

Nothing, But Common Sense!

A mini report on the immunity of the Banks of Lebanon from the Global Financial Crisis



1. Introduction	3
2. The Unfazed Fort	4
3. Standing Tall Against the Financial Crisis	11
4. Conclusion	14

Tables and Graphs

Table 1 - Economic Indicator Listing	4
Fig 1 – Lebanon’s Economic Freedom Score	5
Fig 2 – Economic Growth 1980 – 2005	6
Fig 3 – Banking Sector Deposit Rates	6
Fig 4 – Area of Construction Permits in Lebanon	7
Fig 5 – Money Supply and Inflation	8
Fig 6 – Foreign Sector Indicators	9

1. Introduction

The Global Financial Crisis that broke out in 2007 and grew out of proportion through 2008 affected almost every economy on the planet. We witnessed economies under immense strain to balance its affects, business giants going bankrupt, banks being nationalized and the various stimulus plans of governments to shield itself from lasting damage the crisis brought along. Although most of the GCC has been shielded from the effects of the crisis, it is not to say that they have been completely immune to any kind of impact [Please refer Global Financial Crisis and the GCC – In Pursuit of a Solution, ADVANTAGE-MID Report]. After having gone through the worst, we now need to prepare ourselves to avoid such catastrophes in future. As we look back, it is noteworthy that some economies have been immune to any effects of the crisis while others have not.

One such economy, and the focus of this report, is Lebanon which survived the crisis. The Lebanese Banking sector seems to have been completely immune to the effects of the global financial crisis. Even when the world was plunged in chaos, Beirut was booming. This country, which was best known for its wars, turmoil and instability, has not only been able to survive an economic crisis of global proportion, it has also thrived in it. During the times when the financial crisis hit the global businesses the hardest, Lebanese banks were posting record deposits while bankers claimed it to be the best year in Lebanon's financial history.

What did the Lebanese do to shield themselves from the crisis? How is it that when the entire world has been looking for a remedy, the Lebanese banking system was virtually untouched and reaped record profits? Is there a lesson to be learnt from them to set up adequate shielding from such future events? **This report will focus on Lebanon's banking system and how they were able to shield themselves from a crisis that held the rest of the world hostage.**

2. The Unfazed Fort

The Lebanese economy can be described as a competitive and free market regime with a strong proactive commercial tradition. Lebanon's liberal economy is based on competition and private ownership. Being a service oriented economy; the main growth sectors include banking and tourism. The banking sector in Lebanon is equivalent to over 2.5 times its economic sector. There are no restrictions on foreign exchange or capital movement or on foreign investment, and bank secrecy is strictly enforced. Lebanon benefits from its large, cohesive and entrepreneurial Diaspora. Services and banking sectors represent 70% of the country's gross national product while agriculture and industrial sectors account for 10% and 20% respectively.

Economic Indicator	Indicator Value 2008	Indicator Value 2009
GDP (Constant Prices, National Currency)	LBP 5,286.11 Billion.	LBP 5,550.41 Billion.
GDP Growth (Constant Prices, National Currency)	6%	5%
GDP (Current Prices, National Currency)	LBP 42,246.62 Billion.	LBP 46,585.74 Billion.
GDP (Current Prices, US Dollars)	US\$ 28.024 Billion	US\$ 30.903 Billion
GDP Deflator	799.201 (Index, Base Year as per country's accounts = 100)	839.32 (Index, Base Year as per country's accounts = 100)
GDP Per Capita (Constant Prices, National Currency)	LBP 1,391,275.	LBP 1,442,092.
GDP Per Capita (Current Prices, National Currency)	LBP 11,119,086	LBP 12,103,770
GDP (PPP), US Dollars	US\$ 45.834 Billion	US\$ 48.896 Billion
Implied PPP Conversion Rate	921.735	952.761
Inflation, Average Consumer Prices (Indexed to Year 2000)	126.316 (Index, Base Year 2000 = 100)	134.173 (Index, Base Year 2000 = 100)
Inflation (Average Consumer Price Change %)	10.95%	6.22%
Inflation, End of Year (Indexed to Year 2000)	134.055 (Index, Base Year 2000 = 100)	139.136 (Index, Base Year 2000 = 100)
Population	3.799 Million	3.849 Million
Current Account Balance (US Dollars)	-3.92 Billion	-4.245 Billion
Current Account Balance (% GDP)	-13.989 %	-13.738 %

