, and from retaining most bank profits into their capital to enlarge it. However, the increase in the country risk always necessitates an increase in the capital even at the expense of redistributing profits, which enhances capital adequacy, the liquidity of traded shares, and the solid financial position of the bank and the whole sector. This is supervised by the BDL and the Banking Control Commission.

CAPITAL ACCOUNTS IN THE COMMERCIAL BANKS END OF PERIOD- BILLION LBP



Source: BDL

2-11

The supplementary capital, which includes subordinated bonds and some types of preferred shares, remains low compared to the core capital, as it represented 6.5% of capital accounts at the end of 2017 (6.7% at the end of 2016). It is clear that this is largely in line with the Basel III accord to strengthen the soundness of the banking sector, which includes improving the quality of the capital base through focusing on the concept of shareholders equity within tier one, i.e. the core capital, and the marginalization of tier two, i.e. supplementary capital. This new accord radically amended the structure and quality of capital accounts which ensures for banks the adequate factors of resistance in case their capital are exposed to any emerging pressure. This is an indication of a sound position especially that the liquidity ratio exceeded the required one (30%) which is of utmost importance as bank liquidity became after the global financial crisis a concept as important as capital adequacy. The mentioned indicators of financial performance which reflect the risk coverage in general stand witness to the maintenance of the sector of its international financial stance. Finally, we mention the positive role played by the banking supervisory authorities over the last years in the flourishing of the banking industry in Lebanon, especially concerning preserving high levels of capital adequacy and liquidity which remain appreciated by customers and international financial institutions, despite the sovereign risks that are often highlighted by rating agencies and other international financial institutions.

If double taxation is imposed on banks and assigned to their operations with the Central Bank, they will be charged in amounts exceeding those applied to other non-banking institutions, it is feared that this will limit the ability of banks to increase their capital as required and their ability to attract capital and deposits to finance the economy, public and private, and to actively engage in the infrastructure investment program.

Placements of the Banking Sector

2-12

Deposits at BDL continued its ascending trend to reach 47.0% out of total placements at the end of 2017 against 43.7% at the end of 2016. In return, the share of loans to the public sector continued its decline to reach 14.5% at the end of 2017 compared to 17.0% at the end of 2016, and the share of foreign assets reached 10.7% against 11.3%, and the share of loans to the resident private sector decreased a little to 24.6% from 25.0% in the two mentioned periods respectively.

The table below presents the evolution of the main assets items of commercial banks, in terms of absolute value and percent of the total between the end of 2015 and 2017.

COMMERCIAL BANKS' ASSETS AT THE END OF PERIOD (BILLION LBP AND %)

	2015		2016		2017	
	Value	%	Value	%	Value	%
Reserves	107,021	38.2	135,305	43.9	156,667	47.3
o/w : deposits with BDL	*106,329*	*37.9*	*134,612*	*43.7*	*155,893*	*47.0*
Claims on the resident private sector	72,427	25.8	76,943	25.0	81,667	24.6
Claims on the public sector	56,984	20.3	52,344	17.0	48,163	14.5
Foreign assets	35,870	12.8	34,824	11.3	35,579	10.7
o/w : claims on NR financial sector	*17,422*	*6.2*	*16,945*	*5.5*	*17,835*	*5.4*
claims on NR private sector	*9,316*	*3.3*	*9,256*	*3.0*	*9,263*	*2.8*
Fixed assets & Non-classified assets	8,077	2.9	8,583	2.8	9,357	2.8
Total	**280,379**	**100.0**	**307,999**	**100.0**	**331,433**	**100.0**

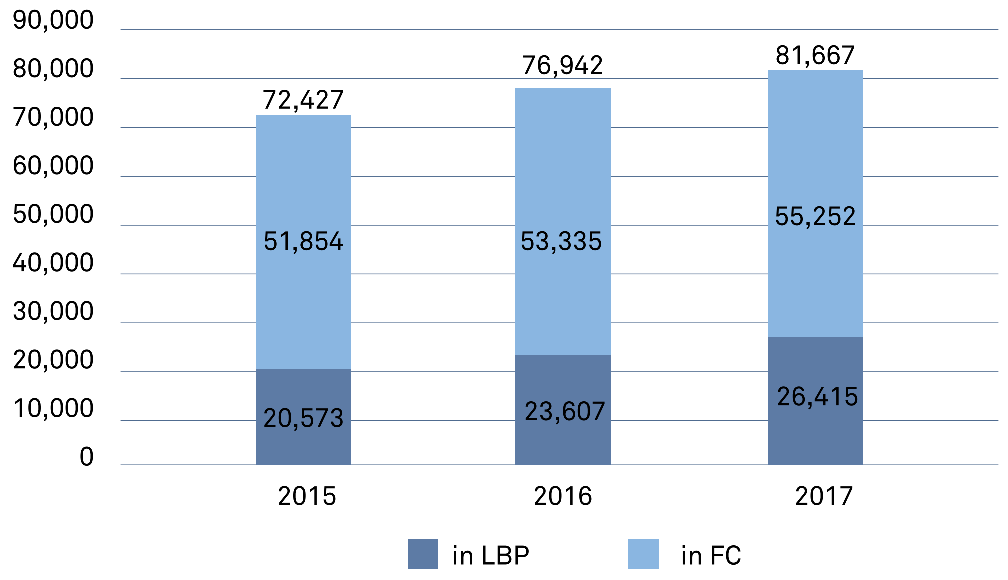
Source: BDL

Claims on Private Sector

2-13

Bank loans to the resident and non-resident private sectors reached around LBP 90,930 billion at the end of December 2017, against approximately LBP 86,198 billion at the end of 2016. Thus, registering a growth of 5.5%, which is similar to its growth registered in 2016, noting that this growth is lower than those registered in the last years reflecting the weak economic growth in Lebanon. However, the annual increase in loans remained good and acceptable in light of the slowdown of the economic activity in the country and the instability in the region. Furthermore, loans granted to the non-resident private sector, of which a large part is related to the financing of projects for Lebanese businesses abroad, particularly in Arab and African countries, represented 10.2% of the total loans granted to the private sector at the end of 2017 against 10.7% at the end of 2016.

