04

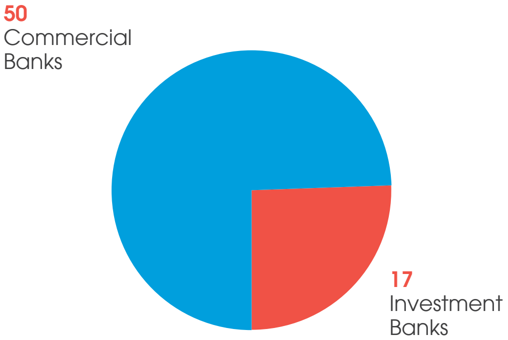
PART IV
THE LEBANESE BANKING SECTOR IN 2016

I. INTRODUCTION

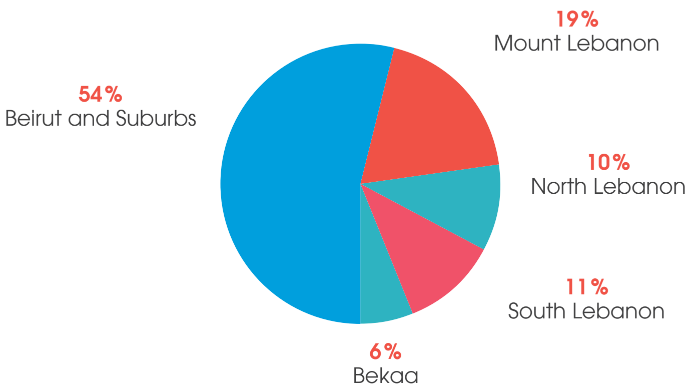
1-1 At the end of 2016, the number of banks operating in Lebanon reached 67 distributed between 50 commercial banks and 17 investment banks. During the mentioned year, the official list of banks was amended by removing each of Al-Ahli International Bank S.A.L. and Bank of Pharaon & Chiha from the list following the merger of the latter with Byblos Bank S.A.L. Also, Near East Commercial Bank merged with BIT Bank to become Bank Saradar S.A.L. It's expected that BLOM Bank Acquisition to HSBC branches in Lebanon will be accomplished during 2017. Difficult operational conditions, pressure on profitability, rising cost of compliance with international laws and capital requirements, and other factors push in the direction of reducing foreign banking presence in Lebanon and the merger of some small and medium-sized Lebanese banks. Bank consolidation would reinforce the sector's stability, enhance its immunity and profitability and improve efficiency and productivity.

1-2 At the end of 2016, commercial banks operating in Lebanon were distributed as follows: 32 Lebanese banks S.A.L. with majority Lebanese control, 7 banks S.A.L. with Arab control owning large shares in Lebanese banks with Lebanese administration, 7 branches for Arab commercial banks and 4 branches for foreign commercial banks. Among commercial banks, five are listed as Islamic banks and a few number as private banks to classify the others as universal banks, that provide clients with retail and corporate banking, foreign exchange & financial markets services, insurance services and others. There are also 12 foreign banks representative offices in Lebanon. Banks operating in Lebanon have correspondence relationships with 183 banks in 82 cities around the world facilitating financial transactions with other countries and vice-versa.

Lebanese Banking Sector Structure end 2016



Geographical Distribution of Commercial Banks branches end 2016



Source: BDL

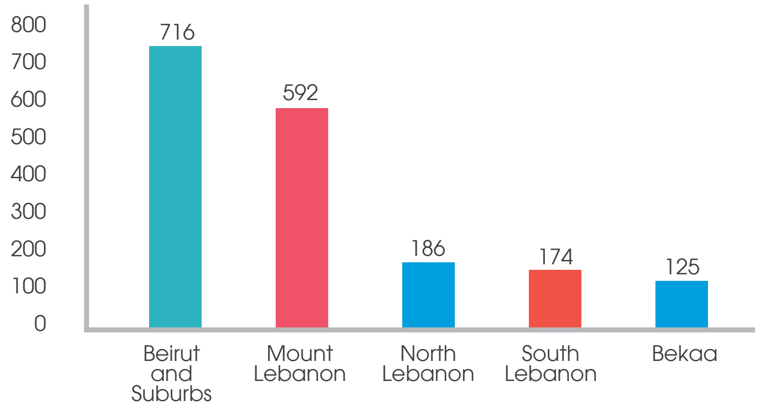
1-3 Lebanese Banks try to balance between external and internal expansion, financing the portfolios and risk management, taking into account regional geopolitical trends and political and economic situation in Lebanon. The strategy of some banks resides on horizontal expansion in Lebanon, in the region and in West Africa, in addition to selected markets that show growth opportunities. In order to strengthen their role in enhancing financial inclusion and facilitating Lebanese individuals dealing with banks, the network of banks in Lebanon reached at the end of 2016 1,078 branches, out of which 1,056 for commercial banks.

1-4 Concerning the banks' presence abroad, and according to the latest available data, there exist 18 Lebanese banks in 32 countries in the world. This presence takes several legal forms distributed over 20 representative offices, 71 direct branches s.a.l., and 37 subsidiaries with 274 branches in their countries of location. The performance of the banking sector abroad remains acceptable in general, despite the presence of some banks in countries that are in trouble, knowing that their exposure to these countries remains limited. Some banks have mitigated exposure to these countries by reducing the volume of operations or the number of branches operating there. The assets of Lebanese banks operating outside Lebanon are estimated at about $ 38 billion, of which about $ 4 billion is capital. The volume of assets of Lebanese banks abroad is only 18% of the sector's total consolidated balance sheet, although it varies between each and every bank.

1-5 The Central Bank continues to keep abreast of the banking spread abroad, putting in place regulations so that banks are committed to apply the Lebanese model in their foreign operations and finance their expansion from their own resources by issuing foreign currency financial instruments. The Central Bank has issued circulars regulating the work of banks abroad (Circulars No. 447-448-449), which are measures relating to liquidity management in foreign currencies in relation with branches abroad. With global tightening supervision, the presence of Lebanese banks in industrialized and developed countries dictates the adoption of these countries' standards. In countries where the banking system is less developed than the one in Lebanon, banks have to apply the standards adopted in Lebanon; what is applied at the local bank is applied to branches of any Lebanese bank abroad, in addition to compliance with appropriate local laws.

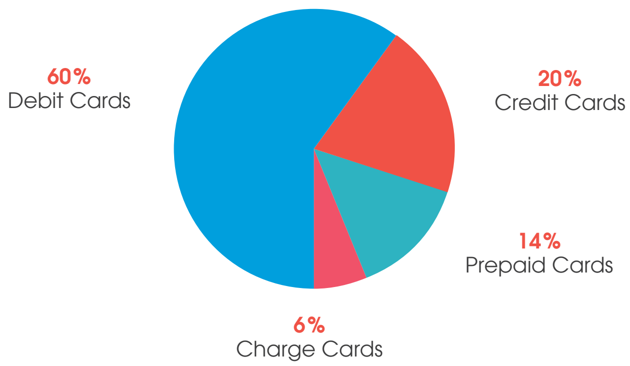
1-6 Banks are expanding vertically well in terms of modernizing and diversifying their universal banking services and products. The past few years have witnessed a major technological step in the Lebanese banking sector, where banks have developed electronic services and many of them have, in addition to their websites, mobile applications that allow transactions without having to go to the bank's branch. All is done with utmost care to ensure the safety and integrity of transactions. The number of ATMs placed at the customers' service reached 1,793 at the end of 2016. The total number of payment & credit cards in circulation was about 2.8 million cards. The Central Bank of Lebanon, in order to fight and prevent fraud, issued in 2016 two intermediate circulars No 415 and 418 that impose new restrictions on prepaid cards. Banks in Lebanon have a leading and distinctive role in the development of the digital economy through their participation in the implementation of BDL's 331 circular related to Knowledge economy.