Source – www.economywatch.com

Table 1 – Economic Indicator Listing

With its economic freedom score at 58.1, the economy of Lebanon is now the 95th freest economy in the 2009 *Index*. This ranks Lebanon the 9th out of 17 countries in the MENA region. The strong points of Lebanon are in its trade freedom, fiscal freedom, and financial freedom. With a weighted average tariff rate of less than 5 percent, its trade freedom score is just above the world average. Although there is significant political instability, Lebanon has an array of private banks and services creating a well developed financial sector.

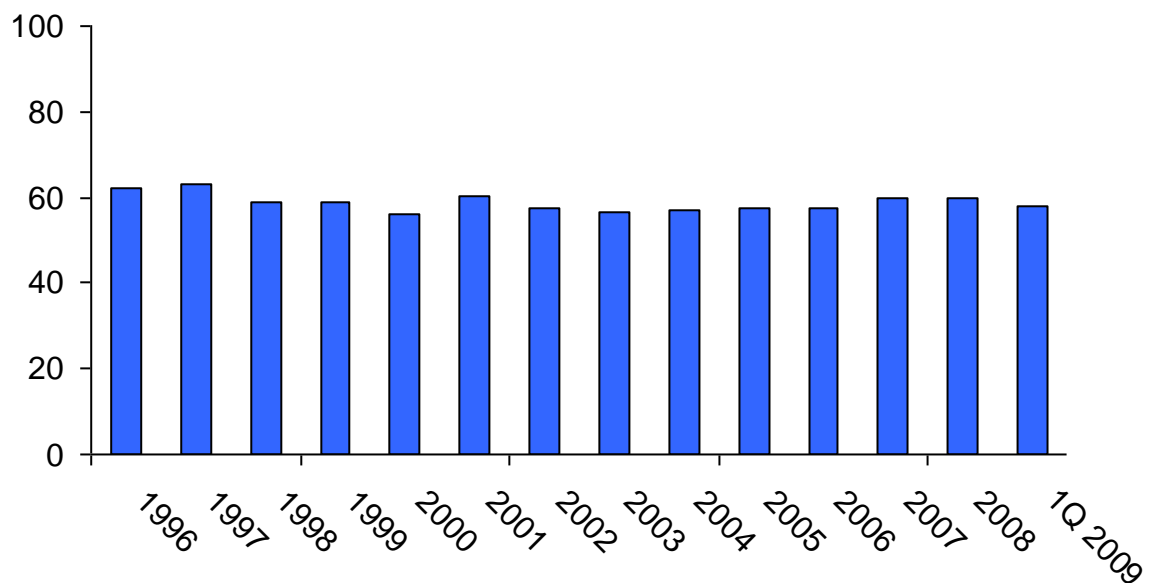


Fig 1 – Lebanon’s Economic Freedom Score

The Lebanese tourism industry has been of historical importance to its local economy and continues to be the major revenue generator for the country. The strategic position of Lebanon, its mild climate and natural beauty, consisting of snow-capped mountains, valleys and the Mediterranean Sea, make it a natural tourist attraction. Apart from its privileged geographical and natural situation, Lebanon benefits from qualified and experienced human resources in the tourism industry.