TOTAL CLAIMS ON RESIDENT PRIVATE SECTOR
END OF PERIOD- BILLION LBP



Source: BDL

2-14

Banks continued in 2017 to finance the resident and non-resident private sectors, individuals and corporations, at an acceptable interest rate which ranged between 7-8% on average in LBP and foreign currencies and for terms relevant to the nature of the financed activities. Moreover, loans granted to the resident private sector represented the equivalent of 103% of GDP at the end of 2017, hence a considerably high ratio compared to many emerging countries. This ratio, for example, reached 69% in the MENA region. This relatively high level in Lebanon could be explained, on one hand, by the enormous private demand, of which a large part is financed by bank loans to individuals and corporations for investment and particularly consumption. On the other hand, it resulted from the low capitalization of the corporate sector, its weak capacity for self-financing, and its excessive reliability on banks' financing, as financing through stocks and corporate bonds markets is almost absent in Lebanon. The privatization of Beirut Stock Exchange and the launching of an electronic trading platform in securities pave the way for the capitalization of the Lebanese economy, as competitiveness in finance is the best and most successful way that make growth a sustainable process ensuring financial and social stability.

2-15

On the other hand, the ratio of loans in foreign currencies to deposits in foreign currencies decreased to 36.9% at the end of December 2017 from 38.8% at the end of December 2016. However, loans in LBP to deposits in LBP continued to increase reaching around 33.2% at the end of 2017 against 28.2% at the end of 2016, especially resulting from the increase of deposits in foreign currencies against a decrease in LBP deposits due to transfers in foreign exchange market in November 2017. Lebanon's ratio of loans to deposits remains low, against high liquidity levels that often characterize the Lebanese banking sector despite the large retreat of domestic savings (resident and non-resident) reflected by the large deficit of balance of payments.

2-16

With the increase of loans in LBP by 11.9% in 2017 and 14.7% in 2016, or at a faster rate than the increase of loans in FC, which reached 3.1% and 2.3% in the two respective years, the loan dollarization rate decreased to 70.9% at the end of 2017, against 72.6% at the end of 2016. The decrease in loan dollarization rate during the last few years, precisely since 2009, was the result of incentives provided by the BDL for several loans, in particular housing loans in LBP and loans granted to productive sectors for the financing of new projects or the expansion of existing ones. They also include loans granted to higher education, environmental friendly projects and agriculture (other than those with interest rate subsidies).

2-17

With the continuing weak foreign demand due to the prevailing situation, the BDL started providing a new stimulus to economic growth through incentives to domestic demand via bank loans, especially in LBP and at acceptable interest rates compared to prevailing market rates. BDL's policy of stimulating the private sector relied in the last years on several different pillars. We first mention **the stimulus package of liquidity** at a low cost to banks launched by the BDL at the beginning of 2013 based on intermediate circular no. 313/ 2013. These initiatives target the sectors of housing, education, environment, alternative energy, entrepreneurship, Research and Development, and the new productive and investment projects. With this initiative, the BDL placed till this date around USD 5.2 billion at the disposal of banks at 1% interest rate, so that they can continue to grant loans to institutions and households through this new mechanism after the mechanism of required reserves was consumed, knowing that banks bare alone the credit risk.

The **second incentive program** is represented by intermediate circular 331/2013 concerning the knowledge economy (amended by intermediate circular 419) as this sector represents an engine for future growth. This circular allows banks and financial institutions to contribute within the limits of 4% of bank's capital (3% before amendment) to finance start-up projects, business incubators and accelerators whose business is centered in the knowledge economy. The BDL provides these projects with a guarantee of 75% which prevents banks from risking their own capital; and for its contribution in any of the companies whose purpose is confined to the contribution in capital of "start-up companies" (Venture capital) not to exceed 20% of this 4% mentioned above, and 10% in any other "companies". However, it is up to the Central Council of the BDL in justified cases to agree on exceeding any of these percentages.

According to the BDL, banks have invested so far around USD 369 million in the knowledge economy till the end of August 2017, of which USD 321 million invested in Venture Capital, USD 34 million invested in accelerators and incubators, and USD 14 million invested directly in start-up companies.

The **third pillar** consists of extending the maturity of subsidized loans to the productive sectors, including tourism, to 19 years based on circular 465/2017, that amended the duration of 13 years, based on circular 400/2015 and from 7 to 10 years, based on circular 335/2013.

SUBSIDIZED LOANS AND LOANS BENEFITING FROM DEDUCTION IN RESERVE REQUIREMENTS (END OF PERIOD – BILLION LBP)

	2015	2016	2017
1- Subsidized -interest medium & long term loans	7,133	7,821	8,269
2- Subsidized-interest loans guaranteed by Kafalat	1,988	2,132	2,209
3- Subsidized-interest loans under the protocol signed with the EIB	204	204	204
4- Subsidized-interest loans granted by leasing companies	212	232	242
5- Subsidized-interest loans granted by IFC	80	80	80
6- Subsidized-interest loans to finance working capital	16	16	16
7- Subsidized-interest loans granted by AFD	7	7	7
TOTAL Subsidized-interest loans (1+2+3+4+5+6+7)	**9,641**	**10,491**	**11,028**
Utilized loans benefiting from deductions in banks liabilities subject to reserve requirements	**3,764**	**3,401**	**3,047**
Utilized loans benefiting from deductions in reserve requirements	**9,915**	**10,201**	**10,839**