Geographical distribution of ATMs in Lebanon end 2016



Source: BDL

Cards distribution end 2016 - %



Source: BDL

1-7 Concerning cybercrime, the Lebanese banking sector organized in 2016 and 2015 conferences and seminars aimed at raising awareness of the financial and non-financial sectors to combat cybercrime and avoid piracy. The number of cases of such operations reached, according to the Special Investigation Commission 134 in Lebanon in 2016, compared to 84 in 2015. The amounts of these operations which hit the Lebanese amounted to 12.6 and 12 million dollars in the two years respectively. "Fighting Financial Cybercrime in Lebanon" a guide issued in 2016, reviews guidelines to prevent cyber-criminal acts through e-mails and ensures the safe implementation of electronic operations. It should be noted that Lebanese banks successfully surpassed the recent piracy operation in May 2017 which took over 200,000 victims in about 150 countries in Asia and Europe. The Lebanese banking sector is adopting prudential and preventive effective measures. These include the development of anti-virus protection programs, more efficient solutions to protect Internet access sites, the activation of the latest Microsoft protection software concerning the command system. Such piracy attack would prompt banks in Lebanon to develop and update their own information security system and renewing it continuously.

1-8 In terms of social responsibility and contribution, banks in Lebanon expanded their implementation of international standards. It is expected that banks would play an important role in developing the society due to their large capabilities and the eventual social implications that can result on the Lebanese society. Some banks invest in their human resources to market a number of programs, advice customers and study the environmental impact of their investments. On the other hand, banks are seeking to enter the SWIFT SMART program, which adopts the e-learning, and would increase employee productivity and enhance the level of tracking the effectiveness of training programs in addition to reducing operational risks and costs. Proceeding from social responsibility, a number of banks have developed a leading and comprehensive vision concerning the projects related to the environment and energy consumption. Social responsibility is subject to a number of circulars issued by the Central Bank, such as circulars No. 134 and No 458, which aim at spreading a culture of transparency and introducing more customers to their rights and duties on the one hand, and at enhancing financial stability and welfare on the other. Basic Circular No. 135 on debt restructuring can also be incorporated in part under social responsibility.

1-9 In the context of serious engagement in financial globalization, Lebanese banks are subject to very strict controls and important regulatory measures for risk management by the Banque du Liban and the Banking Control Commission in accordance with the latest international standards, making the Lebanese banking sector a pioneer in their application, especially Basel Committee requirement for solvency and IFRS 9 requirements. The Bank of Lebanon has imposed on banks the constitution of important preventive provisions to the requirements of the IFRS 9 to be adopted starting 2018. The exceptional measures taken by the Banque du Liban in 2016, in coordination with banks, have helped banks to strengthen their position.

1-10 Lebanese banks renew regularly their commitment to all international financial laws, especially those related to combating money laundering, terrorist financing, risk management, good governance, the relations with correspondent banks and recently the requirements of "GATCA", to protect Lebanon from any international financial isolation and keep customers' deposits away from any sanctions despite the problems surrounding the country. In order to bolster Lebanon's anti-terrorist financing, the Lebanese parliament enacted several laws in 2016, of which law No. 77 that widened the scope of penal code article 316 bis on the terrorism financing offence, and law No. 75 abolishing the notion of bearer shares and shares to order. The parliament also approved law No. 55 on the exchange of information for tax purposes of the Organization for Economic Cooperation and Development (OECD) and law No. 74 on tax requirements for Trustees. In addition to the above, it is worth mentioning the law No. 53 on the accession of Lebanon to the UN Convention on combating Terrorism, the law No. 42 on the need to declare the cross-border transportation of money carried by any individual and the law No. 44, which relates to amendments to the law against money laundering to include new financial offenses.

1-11 Banks are committed to the amendments and adopt the circulars issued by the Banque du Liban and the ones of the Special Investigation Commission, in charge of this subject in Lebanon. They are strict regarding compliance issues, risk management and other requirements of anti-money laundering procedures and terrorism financing and Know Your Client (KYC). Banks also secure the necessary and efficient human resources for compliance services, adopt specialized global software programs, and seek permanently to strengthen relationships with correspondent banks, particularly the US ones, for the reason that most of the Lebanese banking sector transactions with abroad and the financing of Lebanon's foreign trade and remittances of the Lebanese are in US dollars and through correspondent accounts with banks in New York.

In this context, the Banque du Liban issued in 2016, basic circular No 138 and intermediate circular No 411, which prohibit any operation with bearer share companies and gave institutions two years to settle their situation. The BDL also issued the basic circular No. 137 concerning the rules of dealing with US law and its implementing regulations on preventing Hizbullah's access to foreign financial institutions and other institutions (it was complemented with SIC circular No 20), and the basic circular No 2 regulating the activities of specialized lending entities known as "Comptoirs". In addition, in May 2016, The BDL issued intermediate circular No 421 requiring banks to create a board level AML/CFT committee to be headed by an independent board member. This is in addition to the basic and intermediate circulars issued in previous years relating to AML / CFT issues to ensure compliance with international standards and to strengthen the regulatory framework. These include the amendment of the financial and banking control system to combat money laundering and terrorist financing to avoid banks the risk of non-compliance, and consequently reassure correspondent banks.

Special Investigation Commission (SIC) report in 2016

The Special Investigation Commission dealt with the Lebanese Customs to develop a mechanism to implement the law on the cross-border transportation of money to be adopted by the Higher Council of Customs. The Commission's cooperation with the Banque du Liban, the Association of Banks and the Internal Security Forces resulted in the issuance of the cybercrime prevention guidance.

In 2016, the SIC received 470 cases: 107 from foreign sources and 363 from local sources, 161 cases were forwarded to the General prosecutor and/or requesting authorities. The Commission handled also 514 spontaneous disclosures. Also, its mission covered risk based onsite compliance examinations at 22 banks, 14 financial institutions, 22 insurance companies and other reporting entities.

The Commission received several cases (excluding 29 custom cross border cash cases and 14 banking control commission administrative assistance cases). The cases received were distributed among embezzlement of private funds (32.8%), forgery (14.8%), terrorism or terrorist financing (10.8%), fraud (4.2%), trade of narcotics (3.0%), corruption (2.8%), tax evasion (2.1%), human trafficking & insider trading & smuggling (0.7% for each), kidnapping & organized crimes (0.5% for each), environmental crimes (0.2%) and not specified cases (26.2%).