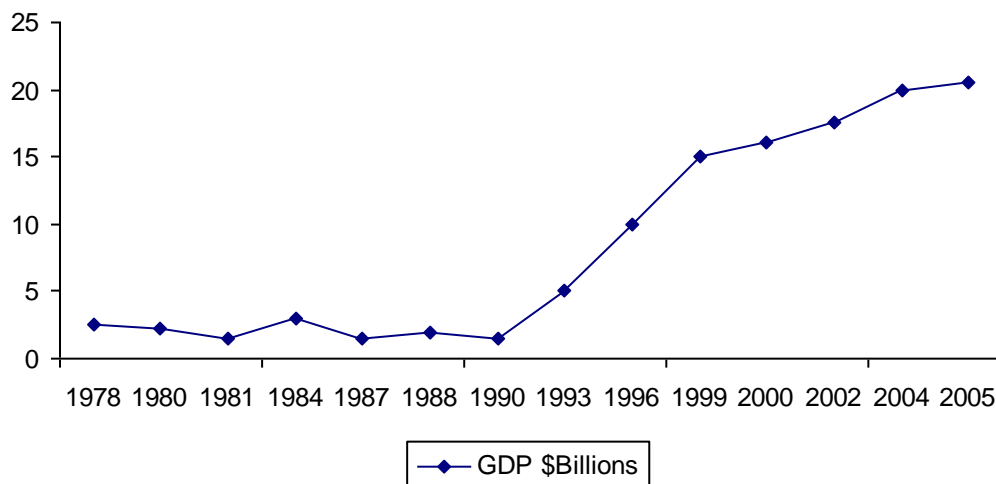
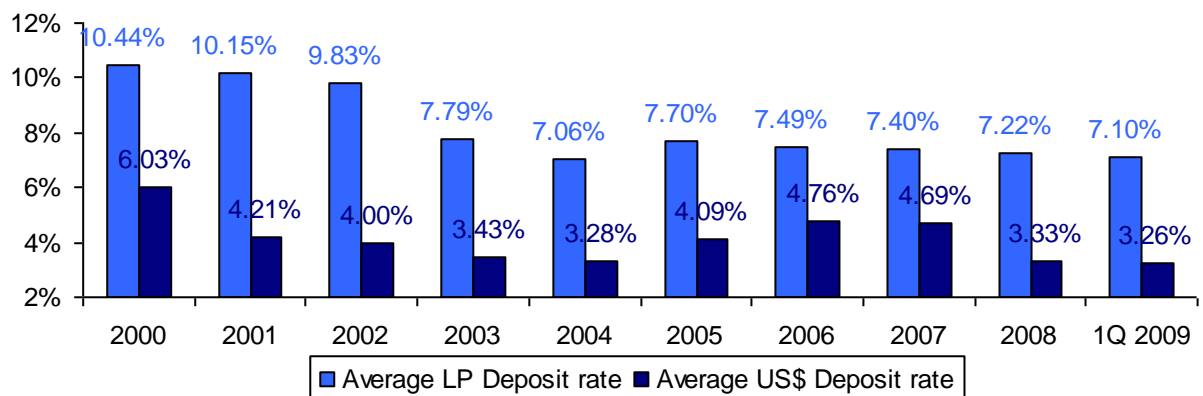


Fig 2 – Economic Growth 1980 – 2005

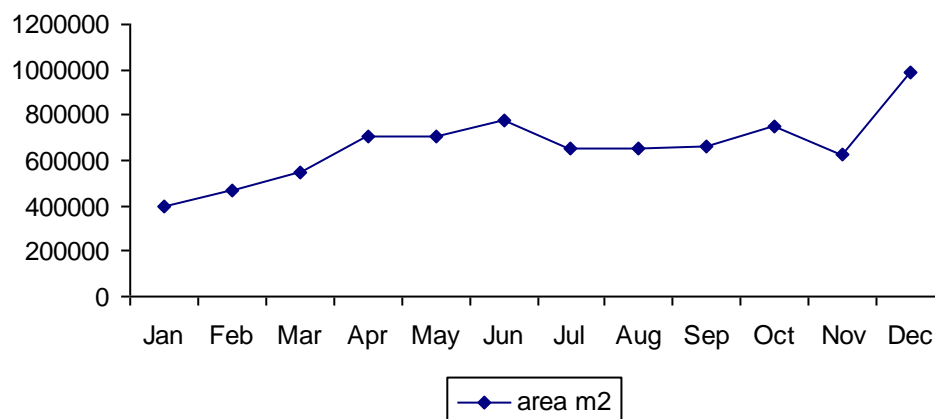
The massive expansion of this sector was facilitated by significant private investment being made by various international hotel companies. A major tourist destination in Lebanon, the Casino du Liban, reopened in 1996 after the disastrous civil war. After the expansion and the modernization of the largest ski resort in the country, Lebanon is now one of the very few countries in the Arab world that offers a venue skiing and other winter sports. Another factor that the Lebanese tourism industry is dependent on is the large number of Non Resident Citizens who return to the country every year.