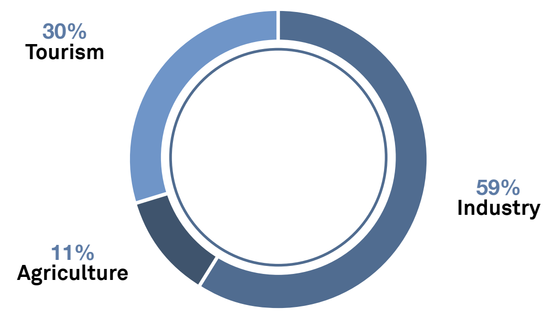
Source: BDL

2-18

Data reveal that loans in LBP benefiting from deductions in reserve requirements increased by around 6.2% in the first nine months of 2017 to reach LBP 10,839 billion at the end of September 2017, against an increase of 2.9% in 2016. However, loans benefiting from deductions in bank liabilities subject to required reserves decreased by 10.4% in the first nine months of 2017 reaching LBP 3,047 billion at the end of September 2017 after decreasing by 9.6% in 2016. The slight increase or decrease in these loans in the last few years is attributed to the fact that banks relied specifically in their lending on the stimulus packages subject of intermediate circular no. 313/2013 previously addressed. It is to mention that loans benefiting from deductions in reserve requirements and loans benefiting from deductions in bank liabilities subject to required reserves have stopped in October 2017 by circular no 475.

Total subsidized interest loans increased by 5.1% in the first nine months of 2017 reaching LBP 11,028 billion (or the equivalent of USD 7.3 billion) at the end of September 2017 against an increase in 8.8% in 2016. The share of the industrial sector out of these loans granted between 1997 and the end of September 2017 represented 59.0%, against 29.6% for the tourism sector and 11.4% for the agricultural sector. Several elements characterize these subsidized loans: the period of the loan for 7 or 10 years, the grace period and the relatively low average interest rate.

DISTRIBUTION OF SUBSIDIZED INTEREST LOANS ON ECONOMIC SECTORS END OF SEPTEMBER 2017



Source: BDL

It is noteworthy to mention in this context that banks play a significant role in the specialized financing schemes to the private sector, institutions and individuals. On one hand, banks are the partners of the Lebanese State as well as the international and regional financial institutions, of which the Overseas Private Investment Corporation (OPIC), the European Investment Bank (EIB), l'Agence Française de Développement (AFD), the International Finance Corporation (IFC), the Arab Development Funds, the Arab Monetary Fund etc., and on the other, banks are the lenders baring solely the credit risk of these loans and offering new and varied loans.

2-19

The data related to the nature of loans granted by the financial sector reveal that, as of the end of December 2017, a large part of these loans -representing 72.5%- consists of limited-term loans, while the remaining part or 27.5% is in the form of overdrafts. It is to note that overdrafts are usually granted to clients with high creditworthiness or to big clients where total loans are concentrated. Therefore, the share of these facilities from the total is in line with the distribution of loans by value and according to the beneficiaries. At the end of December 2017, the share of advances against real estate reached 37.7%, in comparison to 18.4% for the advances against personal guarantees, 11.3% for the advances against cash collateral or bank guarantees, 3.2% for the advances against other real guarantees, and 1.8% for the advances against financial values.

2-20

The distribution of loans among the economic sectors corresponds roughly to the shares of these sectors in GDP, except for the agriculture sector that requires specialized financing schemes, as is the case in most of the developed and emerging countries.

SECTORIAL DISTRIBUTION OF UTILIZED CREDITS IN THE FINANCIAL SECTOR (END OF PERIOD)

	December 2015		December 2016		December 2017	
	Value (billion LBP)	Share (%)	Value (billion LBP)	Share (%)	Value (billion LBP)	Share (%)
Trade & Services	30,991	33.4	31,346	32.4	34,110	33.0
Construction & building	16,335	17.6	17,414	18.0	17,267	16.7
Industry	9,398	10.1	9,517	9.8	10,304	10.0
Personal loans	27,060	29.2	29,662	30.6	32,332	31.2
o/w: housing loans	*16,457*	*17.7*	*17,981*	*18.6*	*19,637*	*19.0*
Financial intermediation	5,458	5.9	5,169	5.3	5,452	5.3
Agriculture	1,064	1.1	1,146	1.2	1,184	1.1
Other sectors	2,468	2.7	2,527	2.6	2,846	2.7
Total	**92,773**	**100.0**	**96,781**	**100.0**	**103,495**	**100.0**

Source: BDL

Whereas the share of personal loans continued its increase to 31.2% at the end of 2017 of total loans to the Financial sector, including housing loans with a share of 19.0%, the share of other sectors witnessed minor upward or downward variations at the end of 2017 in comparison with the end 2016, and loans remain concentrated in the trade and services sector, in addition to the personal loans.

Loans' distribution among the regions and beneficiaries shows their obvious concentration in the region of Beirut and its suburbs and in favor of its inhabitants, with a slight gradual decrease in the share of this region to 75.1% of total loans and 53.2% of the total number of beneficiaries at the end of December 2017. This concentration is in line with the concentration of economic activity, population, and income levels in the capital and its suburbs.

2-21

Concerning the distribution of loans by credit range, statistics show that loans whose value exceeds LBP one billion, are distributed among 1.4% only of the beneficiaries (or 8,571 persons and institutions), out of the total number of beneficiaries of around 615,602. This low percent is in line with the situation of most countries in the world. Knowing that it may be one person (or one institution) benefiting from more than one loan, thus the number of beneficiaries mentioned above could be lower than the one indicated.