The geographical distribution of STR was in 2016 as follows: Beirut (60.4%), Mount Lebanon (23.5%), South Lebanon (7.3%), Bekaa (5.4%) and North Lebanon (3.4%).

The SIC decided to freeze accounts and lift banking secrecy in 42 cases that were forwarded to the general prosecutor, 37 from local sources and 5 from foreign sources.

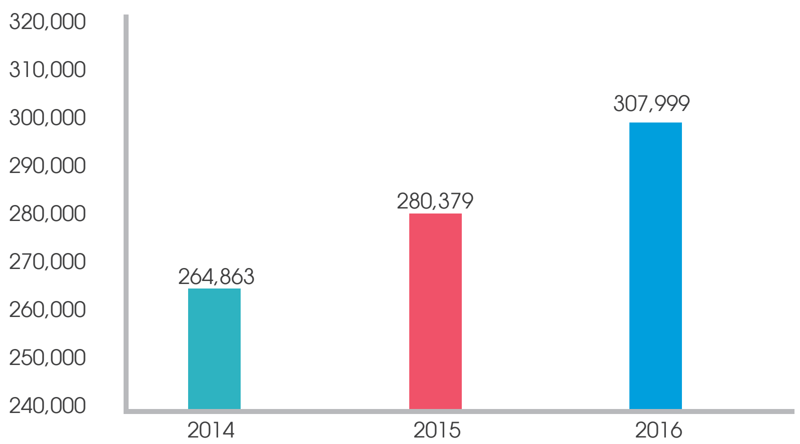
II. BANKING ACTIVITY

2-1 The Lebanese banking sector activity improved in 2016, and contrary to the two previous years, it didn't register a slowdown, but returned to growth levels realized during 2011-2013, due firstly to the recent financial engineering of the BDL, secondly to the improvement of internal political situation, notably the election of a president of the Lebanese Republic following two years and a half of void, and the enhancing of institutional work through a new government of national unity which gives confidence to the consumer as well the investor.

2-2 The immunity of the banking sector remained strong, and is reflected in several indicators positioning it in a comfortable situation to meet customers' needs while keeping a good margin of bank liquidity. The banking sector's strengths rely on the confidence of investors and depositors, resident and non-resident, in its quality and robustness, on one hand, and the comparative advantages that it enjoys through its conservative policy and the deep experience facing the challenges, on the other. During the era of political, security and economic crises, the banking sector maintained the solid trust of the customers and acquired appraisal of the international financial and banking institutions.

2-3 At the end of 2016, total assets of commercial banks operating in Lebanon reached LBP 307,999 billion (the equivalent of USD 204.3 billion) compared to LBP 280,379 billion (USD 186 billion) at the end of 2015. Hence, total assets rose by 9.9% in 2016 compared to a 5.9% growth in 2015.The growth in 2016 is mainly attributed to recent swap operations conducted by the BDL.

Total Assets/Liabilities of commercial banks operating in Lebanon End of period- Billion LBP



Source: BDL

2-4 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 2014 and 2016 show a decrease in resident private sector deposits share (from 65.0% to 62.9%) and non-resident share (from 17.2% to 16.6%) compared to an increase in "other liabilities" share (from 3.7% to 6.5% respectively) due to the financial engineering transactions[1], knowing that "other liabilities" item includes 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 %)

	2014		2015		2016	
	Value	%	Value	%	Value	%
Resident private sector deposits	172,041	65.0	180,489	64.4	193,765	62.9
Public sector deposits	4,842	1.8	5,074	1.8	5,956	1.9
Non-resident private sector deposits	45,680	17.2	48,026	17.1	51,196	16.6
Non-resident financial sector deposits	8,795	3.3	9,864	3.5	9,467	3.1
Capital accounts	23,719	9.0	25,131	9.0	27,497	8.9
Other liabilities	9,786	3.7	11,795	4.2	20,118	6.5
Total	**264,863**	**100.0**	**280,379**	**100.0**	**307,999**	**100.0**

Source: BDL

2-5 Total deposits remain the primary source for the activity of commercial banks operating in Lebanon representing 81.5% of total liabilities at the end of 2016 (83.3% at the end of 2015) and maintaining the highest share on the liabilities side. In addition to deposits, banks include their own resources represented in capital accounts and other resources from 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 in its public and private sectors. Banks also seek to increase their medium and long-term resources through the issuance of certificates of deposits, preferred shares and subordinated debt

[1] See paragraph 4 in section I of this report for details about the financial engineering operations.

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.

Deposits

2-6 At the end of 2016, 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 250,918 billion (the equivalent of USD 166.4 billion), in comparison to LBP 233,589 billion (USD 154.95 billion) at the end of 2015. So these deposits increased by 7.4% in 2016 following a lower increase of 5.0% in 2015. In fact, banks made great efforts and succeeded to attract new deposits from abroad in the framework of the recent financial engineering of the Banque du Liban. It is known that the banking sector effectively attracts deposits from abroad reflecting the important role of the Lebanese diaspora, as the inflow of capital and investments of expatriates working outside represent a fundamental pillar for the banking sector and the economy as a whole, in addition to the social dimension of the financial support to the Lebanese households.

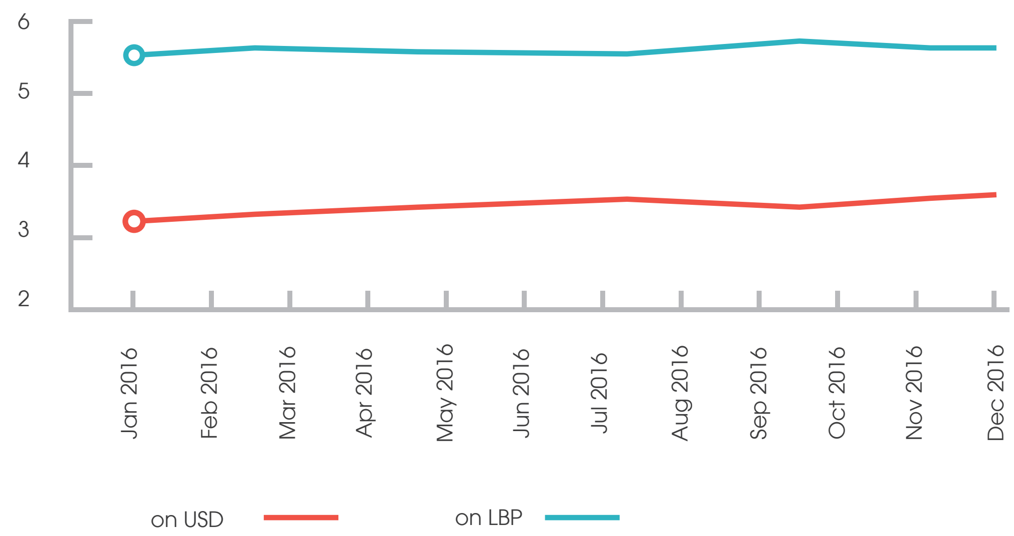
2-7 At the end of 2016, the share of the resident private sector represented 77.2% out of total deposits, compared to 20.4% and 2.4% for non-resident private sector and public sector shares respectively. It should be noted that deposits include certificates of deposits issued by banks that amounted to USD 500 million at the end of 2016, without any change compared to end 2015. The majority of bank deposits are saving accounts (more than 80%) and short-term (less than 90 days). One more time, the deposits growth resulted from resident deposits increase representing 76.6% of the total growth in deposits similar to the preceding year. In another context, total deposits were distributed between 35.7% in LBP and 64.3% in FC at the end of 2016 (36.5% and 63.5% respectively at the end of 2015). The dollarization rate of the private sector deposits slightly increased to 65.8% at end 2016 from 64.9% at end 2015.