Source – Banque Audi

Fig 3 – Banking Sector Deposit Rates

Up until the Civil War [1975 – 1990], Beirut was the financial services center of the region. Currently, the main financial services offered are commercial banking, investment banking and insurance. The banking sector in Lebanon is by far the most prominent and powerful sector of the economy. The regulatory framework for banks in Lebanon is particularly robust with the application of appropriate standards of good governance. The Lebanon’s banking sector has witnessed exceptional growth right from 1992. Total deposits with commercial banks saw an increase from USD 6.5 billion at the end of 1992 to USD 33.9 billion at the end of 1999. Additionally, Lebanese banks have been successfully accessing the international capital markets since 1996. The banking system has a key role in **Lebanon’s economy as they form the** entry point for capital inflows that facilitate the region’s development. Lebanon is also working toward expanding its financial sector by ensuring the establishment of more diversified private financial institutions that are equipped with an effective regulatory framework. Several commercial banks have established investment banking subsidiaries offering similar services. Lebanon’s three biggest banks each recorded double-digit profit growth in the first quarter owing to the tight regulation implemented in the sector. **Lebanon’s Bank Audi witnessed a 11.6% growth in its net profit** reaching USD 61 million in the first quarter of 2009. By the end of March 2009, assets of the Bank Audi stood at USD 20.7 billion as compared to USD 20.4 billion during December 2009. The bank also witnessed significant growth in its customer deposits which grew by USD 406 million during the first quarter of 2009 to reach USD 17.6 billion.

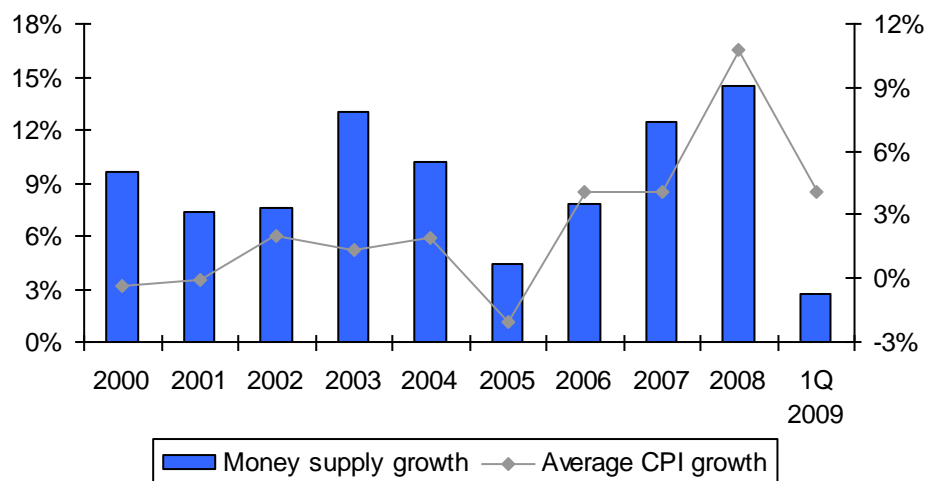


Source - Zawya

Fig 4 – Area of Construction Permits in Lebanon

The real estate sector in Lebanon had significant activity concentrated in Beirut prior to the conflict. Beirut witnessed an uninterrupted boom from the late 1950s to the early 1970s. Mountain towns and villages close to Beirut favored by tourists, such as Aley and Bhamdoun, also experienced a boom. The real estate boom was

also prevalent in the post-conflict era as well. Although real estate prices saw a steep rise, they have now stabilized. Residential property has been concentrated mostly at the upper end of the housing market. The finances for most real estate projects in Lebanon come from its equity investments.