DISTRIBUTION OF LOANS ACCORDING TO THE VALUE AND THE BENEFICIARIES (IN PERCENTAGE – END OF DECEMBER 2017)

	by value (%)	by beneficiaries (%)
Below 5 million LBP	0.17	13.36
5 – 25 million LBP	3.65	49.02
25 – 100 million LBP	5.87	20.69
100 – 500 million LBP	16.84	14.25
500 – 1,000 million LBP	5.21	1.28
1,000 – 5,000 million LBP	12.38	0.97
5,000 – 10,000 million LBP	7.88	0.19
10,000 million LBP and above	48.00	0.24
Total (Billion LBP and Number)	**103,495**	**615,602**

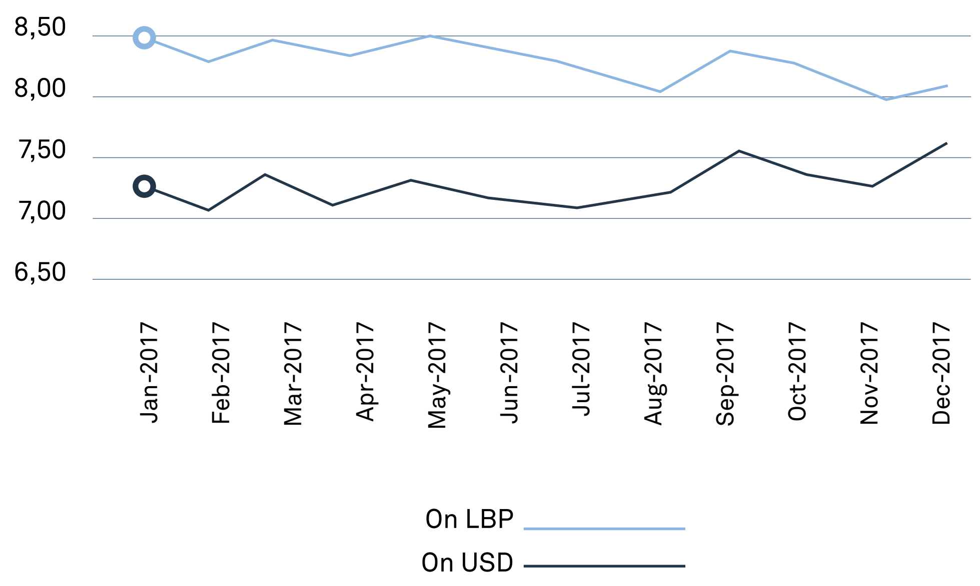
Source: BDL

2-22

As for interest rates on new and renewed loans, the average lending rate on the USD slightly increased from 7.25% in 2016 to 7.34% in 2017, knowing that it reached 7.67% in December 2017, in parallel with the increase of the deposit interest rate on the USD.

Concerning the average lending rate on the LBP, it declined from 8.35% in 2016 to 8.29% in 2017. Noting that the trend is moderate ascending in 2018 in line with the increase of deposit's cost.

EVOLUTION OF LENDING INTEREST RATES ON BEIRUT'S MARKET (%)



Source: BDL

Claims on Public Sector

2-23
The banking sector is a major financier of the public sector, although the volume of funding varies from time to time, influenced by available resources, opportunities, returns and risk management. Commercial banks held 41% of total public debt at the end of 2017, while BDL held more than 36% against more than 11% with the public. Whereas, the remained part held by countries and multilateral institutions and Non-residents.

The **claims of commercial banks on the public sector** decreased at the end of 2017 to reach LBP 48,163 billion in comparison with LBP 52,344 billion at the end of 2016, thus registering a decrease of 8.0%, an approximate similar decline in 2016. This drop in 2017 resulted from a retreat in each of claims in LBP and in foreign currencies along with bank's preference of placements at BDL under the implemented financial engineering in 2017 and the related higher return, knowing that deposits in LBP registered a decrease of LBP 3,663 billion or 4.1%. Whereas, the decrease in 2016 resulted particularly from a net sales of Eurobonds (thus the value of sales operations exceeded the purchasing ones in the first half 2016), due to liquidity and profitability management considerations and the BDL's financial engineering operations.

2-24
In detail, claims on the public sector in LBP declined by LBP 2,364 billion or 8.1%, and claims in foreign currencies dropped by around USD 1,818 billion or 7.8%, after a decrease of 4.0% for claims in LBP and 12.8% for claims in foreign currencies in 2016.

The commercial banks' portfolio of Treasury bills in LBP decreased from LBP 28,936 billion at the end of 2016 to LBP 26,556 billion at the end of 2017 indicating that banks' new subscriptions came less than maturing bills, knowing that banks concentrated their subscriptions in long-term categories (7 years and more) with relatively higher return and get used to be issued periodically. The banks' portfolio of Eurobonds decreased from USD 15,383 million at the end of December 2016 to USD 14,178 million at the end of 2017 under the management of liquidity in foreign currencies and BDL's financial operations.

As a result, the share of the claims on the public sector in LBP out of total loans to the public sector stood almost unchanged at 55.6% and the share of claims in foreign currencies at 44.4% at the end of 2017 (55.7% and 44.3% consecutively at the end of 2016).

Foreign Assets

2-25
Deposits of commercial banks at correspondent banks increased to reach USD 11.8 billion at the end of 2017 against USD 11.2 billion at the end of 2016. Thus, these deposits increased by 5.2% in 2017 after a decrease of 2.7% in 2016. The share of these deposits out of total banks' assets reached 5.4% at the end of 2017, approximately similar to the share at the end of 2016. The ratio of these deposits out of total customer's deposits in foreign currencies at banks declined to 10.2% at the end of 2017 from 10.5% at the end of 2016. This decrease in the last years is attributed especially to their very low return and the preference of banks to place their liquidity in foreign currencies at the BDL, knowing that the BDL reinvests these deposits with foreign banks, which means that these deposits still carry the same levels of liquidity and risk for banks while contributing to the support of the BDL's foreign assets and reinforcing monetary stability. It is to note that BDL's foreign assets increased to USD 42 billion at the end of 2017 against USD 40.7 billion at the end of 2016.