2-8 Bank deposits are concentrated in Beirut and its suburbs which attracted 69.4% of total deposits at the end of 2016, allocated to 48.0% of the total number of depositors, whereas 30.6% of the deposits belong to other regions and allocated to 52% of depositors, indicating a difference in the average deposit value between Beirut & its suburbs and the other regions.

2-9 In parallel to the stability of interest rates on Treasury-bills in 2016 as in the previous year, the average interest rate on new or renewed deposits in LBP remained quasi-stable at 5.56% compared to 5.58% in 2015, while the average interest rate on new or renewed deposits in USD increased to 3.34% from 3.16% in the two periods respectively.This may be due in part to the global increase in USD interest rate: the

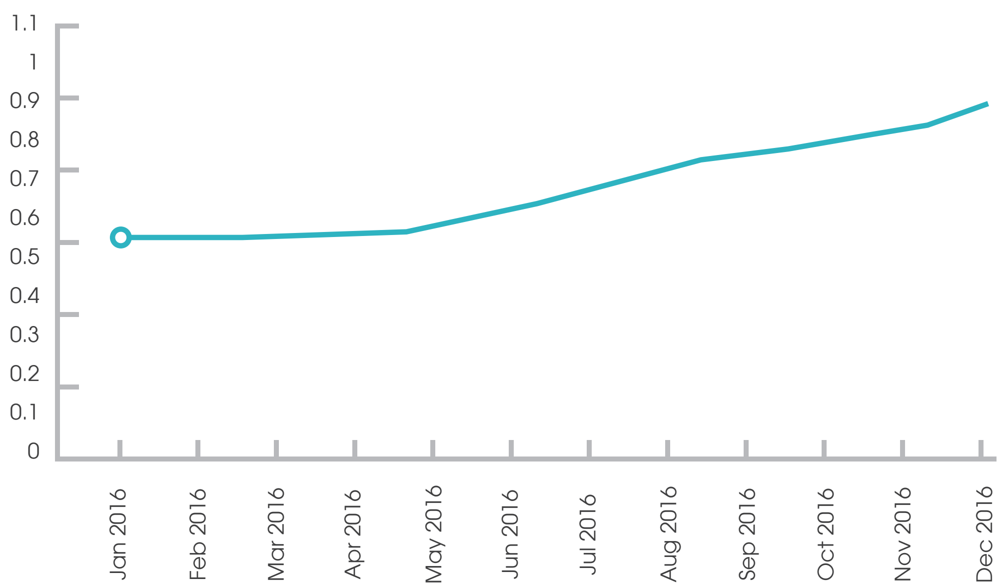
Federal Reserve raised its benchmark interest rate by a quarter percentage point in December 2015, and raised it again by the same percent in December 2016. The recent financial engineering has encouraged as well USD deposits and has had an impact on foreign currency liquidity.

Deposit interest rates in Beirut Market (%)



Source: BDL

Libor 3 Month on USD (%)

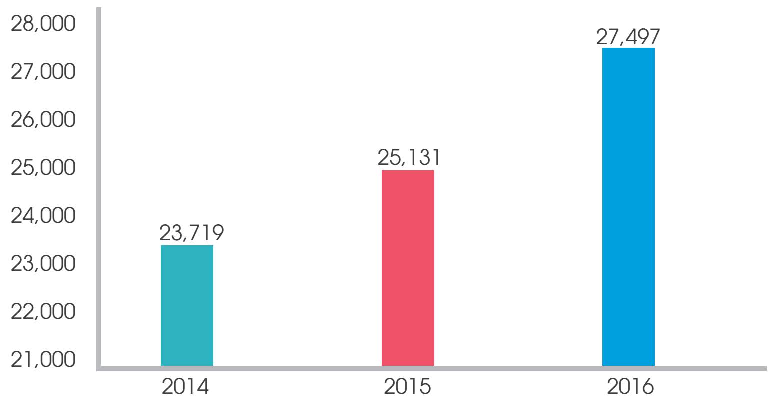


Source: BDL

Capital Accounts

2-10 | Capital accounts of commercial banks operating in Lebanon continued to increase, reaching LBP 27,497 billion (the equivalent of USD 18.2 billion) at the end of 2016 from LBP 25,131 billion (the equivalent of USD 16.7 billion) at the end of 2015 registering an increase of 9.4% in 2016 in comparison to 6% in 2015. At the end of December 2016, capital accounts represented 8.9% of the consolidated balance sheet (around 9% at the end of 2015) and 31.9% of the total claims on private sector (30.7% at the end of 2015). These ratios are considered good compared to their similar in numerous European advanced countries banking sectors. In addition to attracting deposits which provide the financing needs of the public and private sectors, the financial sector has also 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.

Capital Accounts in the Commercial Banks
end of period- billion LBP



Source: BDL

2-11 | 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. Enlarging the size of capital is a must for banks whose capital is formed 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 the increase in the size of capital even at the expense of redistributing profits, which enhances capital adequacy, the liquidity of traded shares, transparency, and the solid financial position of the bank and the whole sector. This is supervised by the BDL and the Banking Control Commission.

2-12 The supplementary capital, which includes subordinated bonds and some types of preferred shares, remains low compared to the core capital, as it represented 6.7% of capital accounts at the end of 2016 (7.3% at the end of 2015). 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 banking supervision 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.

Placements of the Banking Sector

2-13 The structure of commercial banks uses of funds witnessed major changes at the end of 2016 in comparison to the end of the year 2014. The share of deposits at BDL continued its ascending trend to reach 43.7% out of total placements at the end of 2016 from 36.1% at the end of 2014. In return, the share of loans to the public sector continued its decline to reach 17.0% at the end of 2016 compared to 21.3% at the end of 2014. The share of foreign assets continued to decline to reach 11.3% compared to 13.8% in the two mentioned periods respectively, and the share of loans to the resident private sector decreased a little from 25.8% at the end of 2014 to 25.0% at the end of 2016.

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 2014 and 2016.