Source – Banque Audi

Fig 5 – Money Supply and Inflation

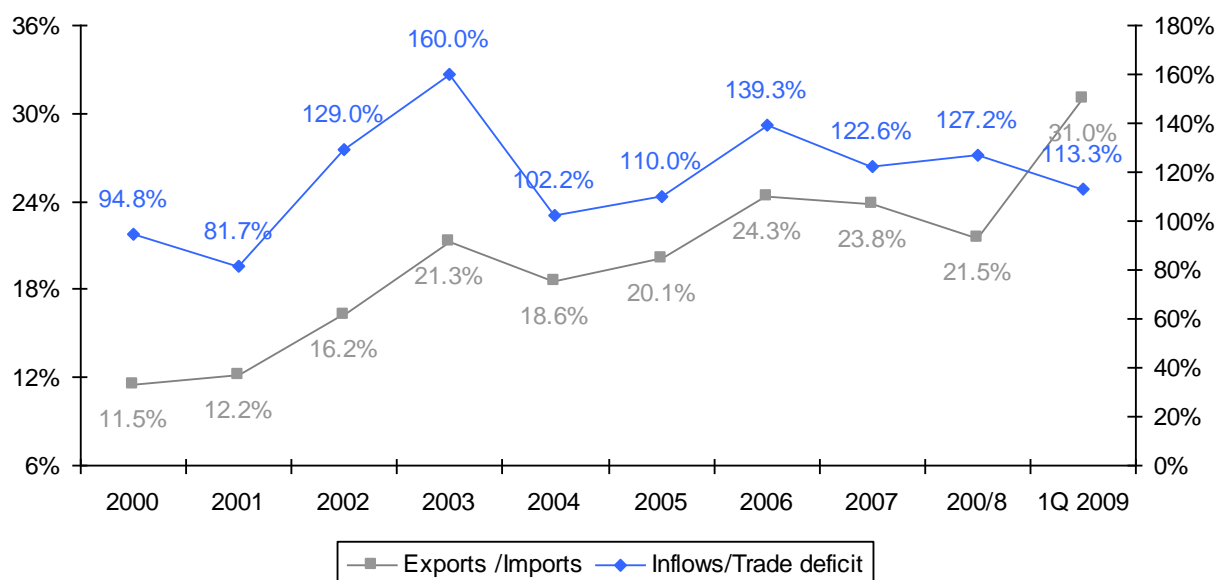
The agriculture sector is the 3rd most important sector in Lebanon. According to the Ministry of Agriculture in Lebanon, agricultural land in Lebanon comprises **around 25% of Lebanon’s total area. The sector employs 12% of the workforce** as well as plentiful seasonal imported labor, and contributes up to 12% of GDP. Main crops include Cereals (mainly wheat and barley), fruits and vegetables, olives, grapes, and tobacco, along with sheep and goat herding. Arable land forms approximately one third of Lebanon. The coastal strip and the Bekaa valley account for the most fertile areas. With its diverse topography and climate, Lebanon is able to cultivate a wide variety of vegetables, fruits, industrial crops and cereals. Food and agricultural exports, which include forestry products, provide about 10% of merchandise export earnings.

Although Lebanon has been infamous for its wars and political unrest, these scenarios brought about the establishment of economic reforms that made it a free economy that could protect itself through clear government economic policies and rules and regulations. The International Monetary Fund reported that **Lebanon’s economy grew by 8% in 2008.** Lebanon’s reforms focuses on three main pillars:

- Economic revival and sustainable growth, with the private sector as the engine of growth;

- Fiscal consolidation and structural improvement in public sector finances; and
- Monetary, financial, and price stability.