2-26
In addition to being a main source of liquidity in foreign currency, these deposits at correspondent banks play an important role in Lebanon's financing of transactions with abroad and in management of liquidity and risks. Therefore, despite the relatively low return of these foreign placements, banks always try, while managing their resources, to ensure a minimum level of liquidity in foreign currencies at correspondent banks which helps contain any negative incidental developments and limits De-risking policy adopted sometimes by correspondent banks.

2-27
It is to note that deposits of commercial banks at correspondent banks, net of deposits of non-resident banks, decreased to USD 4.3 billion at the end of 2017 against around USD 5 billion at the end of 2016. In other terms, deposits at correspondent banks covered 1.6 times the foreign liabilities towards the non-resident banks at the end of 2017 (1.8 times at the end of 2016). It is to mention that non-resident banks that own creditor accounts in the Lebanese banking sector include subsidiaries of Lebanese banks.

2-28
On the other hand, banks' other foreign assets decreased to USD 5,626 million at the end of 2017 in comparison to USD 5,720 million at the end of 2016, thus by 1.6% after a decline of 5.6% in 2016. These assets mainly consist of direct investments in sister or affiliated banks and of investments in foreign bonds whose credit rating is at least BBB and above and subject to the control of countries classified as BBB sovereign rating and above in case they are issued by corporations. These placements generate in general a high return compared to the deposits at non-resident banks and these foreign assets represent a desired diversification of foreign placements and thus a distribution of risks.

Deposits at BDL

2-29

Deposits of commercial banks at the BDL continued to increase in 2017 reaching LBP 155,893 billion at the end of the mentioned year in comparison with LBP 134,612 billion at the end of 2016. Thus, they increased by LBP 21,281 billion in 2017 in comparison with a higher increase of LBP 28,284 billion or 26.6% in 2016. The share of these deposits out of total banks' assets increased to 47.0% at the end of 2017 from 43.7% at the end of 2016. The significant rise in 2017 is attributed to the BDL's financial operations implemented in 2017 and other procedures taken for the purpose of maintaining the monetary stability. The significant increase in 2016 is attributed particularly to the BDL's financial engineering. Deposits at BDL included required reserves in LBP and required deposits in USD, in addition to certificates of deposits in LBP and foreign currencies and other deposits. The structure of bank's placements at BDL reflected management requirements of liquidity and profitability.

III- BANKS AND RISK MANAGEMENT

3-1

The banking profession entails banks' exposure to several types of risks that are effectively managed. Lebanese banks adopt international regulatory and supervisory standards and practices of the banking industry through compliance with rules, regulations and guidelines issued by the local monetary and supervisory authorities in Lebanon and in all the countries where banks operate. These regulations stipulate the application of specific standards peculiar to the Lebanese situation, in addition to the international standards and with a margin of flexibility in the application and progressiveness in implementation, according to the needs and circumstances.

3-2

The BDL took in the last years additional precautionary measures aimed at better management of bank risks addressing specifically combating money laundering and terrorist financing and other issues in the banking profession such as the modification of the status of the Central Office of Credit Risk (Centrale des Risques) in a more strict direction, the classification of loans, distributing the principal credit portfolios, debt restructuring, lending to related parties, real estate loans, placing higher ceilings on retail loans, forming provisions and general reserves on retail loans, in the presence and even in the absence of indicators of payment delays, and forming collective provisions on interest generating loans portfolio other than retail ones, and recently, the constitution of provisions in LBP from the profits generated by the financial engineering operations carried out by BDL in 2016, the application of new minimum solvency ratios and capital conservation buffer for the period 2016-2018. For further details on measures taken in 2017, please refer to part II of this report.

Alternatively, it should be recalled that the BDL established the "Compliance Unit" at the beginning of 2016 with the aim to ensure that all departments at the BDL and also in banks and regulated institutions comply with the applicable laws and regulations especially those in relation to combating money laundering and terrorist financing and suggesting measures to prevent and/or manage the ensuing risks. The BDL had established in 2014 the "Financial Stability Unit" with one of its main functions being to observe the financial and banking situation, to look-up the potential risks and crisis and to prevent crisis occurrence.

Reputation Risk resulting from the non-application of compliance measures

3-3

Banks are seriously involved in the subject of combating money laundering and terrorist financing and with the international sanctions imposed on individuals and institutions in several countries, first by a conscious and responsible decision of banks' administrations and second, in compliance with Law No. 44/2015 and before it with Law No.318/2001 and with international standards of the banking industry and with circulars and lists issued by the monetary and supervisory authorities in order to safeguard the banking sector, the savings of the Lebanese, and to protect the Lebanese economy. Banks have developed in this domain throughout the last few years effective policies and systems, which made them gain credibility in the international financial markets and continue vigorously their commitment to AML/CFT and KYC rules. Bank management is seriously emphasizing the attendance of its employees on a permanent and intensive basis training seminars and workshops. These seminars cover laws, systems, and also the standards and international developments concerning the subject of combating money laundering and terrorist financing, and the awareness on how to identify, freeze and report suspicious transactions, and the constant communication with the Special Investigation Commission, with the purpose of reaching higher levels of culture, technical know-how, and professionalism in the banking profession.