Commercial Banks' Assets at the end of period (Billion LBP and %)

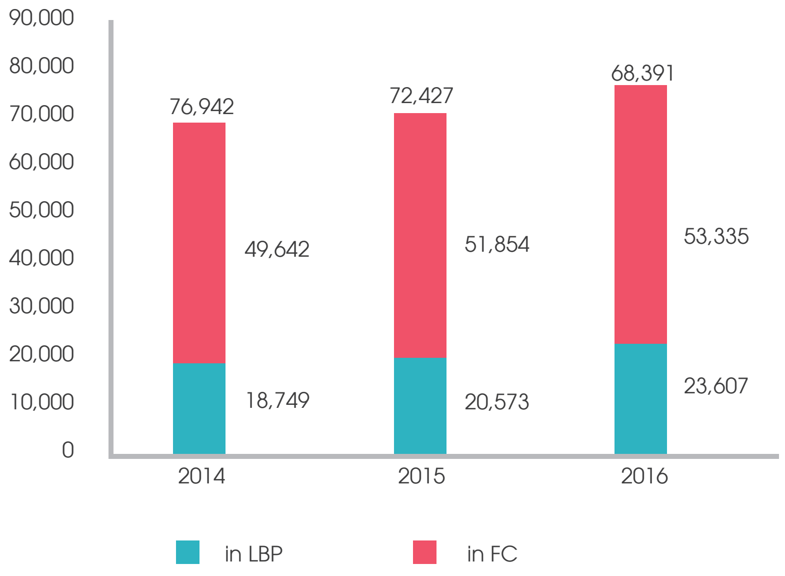
	2014		2015		2016	
	Value	%	Value	%	Value	%
Reserves	**96,314**	**36.4**	**107,021**	**38.2**	**135,305**	**43.9**
o/w : deposits with BDL	95,707	36.1	106,329	37.9	134,612	43.7
Claims on the resident private sector	**68,391**	**25.8**	**72,427**	**25.8**	**76,943**	**25.0**
Claims on the public sector	**56,308**	**21.3**	**56,984**	**20.3**	**52,344**	**17.0**
Foreign assets	**36,470**	**13.8**	**35,870**	**12.8**	**34,824**	**11.3**
o/w : claims on NR financial sector	18,342	6.9	17,422	6.2	16,945	5.5
claims on NR private sector	8,339	3.1	9,316	3.3	9,256	3.0
Fixed assets & Non-classified assets	**7,380**	**2.8**	**8,077**	**2.9**	**8,583**	**2.8**
Total	**264,863**	**100.0**	**280,379**	**100.0**	**307,999**	**100.0**

Source: BDL

Claims on Private Sector

2-14 In 2016, bank loans to the resident and non-resident private sectors continued to increase, reaching LBP 86,198 billion at the end of December 2016, against approximately LBP 81,744 billion at the end of 2015. However, its growth has slowed down in general in the last 5 years reflecting the weak economic growth in Lebanon, reaching 5.4% in 2016 in comparison to 6.5% in 2015, while the growth rate of these 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 10.7% of the total loans granted to the private sector at the end of 2016 against 11.4% at the end of 2015.

Total claims on resident private sector end of period- billion LBP



2-15 Banks continued 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 101% of GDP at the end of 2016, 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.

2-16 On the other hand, the ratio of loans in foreign currencies to deposits in foreign currencies decreased to 38.8% at the end of December 2016 from 41.3% at the end of December 2015. However, loans in LBP to deposits in LBP continued to increase reaching around 28.2% at the end of 2016 against 25.6% at the end of 2015. Lebanon's ratio of loans to deposits remains low, given the high liquidity levels of the Lebanese banking sector and the large size of domestic savings (resident and non-resident) in comparison to the absorptive capacity of the Lebanese economy.

2-17 With the increase of loans in LBP by 14.7% in 2016 and 9.7% in 2015, or at a faster rate than the increase of loans in FC, which reached 2.3% and 5.5% in the two respective years, the loan dollarization rate decreased to 72.6% at the end of 2016, against 74.8% at the end of 2015. The decrease in loan dollarization rate during the last few years, precisely since 2009, was the result of incentives provided by the BDL for specific 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). It is expected that loans in LBP will also witness an increase in 2017 due to the banks' marketing of several products in LBP given the high liquidity levels in local currency prompted by the last BDL's Financial Engineering.

2-18 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 that included most of the economic sectors, particularly the housing sector. 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. With this initiative, the BDL placed in 2013 USD 1.4 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 BDL also specified the benefit structure of this mechanism to economic activities, in addition to a lending rate ceiling of 5%. Banks responded so well to the program that the BDL placed in early 2014 an additional amount of USD 800 million to be lent through this mechanism for further economic incentives and repeated the initiative one more time allocating a sum of USD 1.0 billion in each of both years 2015 and 2016 and is planning on providing a sum of USD 1.0 billion in 2017. These initiatives target the sectors of housing, education, environment, alternative energy, entrepreneurship, Research and Development, and the new productive and investment projects. The second incentive program is represented by intermediate circular 331/2013 concerning the **knowledge economy** as this sector represents an engine for future growth. This circular allows banks and financial institutions to contribute within the limits of 3% of bank's capital 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. The purpose of this circular is to activate the procedures of establishing new promising companies that in the future could turn into companies capable of enriching the national wealth and creating new jobs. Capitalizing through partnerships and participations to capital is a new mission allowing banks to support the intellectual competencies and professional inventions that fit into the framework of the knowledge economy. In 2016, basic circular 23 was amended through intermediate circular no. 419 so that it is not possible for the total contributions of any bank in "companies" to exceed 4% of its capital, and for its contribution in any of the companies whose purpose is confined to the contribution in capital (Venture capital) "start-up companies" not to exceed 20% of this percentage 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 330 million in the knowledge economy till the end of June 2016, of which USD 291 million invested in Venture Capital, USD 29.5 million invested in accelerators and incubators, and USD 9.7 million invested directly in start-up companies. The third pillar consists of **extending the maturity of subsidized loans to the productive sectors,** including tourism, from 7 to 10 years[1], based on circular 335/2013.

[1] Than to 13 years according to circular 400/2015, and lately to 19 years according to circular 465/2017

Subsidized loans and loans benefiting from deduction in reserve requirements (End of period – billion LBP)

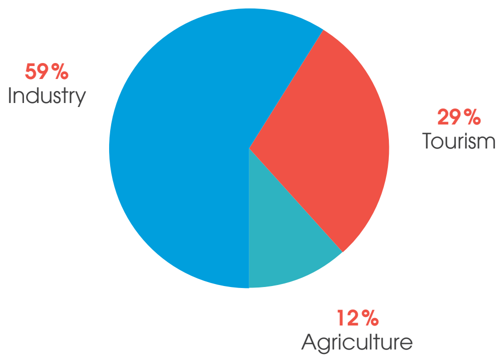
	2014	2015	2016
1- Subsidized -interest medium & long term loans	6,656	7,250	7,902
2- Subsidized-interest loans guaranteed by Kafalat	1,871	2,002	2,146
3- Subsidized-interest loans under the protocol signed with the EIB	204	204	204
4- Subsidized-interest loans granted by leasing companies	191	213	232
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)	**9,025**	**9,772**	**10,587**
Utilized loans benefiting from deductions in banks liabilities subject to reserve requirements	3,939	3,764	3,401
Utilized loans benefiting from deductions in reserve requirements	9,930	9,915	10,201

Source: BDL

2-19 Data reveal that loans in LBP benefiting from deductions in reserve requirements increased by 2.9% to reach LBP 10,201 billion at the end of 2016, given that they registered a slight decrease of around 0.2% in 2015. It is to mention that its increase in the last few years mainly resulted from the increase in housing loans. However, loans benefiting from deductions in bank liabilities subject to required reserves decreased by 9.6% in 2016 reaching LBP 3,401 billion at the end of the mentioned year after decreasing by 4.4% in 2015.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.