Lebanon has maintained a firm commitment to the Lebanese pound, which has been pegged to the dollar since September 1999. During the late 2000, Lebanon reduced its customs duties significantly; decreased social security fees as well as restrictions on investment in real estate by foreigners, adopted export promotion schemes for agriculture, and adopted an open-skies policy, with positive effects on trade.



Source – Banque Audi

Fig 6 – Foreign Sector Indicators

Turning its focus to fiscal measures, the Lebanese Government in 2001, worked toward increasing gasoline taxes, reducing expenditures, and approving a value-added-tax that became effective in February 2002. The burden on the central banks increased as the ability of commercial banks to finance the government was restricted by slow money growth and dollarization of deposits. However, the central bank has been able to maintain stability of its currency through direct intervention in the market. This enabled them to successfully maintain investors' confidence. However, this came at a cost as international reserves declined by USD 2.4 billion in 2000 and by USD 1.6 billion in the first half of 2001.

The Lebanese government has put substantial emphasis on privatization, starting with the telecom sector and electricity, with continued planning for sales of the

state airline, Beirut port, and water utilities. Additionally, the government has also undertaken the challenging task of administrative reform, thereby bringing in qualified technocrats to address its economic programs, and reviewing further savings that can be realized through reforms of the income tax system.

The U.S. enjoys a strong exporter position with Lebanon, generally ranking as Lebanon's fourth-largest source of imported goods. More than 160 offices representing U.S. businesses currently operate in Lebanon. Since the lifting of the passport restriction in 1997, a number of large U.S. companies have opened branches or regional offices.

The Lebanese government and the central bank through its reforms and effective implementation of regulatory policies that helped protect the economy of Lebanon from any impact of the global financial crisis.

3. Standing Tall Against the Financial Crisis

The global financial crisis that was set loose from the US, is mainly the product of credit problems and deflation that was fueled by complex derivative trade. As the crisis ravaged throughout the globe, the world has witnessed the failure of a number of major banks, declines in various stock indexes, and large reductions in the market value of equities and commodities worldwide. The credit system was criticized for constituting centralization at a massive scale, and giving unprecedented power to banks, money-lenders, and usurers as early as the 19th century.

Even through all the perils presented by the crisis, Lebanon was able to stand tall and withstand the effects of the crisis. In fact it was able to flourish its banking sector during the same period the rest of the world was caught off guard. As cheesy as it may sound, it was nothing more than common sense that was backed by strong regulatory system that formed the foundation of the Lebanese banking system that saved Lebanon from the economic disaster that swept the rest of the world. **The immunity of Lebanon's economy is proof that a free economy can barricade itself through effectively enforced economic policies and regulations.** According to the International Monetary Fund, the Lebanese economy grew by 8% in 2008 and is forecasted to grow by 4% in 2009.

The Lebanese Financial model has been based on the following principles –

- Currency stability: The Lebanese currency has been stable through out the past 15 years, despite the political and security problems that Lebanon encountered.
- Second, the growth of the banking sector during this difficult period, enabling it to extend credit today without reluctance or hesitation.
- Third, the Central Bank of Lebanon does not allow the bankruptcy of any bank. This enhanced their financial credibility and raised deposits in Lebanese banks to more than three and a half times the size of the local economy.
- Fourth, the state pays all its debts, both capital and interest, hence enhancing the financial credibility of the country.

Lebanon has had a tradition of conservative regulation in its financial sector. The Central Bank avoided raising the leverage of the banks. The regulations in Lebanon require that the banks can provide credit of up to 70% of their deposits, whereas some international banks were exceeding 100% of their deposits. Moreover, the inter-bank market rate was lower in Lebanon since the banks have to retain 30% of their deposits in their budgets, while there was much dependence abroad on the inter-bank market. Owing to these regulations banks were required to desist from taking on too much debt and they were required to have at least 30% of their assets in cash. Speculation was not allowed while dealing with risky

packages of bundled up debts. Moreover M&As were forced on weak banks before they got into trouble.