3-4

The legal framework for fighting money laundering and terrorist financing and tax evasion has been completed after the Parliament passed a series of financial laws in 2015 and 2016, which protect the work and practice of banks in this regard, in addition of course to the circulars and decisions of the BDL and the Special Investigation Commission SIC. These laws include: Law No.55/2016 on the Exchange of Information for Tax Purposes (replacing Law No. 43/2015), Law No. 75/2016 on cancelling bearer shares and promissory notes, Law No. 77/2016 amending article 316 of the Lebanese Penal Code related to terrorism financing, Law No. 44/2015 related to combating money laundering and terrorist financing, Law No. 42/2015 on declaring the Cross-Border Transportation of Money and Law No.53/2015 on Lebanon's adherence to United Nation's International Convention for the Suppression of the Financing of Terrorism of 1999.

3-5

The BDL took also intensive and important measures in the last years to fight money laundering and terrorist financing out of which we mention the issuance of circular no 126/2012 on the relation of banks with the correspondents, and circular no. 128/2013 related to the establishment of the compliance department, and also issuing in September 2014 intermediate circular no. 371 in which BDL asks banks, among other things, to appoint an AML/CFT Branch Officer, a person in charge of controlling the financial and banking operations to combat money laundering and terrorist financing in each branch of the bank. Through intermediate circular no. 393 issued in June 2015, banks were asked to establish an effective internal control system to combat money laundering and terrorist financing concerning the electronic banking and financial transactions. The BDL also issued in December 2015 basic circular no. 136 concerning the application of the UN Security Council resolutions no. 1267 (1999), 1988 (2011), 1989 (2011), and any related successor resolutions. Through intermediate circular no. 411/2016, the BDL prohibited banks from dealing with companies whose stocks are issued in bearer form. In April 2016, the BDL prohibited banks from issuing prepaid cards that are not linked to a bank account. The Central Bank also issued in May 2016 basic circular no. 137 on dealing with the US Act of December 18, 2015 and with its implementing regulations regarding the prevention of access by Hizballah to international financial and other institutions. The BDL also modified through intermediate circular no. 421 issued in May 2016 the "Regulations on the Control of Financial and Banking Operations for Fighting Money Laundering and Terrorist Financing", incorporated in the basic circular no. 83/2001, as it added from among many things, some types of institutions (such as specialized lending entities "comptoirs") and Non-Profit Organizations (NPOs) on the list of high risk entities, as well as asking for the establishment of an AML/CFT board committee. In August 2016, before the parliament passed Law 55/2016 on the exchange of information for tax purposes, the Banque du Liban issued basic circular No 138, under which banks were required to take all appropriate measures to provide the Special Investigation Commission SIC with the information that may be required by foreign authorities within the tax information exchange framework, in compliance with the recommendations issued by the Global Forum on Transparency and Exchange of Information for Tax Purposes and by OECD. BDL issued in August 2016 as well intermediate circular No. 431, requesting banks to provide the Compliance Unit at the central bank with detailed organizational chart, the work rules and work program of the compliance department at banks and the curriculum vitae of key employees in that department. In July 2017, the Central Bank issued basic circular No 139 relating to the Common Reporting Standard (CRS) in order to help and guide the banks in implementing the provisions of Law 55/2016.

3-6

In the same framework, and by a decision of the Committee on Compliance and Anti-Money Laundering at ABL, several "Compliance General Meetings" were held in 2017[1] for the directors of compliance departments in banks. Various subjects were discussed and coordinated, in their last meetings, related to the scope of work of the compliance department out of which, for example, the De Risking and correspondent banking relationships, the visits of ABL delegations to international financial capitals, the compliance with the international laws and requirements, the automatic exchange of information and the preparations and readiness of banks in this regard, the latest developments related to sanctions, where the trend is towards further tightening, in addition to other subjects.

In its ongoing effort to raise awareness and to support medium and small banks, the Association of Banks asked Deloitte to develop a manual on the common reporting standard CRS which was distributed to banks in February 2017. The ABL had previously distributed to banks several important guidance manuals, of which the Generic Policy and Procedures Manual on Sanctions and Embargoes Program (2015), the Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) Generic Policies and Procedures Manual (2013), and Generic FATCA Policy Manual (2013).

The ABL and Lebanese banks continued their regular external moves in 2017 aimed especially at the USA and a number of European countries with special importance to the banking sector. Meetings were held with high level public officials and bankers, in particular with the directors of compliance departments, to reinforce the reputation of the Lebanese banking sector and its image abroad and to preserve, even strengthen, the relationship with correspondent banks and avoid De Risking to remain a part of the international financial system, for the benefit of the customers, the banking sector and the Lebanese economy.

1 For the fifth consecutive year.

Solvency Risk

3-7

Banks pay special attention to the subject of risks related to weak solvency or to the insufficient capital to cover all types of risk inherent in the daily commercial operations of the bank. Banks always seek to reinforce their solvency and capital base not only for the purpose of facing the many risks, covering possible losses, and the compliance with related local and international standards, but also to preserve the high financial strength to support the requirements of growth and expansion in the existing and potential activities and in the financial markets, in addition to protecting the funds of depositors, other lenders and investors in the banks. The process of evaluating and following the sufficiency of capital is in line with the policies and procedures established by the banks' administrations and based on the rules, ratios and measures imposed by the local supervisory authorities, and as such based on the provisions of the circulars on capital adequacy especially BDL's basic circular no. 44 and its amendments. The size of capital required at all times and conditions is thus matched with the Risk Weighted Assets and Off-Balance sheet commitments in particular credit risk, market risk, operational risk, as it is practiced in the international banking industry and based on international standards.