2-20 Total subsidized interest loans increased by 8.3% in 2016 reaching LBP 10,587 billion (or the equivalent of USD 7.0 billion) given that they registered the same increase in 2015. The share of the industrial sector out of these loans granted between 1997 and the end of 2016 represented 59.1%, against 29.4% for the tourism sector and 11.5% for the agricultural sector. Four elements characterize these subsidized loans: the period of the loan for 7 or 10 years, the grace period, the relatively low average interest rate, and facilities and exemptions based on the usage or reduction in required reserves.

Distribution of subsidized interest loans on economic sectors end of 2016



Source: BDL

2-21 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.

2-22 The data related to the nature of loans granted by the financial sector reveal that, as of the end of December 2016, a large part of these loans -representing 72.5%- consist 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 2016, the share of advances against real estate reached 37.3%, in comparison to 18.2% for the advances against personal guarantees, 11.5% for the advances against cash collateral or bank guarantees, 3.5% for the advances against other real guarantees, and 2.0% for the advances against financial values.

2-23 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 2014		December 2015		December 2016	
	Value (billion LBP)	Share (%)	Value (billion LBP)	Share (%)	Value (billion LBP)	Share (%)
Trade & Services	29,373	34.0	30,991	33.4	31,346	32.4
Construction & building	14,471	16.7	16,335	17.6	17,414	18.0
Industry	9,320	10.8	9,398	10.1	9,517	9.8
Personal loans	24,911	28.8	27,060	29.2	29,662	30.6
o/w: housing loans	14,893	17.2	16,457	17.7	17,981	18.6
Financial intermediation	5,171	6.0	5,458	5.9	5,169	5.3
Agriculture	994	1.2	1,064	1.1	1,146	1.2
Other sectors	2,214	2.5	2,468	2.7	2,527	2.6
Total	**86,454**	**100.0**	**92,773**	**100.0**	**96,781**	**100.0**

Source: BDL

Loans remain concentrated in the trade and services sector, despite the continuous decrease of its share as percent of total loans that declined to 32.4% at the end of 2016 from 34% at the end of 2014 along with the share of the industrial sector that declined to 9.8% from 10.8% at the end of the two mentioned periods respectively. In return, the share of construction loans increased to 18.0% at the end of 2016 from 16.7% at the end of 2014, and the share of personal loans continued its increase to 30.6% at the end of 2016 with the increase in the share of housing loans included in this figure to 18.6%, whereas the share of other sectors witnessed minor upward or downward variations.

2-24 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 75.7% of total loans and 54.2% of the total number of beneficiaries at the end of December 2016. This concentration is in line with the concentration of economic activity, population, and income levels in the capital and its suburbs.

2-25 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 8,373 persons and institutions), out of the total number of beneficiaries of around 593,758. This low percent is in line with the situation of most countries in the world. Knowing that it may be one person or institution benefiting from more than one loan, thus the number of beneficiaries mentioned above could be lower than the one indicated.

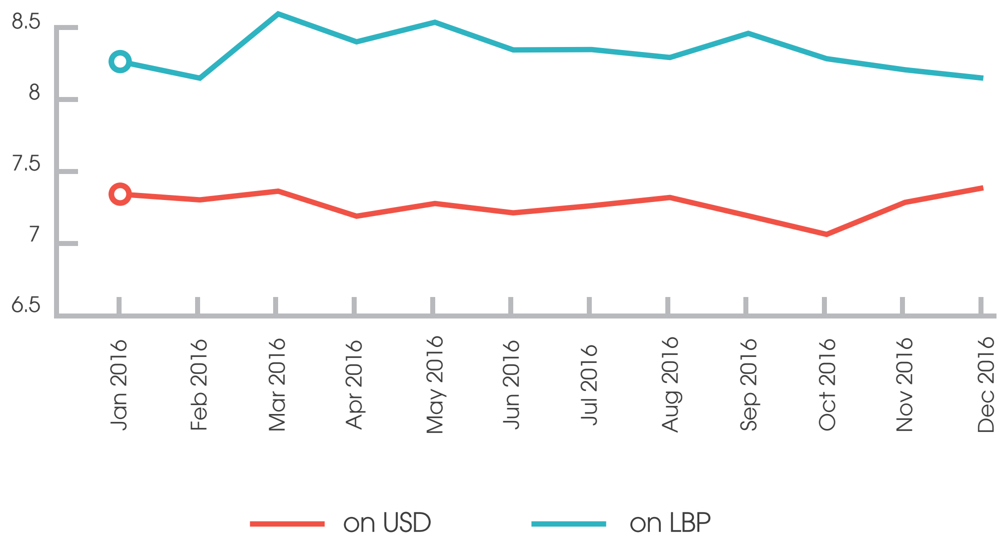
Distribution of loans according to the value and the beneficiaries (In percentage – End of December 2016)

	by value (%)	by beneficiaries (%)
Below 5 million LBP	0.16	12.08
5 - 25 million LBP	3.97	51.53
25 - 100 million LBP	5.87	20.20
100 - 500 million LBP	16.52	13.54
500 - 1,000 million LBP	5.23	1.24
1,000 - 5,000 million LBP	12.79	0.98
5,000 - 10,000 million LBP	8.85	0.21
10,000 million LBP and above	46.60	0.22
Total (Billion LBP and Number)	**96,781**	**593,758**

Source: BDL

2-26 As for interest rates on new and renewed loans, the average lending rate on the USD increased to 7.25% in 2016 from 7.08% in 2015 in parallel with an approximate similar increase of the deposit interest rate on the USD. Concerning the average lending rate on the LBP, it reached 8.35% in 2016 according to the calculation as prior to any subsidy, or facility or deduction in reserve requirements, against 7.09% in 2015. Thus, it is no longer possible to compare lending rates in 2016 with those of previous periods.

Evolution of lending interest rates on Beirut's market (%)



Source: BDL

Claims on Public Sector

2-27 The claims of commercial banks on the public sector decreased at the end of 2016 to reach LBP 52,344 billion in comparison to LBP 56,984 billion at the end of 2015, thus registering a decrease of 8.1% after a slight increase of 1.2% in 2015. This decrease in 2016 resulted particularly from a net sales of Eurobonds (thus the value of sales operations exceeded the purchasing ones in the first quarter 2016), due to liquidity and profitability management considerations and the BDL's financial engineering operations. In 2016, claims in LBP declined by LBP 1,230 billion or 4%, and claims in foreign currency dropped by USD 2,262 million or 12,8%.