The effective supervision of the Central Bank of Lebanon has protected the Lebanese economy from any direct impact of the global financial crisis. This was essentially because the Central Bank used a prevention-over-cure strategy. As a result the banking sector performed well in first half of 2008. There was a 7.5% increase in banking activity as compared to the same period during the previous year. The banking activity is measured by the consolidated assets of banks in Lebanon. Total private sector deposits increased by 6.8% to reach USD 72.1 bn as compared to the previous year.

Lebanese banks have a relatively low loan to deposit ratio (33% – 34%) which is evidence for more liquid balance sheets as compared to other banks in the region. Considering the strong liquidity of the banks even through the crisis Lebanese banks are expected to continue to perform well with adequate immunity to any immediate risks from the global financial crisis.

This record deposits-to-GDP ratio for Lebanon can be explained by the following factors:

A recurring inflow of funds from the Lebanese diaspora. The expatriates' remittances totaled an estimated USD 5.5 Bn in 2007, according to the IMF. This represents nearly a quarter of Lebanon's GDP. Lebanon ranks fifth in the world in terms of remittances to GDP (approximately 25%) after countries such as Mexico, China and India.

The implicit support from the GCC countries, which have continuously poured in investments into the country and have regularly injected significant amounts into the Central Bank's foreign currency reserves, the most significant being a \$1.5 billion injection by both Saudi Arabia and Kuwait in the aftermath of the 2006 war.

The perception of an implicit guarantee offered by the international community. The most recent example is the aid received in the Paris III conference held in January 2007, totaling USD 7.6 Bn. The continuing support from donors affirms the idea that a "lender of last resort" would always be there to bail out Lebanon in case of emergency.

Lebanon's strong track record of debt repayment and servicing: even though Lebanon's sovereign rating was recently downgraded to CCC+ by S&P, i.e. seven notches below investment grade, the country still enjoys a strong track record as it never defaulted in spite of adverse geopolitical conditions.

Underdeveloped financial markets offer few alternatives to investors: the average MENA market capitalization-to-GDP ratio stood at 110% in 2006, according to the IMF, while it merely reached 37% in Lebanon in the same year. This forces banks to be the main players in financial intermediation in the country.

Although the Lebanese economy has many problems, primarily due to the unstable political system and the damages caused by the Civil War, its financial system has been able to adapt to the uncertainty and grow significantly to enable it to withstand a financial crisis of global proportions.

4. Conclusion

The Lebanese economy is proof that the impact of even a financial crisis at a global scale can be avoided by strong regulations and effective policies. Right through a financial crisis, Lebanon has been able to remain a land of opportunity. Moreover, the financial crisis seems to be bolstering the Lebanese economy and enabling banks to post record deposits. The most important factors that have made this possible for Lebanon are: a well educated population, a strong banking system with strong regulation and effective economic policies, and financial services that have formed the backbone of the Lebanese economy.

There is definitely a lesson that needs to be learnt from Lebanon's success. And that is the importance of regulation and the role effective governance can play to implement it effectively. Lebanon has a tried and tested system in place, which has been tested against wars, political instability, and other civil unrests. In a certain respect such an environment required the Lebanese banking system to evolve in such a way so as to shield itself from the very causes that brought about the global financial crisis. It enabled the Lebanese to incorporate a conservative reflex as a constant preparation for the worst case scenario.

The world needs to realize the importance of effective governance and its application to setting up strong regulatory filters in our dynamic monetary system. Lebanon is a prime example of the merits of such measures as they take into consideration the long term security of the economy rather than the making quick profits through high risk. The financial crisis has shown us the damage that can be caused by minimal regulation and its time we learned from the mistakes of the past and work toward a secure future.

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