3-8

In general, Lebanese banks adopt the Standardized Approach in measuring credit risk weighted assets, and the Standardized Measurement Method in evaluating market risk weighted assets, and the Basic Indicator Approach in measuring operational risk. In order to meet the requirements of capital adequacy based on Basel 3, the BDL set in 2011 a minimum level of capital to risk weighted assets to be gradually achieved by the end of 2015 (Common Equity Tier 1 Ratio should be no less than 8%, Tier 1 capital ratio should be no less than 10%, and Total Capital Ratio should be no less than 12%.These ratios include a capital conservation buffer that is to reach 2.5% of risk weighted assets by the end of 2015). In September 2016, the BDL requested banks to comply with the new minimum solvency ratios for the period 2016-2018 as follows:

- The Common Equity Tier 1 Ratio should be no less than 8.5% at the end of 2016, 9% at the end of 2017 and 10% at the end of 2018.
- The Tier 1 Capital Ratio should be no less than 11% at the end of 2016, 12% at the end of 2017 and 13% at the end of 2018.
- The Total Capital Ratio should be no less than 14% at the end of 2016, 14.5% at the end of 2017 and 15% at the end of 2018, knowing that the Basel 3 accord stipulates a period ending in 2019 to reach the ratio of 10.5%.
- The above ratios include a Capital Conservation Buffer set to reach 4.5% of risk weighted assets at the end of 2018.

3-9

In fact, the Lebanese banking sector reached the targeted solvency ratios. According to the monetary and supervisory authorities, the solvency ratio (Total Capital/Risk Weighted Assets) was around 15.8% at the end of September 2017, based on Basel 3 standard. The Lebanese banking sector did not face difficulties related to the implementation of Basel 3 as it attempted in the last previous years to strengthen its Tier 1 Capital by retaining part of the profits in capital and through the issuance of shares. Furthermore, the banking sector always goes in pair with new international regulations and measures which became stricter with the increase in the level of quality and transparency in the capital base and the enhancement of the level of risk coverage and the control of the excess borrowing, or the ratio of debt to bank sources of funds and other subjects. It is also to note that the Basel Committee leaves to the local monetary authorities an important margin to assess what is appropriate to the local market.

It should be noted in this context that strengthening the capital base of banks was one of the objectives of the financial operations undertaken by the central bank of Lebanon in 2016, in order to enable banks to comply with the new international standards and thus continue to finance the economy and to back up BDL's reserves. Therefore, the central bank has requested banks to allocate the surplus resulting from these transactions in the capital accounts, which enable banks to meet IFRS 9 requirements that came into effect at the beginning of 2018 and to reach the BDL targeted capital adequacy ratios detailed above.

Credit Risk

3-10

In line with the international guidelines on Compliance and Corporate Governance, banks operating in Lebanon determine the level of their credit risk appetite and credit risk limits through their boards of directors that inform in their turn the specialized committees and directorates about this subject to set policies and take procedural measures commensurate with their decisions and stated goals. Banks try to control or limit credit risk by placing limits or maximum ceilings on the size of risks they are willing to accept be it in relation to counterparties or the industry and geographic concentration as well as monitoring and following up the degree of risk exposures and its suitability or conformity with the limits that have been set. In fact, there are ceilings placed for placements at banking or financial institutions and in financial instruments with high credit rating, and for exposure to sovereign risk, in addition to the restrictions applied on loans and advances to customers including for example restrictions concerning the country, the economic sector, the terms, the credit rating, the guarantors to avoid concentration risk.

3-11

Banks try to limit credit risks related to loans and advances granted to customers, through a series of adopted measures that address the initiation of the loan, the formation of the credit file, the provision of necessary documents, guarantees and collaterals, the follow-up, the periodic classification of loans based on the instructions of the monetary and supervisory authorities, and by constituting the necessary provisions against loans according to their classification, so that bad loans are fully provisioned and recorded off-balance sheet. Banks are also committed to the precautionary standards pertaining to loans to one borrower and those granted to related parties- individuals and companies. Additionally, bank management insists that large institutions and large borrowers provide audited balance-sheets, on one hand, and adequate guarantees, on the other. Granting credit facilities is the beginning of joint work between bank branches and the concerned divisions, departments, and units in the head office where credit analysis is performed on the creditworthiness of the borrower and his ability to repay, and the feasibility study of projects. The credit risk management division reviews the file and conducts credit analysis independently and prepares a written opinion of the risks associated with the credit facilities that were studied and submits it to the concerned credit committees. Credit committees are responsible for approving the facilities up to the level specified for them. Banks have different levels of authorities or parties trusted with approving loan application, and this depends on the nature and size of requested facilities and designated ceilings. Thus, approving the loan may be confined to the approval of credit committees or may be subject to the executive committees or to the boards of directors.

3-12

Credit risks associated with the performance of the Lebanese economy remained in general and to a large extent under control despite the weak economic growth in the last few years. Under these circumstances, the ratio of doubtful debts/ total loans increased slightly to 3.86% at the end of 2017 against 3.58% at the end of 2016, - level considered acceptable when compared to the sector averages in the MENA region and low when compared to the sector averages in emerging markets - and the provisions on doubtful debts (provisions/ doubtful debts) decreased to 60.9% against 66.2% during the two mentioned years respectively.

On the other hand, bank sovereign risk exposure increased in 2017, where the share of banks' loans to the public sector and deposits at the BDL reached 61.6% of total placements at the end of the mentioned year, against 60.7% at the end of 2016. It is worth indicating that a relatively large part (more than 45%) of placements with the public sector and the BDL is in LBP practically negating default risk. As for placements in foreign currencies, they are invested for a large part at the BDL, which re-invests such placements abroad in low-risk and highly liquid instruments that may be similar to the structure of banks' assets abroad. Moreover, the sovereign rating of Lebanon did not witness a major decline in 2017 except that "Moody's" downgraded in August 2017 Lebanon's credit rating from B2 to B3, with a stable outlook, whereas "Fitch" affirmed in February 2017, September 2017 and February 2018 Lebanon's credit rating and maintained the stable outlook, and "Standard and Poor's" affirmed in March 2017, September 2017 and March 2018 Lebanon's sovereign credit ratings and kept the outlook stable.