2-28 In detail, the commercial banks' portfolio of Treasury bills in LBP decreased to LBP 28,936 billion at the end of 2016 compared to LBP 30,243 billion at the end of 2015 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 good return and get used to be issued periodically. Banks subscribed in December 2016 in 5-year LBP Treasury Bonds (amounts of LBP 1,100 billion) issued by The Ministry of Finance at an exceptional yield of 5% to absorb the excess of liquidity in LBP at the BDL resulting from the last Financial Engineering operations.

2-29 The banks' portfolio of Eurobonds decreased to USD 15,383 million at the end of December 2016 from USD 17,645 million at the end of 2015 after the sale of Eurobonds conducted by some banks from their portfolios to ensure liquidity in foreign currencies as mentioned before.

2-30 As a result, the share of the claims on the public sector in LBP out of total loans to the public sector increased to 55.7% at the end of 2016 against 53.3% in 2015, while the share of claims in foreign currencies decreased to 44.3% against 46.7% at the end of the two consecutive dates.

Foreign Assets

2-31 Deposits of commercial banks at correspondent banks slightly declined in 2016 to reach USD 11.2 billion at the end of the mentioned year against USD 11.6 billion at the end of 2015. Thus, these deposits decreased by a 2.7% in 2016 against 5% in 2015. The ratio of these deposits out of total customer's deposits in foreign currency at banks declined to 10.5% at the end of 2016 from 11.8% at the end of 2015. This is attributed especially to their very low return and the preference of banks to place them 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 currency reserves and reinforcing monetary stability. It is to note that the level of these assets at the end of 2016 was close to their level at the end of the preceding year, to register after that a consecutive increase in the first months of the year 2017.

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 risk management. 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 potential De-risking practices from correspondent banks.

2-32 Deposits of banks at correspondent banks, net of deposits of non-resident banks, stood almost unchanged at around USD 5 billion at the end of 2016 as at the end of 2015. In other terms, deposits at correspondent banks covered 1.8 times the foreign liabilities towards the non-resident banks at the end of both years 2016 and 2015. It is to mention that non-resident banks that own creditor accounts in the banking sector are largely subsidiaries of Lebanese banks.

2-33 On the other hand, banks' other foreign assets decreased to USD 5,720 million at the end of 2016 in comparison to USD 6,058 million at the end of 2015, thus by 5.6% after a decline of 6.7% in 2015. 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 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

2-34 The deposits of commercial banks at the BDL continued to increase in 2016 reaching LBP 134,612 billion at the end of the mentioned year in comparison to LBP 106,329 billion at the end of 2015. Thus, they increased by LBP 28,284 billion or by 26.6% in 2016 in comparison to an increase of LBP 10,621 billion or 11.1% in 2015. The share of these deposits out of total banks' assets increased to 43.7% (its highest level historically) at the end of 2016 from 37.9% at the end of 2015.

2-35 The significant rise in 2016 is attributed particularly to the BDL's financial engineering consisted of banks' subscription in USD Certificates of Deposits at BDL, where they placed the excess of liquidity resulting from the discount of LBP Treasury Bills. The large increase in these placements in the previous two years was due to the excess sources of funds in banks that were not invested in the economy- with the slowdown of the private sector lending activities and a decline or a slight increase in credits to the public sector-, and due to the redistribution of portfolios especially deposits at correspondent banks in addition to the constitution of the required reserves in LBP and required deposits in foreign currencies. It is to mention that the BDL started issuing from the beginning of 2015, CDs for banks in LBP and USD for 20 and 30 years, in addition to other categories that are regularly issued. It is to mention that banks' deposits in foreign currencies at the BDL contribute to a great extent to the strengthening of monetary stability.

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, as needed.

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 which we will tackle in the next section. These measures have also focused on 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 2016, please refer to part II of this report.

Alternatively, 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. 318/2001and 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 1999 International Convention for the Suppression of the Financing of Terrorism.

3-5 The BDL took 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.

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 on a regular basis since 2013 for the directors of compliance departments in banks operating in Lebanon. Several 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 policies and procedures related to anti-bribery and corruption, the automatic exchange of information and the preparations of banks in this regard, 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 2016 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.

The ABL also received foreign delegations at its headquarters for the same purposes, including the delegation of the Federal Reserve Bank- New York in September 2016, which underscores the sophistication and professionalism in the Lebanese banks in terms of compliance and the highly qualified human resources.

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, 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 and 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 Lebanese banks adopt in general 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[1] 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 The Lebanese banking sector is characterized by a high solvency ratio, according to Basel standards and in conformity with the best practices and criteria adopted in the banking industry worldwide. According to the monetary and supervisory authorities, the solvency ratio (Total Capital/Risk Weighted Assets) was around 14.6% at the end of June 2016 and 15.1% at the end of 2015, 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.

[1]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.)

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 Tier 2 Capital, which enable banks to meet IFRS 9 requirements 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 The 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. The ratio of doubtful debts/ total loans increased slightly to 3.68% at the end of 2016 against 3.64% at the end of 2015, - level considered acceptable when compared to the sector averages in the MENA region (3.3%) and low when compared to the sector averages in emerging markets (7.2%) - and the provisions on doubtful debts (provisions/doubtful debts) decreased slightly to 66.2% against 68.8% during the two mentioned years respectively.

On the other hand, bank sovereign risk exposure increased in 2016, where the share of banks' loans to the public sector and deposits at the BDL reached 60.7% of total placements at the end of the mentioned year, against 58.2% at the end of 2015. It is worth indicating that a relatively large part (more than 46%) 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 bank assets abroad. Moreover, the sovereign rating of Lebanon did not witness a major decline in 2016 except that "Fitch" downgraded in July 2016 Lebanon's long-term foreign and local currency sovereign credit ratings from B to B-, with a stable outlook, followed by a positive development in September 2016 where "Standard and Poor's" updated the outlook of Lebanon from negative to stable and affirmed its rating. For its part, "Moody's" affirmed in June 2016 Lebanon's credit rating and maintained the negative outlook.

Interest Rate Risk

3-13 There were no negative developments concerning interest rate risk in 2016, due to the quasi-stability of the interest rates on the LBP while interest rates on the USD have increased slightly following the rise in US interest rates. 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 3.5 years for the Treasury bills portfolio in LBP at the end of 2016 and around 6.3 years [2] for the Eurobonds portfolio (without Paris 2 and 3 Eurobonds). It is noteworthy that interest paid on deposits in LBP is related to the return on Treasury bills in LBP, not the opposite. Moreover, the yield on long-term Treasury bills and CDs 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 will remain 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 a quarter-point at the end of 2015 and also by 25 basis points in December 2016. The Fed hiked US interest rates by another 25 basis points in March 2017.