Interest Rate Risk

3-13

There were no important negative developments concerning interest rate risk in 2017, although interest rates on LBP deposits have risen since November 2017, as well on USD deposits, albeit to a lesser extent. This trend was linked to the rise in US interest rates and the measures taken to contain the November political crisis. The risks related to interest rate fluctuations are considered under control regarding banks' loans to the private sector, as they are variable rate loans by nature in a large part. Therefore, interest rates applied on these loans are being periodically reviewed in line, to a large extent, with the period of revision of interest rates applied on deposits. However, the situation is not the same for loans granted to the public sector and for banks' holdings of CDs at the Central Bank, since their maturities are relatively longer with fixed rather than variable interest rates. The weighted life, for example, was around 4 years for the Treasury bills portfolio in LBP at the end of 2017 and around 7 years for the Eurobonds portfolio, making the maturity gap between liabilities and placements very large.

It is noteworthy that, firstly, the rise in interest rates on long-term deposits in LBP whose maturity has been extended was borne by the BDL and not by banks, as indicated in the first part of this report. This also applies on the interest rates rise on USD deposits. Secondly, banks have high primary liquidity levels in foreign currencies, and the interest paid on deposits in LBP is in general related to the return on Treasury bills in LBP, not the opposite. Moreover, the yield on long-term Treasury bills, CDs and placements at the central bank takes into account these risks, i.e. interest rates fluctuations, in addition to the fact that Treasury bills and CDs are marketable and relatively liquid, unlike the loans to the private sector. All these factors tend to limit these risks. While the risks associated with a further increase in interest rates on the USD may exist in the future with the possibility of an interest rate rise by the US Federal Reserve, its impacts on the cost of banks' sources of funds and interest margin will remain, to a large extent, limited as interest rate increases will gradually take place over many years so that this policy does not negatively affect the already weak growth rates in the USA. It is to note that the Federal Reserve Bank increased its benchmark interest rate by 25 basis points in March and June and December 2017. The Fed hiked US interest rates by another 25 basis points in March 2018.

Exchange Rate Risk

3-14

Exchange rate risks remained to a large extent under control in 2017 as there were no new developments regarding the commitment of the government and BDL to the policy of fixing the exchange rate of the LBP per USD and the availability of sufficient means for that, despite the fact that the national currency has experienced temporary pressures following the sudden political crisis in early November 2017, which the central bank was able to contain quickly in cooperation with banks (for more details, please refer to section one). After the sizeable financial operation carried out in 2016 and 2017, the BDL has been able to shore up its foreign currency reserves to USD 35.8 billion at the end of 2017 which covers 22 months of imports and the equivalent of 68.2% of the monetary aggregate in LBP (M2) and 25.9% of the broad monetary aggregate (M3). Exchange rate risk remained also low in terms of the structure of exchange positions in banks' balance-sheets given the related BDL's circulars. For the record, banks are strictly not authorized to take net, short or long, trading positions that exceed 1% of the net Tier One capital. At the same time, banks' global foreign exchange position should not exceed 40% of the net Tier One Capital.

Operational Risk

3-15

Banks operating in Lebanon adopt a set of policies and procedures in managing operational risks related to a sudden interruption in working systems, or to human and administrative errors in achieving required duties, or to fraudulent operations, or to the exposure to external events such as natural disasters, strikes, demonstrations or others which could cause a damage to the reputation of the bank, or could have legal or organizational impacts, or could lead to a financial loss. There is an operational risk management framework subject to annual audit based on required supervision and in line with the practices of the international banking industry, and also an independent team to manage these operational risks whose main duty is to apply the contents of the mentioned framework, in coordination and cooperation with other units in the bank such as internal audit, or the corporate information security and business continuity. The framework for managing the operational risk includes principles tested on the ground such as the Redundancy of Mission Critical Systems, Segregation of Duties, Application of Strict Authorization Procedures, Daily Reconciliation, in addition to managing operational risks at the practical level, and other principals or directives. Insurance coverage is used as an External Mitigant to limit risks in accordance with the size and characteristic of the activity. Banks operating in Lebanon apply in general the Basic Indicator Approach for calculating the required capital for operational risk, thus complying with the Standardized Approach of Basel 2 accord on capital adequacy.

Liquidity Risk

3-16

The Lebanese banking sector enjoys adequate liquidity levels, whether in LBP or in foreign currencies, which keep the liquidity risk under control to a great extent. Banks have adopted for many years a strategy of maintaining a floor level of liquidity in LBP and particularly in foreign currencies in order to reinforce the confidence in the banking sector in general, and to have recourse to it in the event of any negative development that need to be dealt with quickly, such as the sudden political crisis in early November 2017, where the comfortable liquidity of banks in foreign currencies played a key role in coping with the crisis. This strategy has proven its efficiency in overcoming many crises, has strengthened confidence in the sector and has contributed to maintaining monetary stability. The ratio of overall liquidity in LBP and foreign currencies, i.e. reserves and portfolio of Treasury bills in LBP and FC of less than one year maturity and foreign assets, excluding claims on the non-resident private sector, increased to around 69% of total deposits and other liabilities at the end of 2017, against around 66% at the end of 2016. This ratio is the highest in the region in comparison with the average ratio of reserves and foreign assets over total assets for the Arab banking sector standing at around 30%. Moreover, the ratio of primary liquidity in foreign currencies or deposits at BDL and at banks abroad reached around 60% of total deposits and other liabilities in foreign currencies, knowing that such a high level is considered necessary for good management of deposits in foreign currencies in a dollarized economy and in the absence of a lender of last resort in foreign currencies.