Exchange Rate Risk

3-14 Exchange rate risks remained low and acceptable in 2016 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. After the sizeable financial operation carried out in 2016, the BDL has been able to shore up its foreign currency reserves to USD 34.0 billion at the end of 2016 which covers 22 months of imports and the equivalent of 62.2% of the monetary aggregate in LBP (M2) and 25.6% of the broad monetary aggregate (M3). Exchange rate risk remained also low in terms of the structure of exchange positions in banks' balance-sheets. 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

[2] 7.3 years at the end of March 2017

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 practice 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 principals tested in reality 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 high 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 preserve it by dealing quickly with any negative development which may suddenly occur. 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, reached 65.8% of total deposits and other liabilities at the end of 2016 (against 57.4% at the end of 2015). This ratio is the highest in the region in comparison to 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 55% 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.

IV. BANKING SECTOR PERFORMANCE

4-1 In 2016, net consolidated profits of banks operating in Lebanon (Lebanon's branches) reached LBP 2,864 billion (USD 1,900 million), compared to LBP 2,811 billion (USD 1,865 million) in 2015, thus registering a moderate increase of 1.9% compared to a 8.6% growth in 2015. Accordingly, each of the return on average shareholders' equity (ROAE) and the return on average assets (ROAA) slightly declined to 10.83% and 0.95% in 2016 from 11.51% and 1.1% in 2015 respectively.

4-2 The ROAE and the ROAA for banks in Lebanon are comparable to the world averages but lower than the ones in Arab and emerging countries (especially ROAA). For the sake of comparison, the ROAE reached 11.4% and the ROAA 1.5% for banks in the Middle-East based on the latest available information. This reflects the fact that banks in Lebanon maintain a high level of liquidity to face risks and any fluctuations that may occur in light of the instability prevailing in Lebanon and the region as a whole.

4-3 The cost to income ratio increased to 53.3% in 2016 from 49.5% in 2015. There was an increase in the cost that includes total staff expenses and operating & general expenses, by 29.2% meanwhile the growth of net financial income, including net interest and net commissions and other revenues, was lower (19.9%). Net provision on doubtful debt retreated in 2016 compared to 2015, because banks weren't obliged to constitute additional provisions which take in consideration the economic and domestic situations and risks that affect clients in neighboring countries. It's stated under intermediate circular no. 420, that banks are also required to constitute provisions against debit accounts that are closed in applying the measures, sanctions, and restrictions set by the legal international organizations or by foreign sovereign authorities and are required to work on collecting these loans from the concerned clients without amending their credit classification.

Profit & Loss Accounts of the banking sector (LBP billion)

	2014	2015	2016
1- Interest received	13,709	14,849	15,990
2- Interest paid	9,212	10,020	10,866
3- Interest margin (1)-(2)	**4,497**	**4,829**	**5,124**
4- Net provisions	-294	-323	-262
5- Net interest received (3)-(4)	**4,203**	**4,506**	**4,862**
6- Net commissions & other income	2,294	2,513	3,555
7- Net financial income (5)+(6)	**6,497**	**7,019**	**8,417**
8- Operating & General expenses	3,230	3,472	4,486
9- Depreciations & net provisions/profits on tangible and intangible assets	214	240	262
10- Ordinary profits before tax (7)-(8)-(9)	**3,053**	**3,307**	**3,669**
11- Extraordinary net income	30	39	-29
12- Profits before tax (10)+(11)	**3,083**	**3,348**	**3,640**
13- Tax on profits	493	537	776
14- Net profits (12) – (13)	**2,590**	**2,811**	**2,864**

Source: BDL

4-4 The table below details the income evolution between 2015 and 2016. Total revenues increased from LBP 17,401 billion to LBP 19,516 billion respectively, the equivalent of LBP 2,115 billion or 12.2% (+8.5% in 2015). This resulted mainly from the increase in net commissions (+84.4%), net gains on financial instruments (+42.8%), and interest received (7.7%), in comparison to a decline in net profits on foreign exchange (-18.6%), and gains (losses) on stocks, shares and participations (-41.9%). The interest received is tied to the loans to the private sector, and the investment in sovereign financial instruments- such as Treasury bills and CDs in local currency and US dollar- and non -sovereign financial instruments, knowing that interest rates on Beirut market registered slight changes in general between 2015 and 2016, and the global interest rates remained at low levels though the Federal Reserve slightly increased reference rates. The net commissions increase is due to the increase of commissions received from clients on all services provided by banks, such as those tied to the letters of credit, asset management accounts and retail banking. Consequently, the share of interest received dropped to 81.9% out of total revenues in 2016 (85.3% in 2015) compared to a rise in the share of commissions and other income to 18.2% (14.4%) for the same two periods respectively.

4-5 It is noteworthy that the share of net interest received out of net financial income decreased to 57.8% in 2016 (64.2% in 2015), leading the share of net commissions and other net income to constitute 42.2% (35.8%) for the two mentioned years respectively. This confirms that banks are interested in diversifying services, of which private banking, retail operations, capital market services, consultancy services and trade financing and other off-balance sheet operations, which will provide them with a parallel non-interest income in the form of fees and commissions.

Income Composition (LBP billion)

	2014	2015	2016	Change (%) 2016-2015
Interest received	13,709	14,849	15,990	+7.7
Net commissions & other income	2,294	2,513	3,555	+41.5
Net extraordinary income	30	39	-29	-
Total income	**16,033**	**17,401**	**19,516**	**12.2**

Source: BDL

4-6 The table below details the distribution of expenses during the last three years. Total expenses increased from LBP 14,591 billion in 2015 to LBP 16,653 billion in 2016, the equivalent of LBP 2,062 billion or 14.1%. Interest paid increased by 8.4% in 2016 in comparison to an 8.8% increase in 2015, thus slightly exceeding the growth in interest received. This is tied to the increase in deposits by more than 7% with a slight decrease in the average deposit rate on LBP (from 5.58% in 2015 to 5.56% in 2016) against a slight increase in the average deposit rate on the USD (from 3.16% to 3.34%), knowing that interest rate on the non-resident financial sector remained at low levels despite its slight increase following the reference rate raise by the Federal Reserve. In 2016, banks constituted less provisions for hedging risks as previously mentioned.

Expenses Composition (LBP billion)

	2014	2015	2016	Change (%) 2016-2015
Interest paid	9,213	10,020	10,866	+8.4
Net provisions	294	323	262	-18.9
General & operating expenses	3,444	3,712	4,748	+27.8
o/w staff expenses	1,913	2,025	2,196	+8.4
Tax on Profit	493	537	776	+44.5
Total expenses	13,443	14,592	16,652	+14.1

Source: BDL

4-7 General and operating expenses increased by 28% in 2016 (7.8% in 2015). This increase partially resulted from the increase in staff expenses (+8.4% in 2016 compared to 5.9% in 2015) related particularly to the increase in the number of employees in the sector (+622 persons in 2016), and the annual increase and allowances that banks grant their employees based on the collective labor agreement. It is to mention the remarkable increase in other operating expenses (44.5% in 2016 compared to 9.8% in 2015) that banks bear for development and improvement required to keep pace with world banking standards. The tax on profit increased by 58.2% in 2016 (8.9% in 2015), reaching LBP 776 billion against LBP 537 billion in 2015, representing more than 21.0% of net profit before tax.