The banking sector in Lebanon: Rising up to the challenges of a conflict zone

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The banking sector in Lebanon has faced rough operating conditions in the past three years both of domestic and regional sources. Yet, Lebanese banks managed to post growth and remain profitable, all the while staying ahead of international requirements and regulations, thanks to solid fundamentals and proven resilience to crises. While the mystery is more understandable through their performance analysis, many challenges await in the horizons especially if the current political circumstances in the region don't reverse or come to an end.

OPERATING ENVIRONMENT

The last three years have seen political and military havoc in Lebanon's surrounding countries. From the break of war in Syria in early 2011, to the first and second presidential outcasts in Egypt, and going through the persistent Israeli-Palestinian conflict, operating environment in Lebanon was getting tougher by the second. Domestically, the country was deeply affected by the regional developments and witnessed atypical circumstances. The state attempted to control the sporadic security breaches but failed to avoid political deadlocks, first stalling the formation of a government and then leaving the presidency vacant.

Since 2011, the year when neighboring Syria caught the Arab Spring wave, economic growth has been slowly subsiding in Lebanon under the regional pressures and the resulting domestic stumbles. Real GDP growth slowed down from an average of 8% in the period 2007-11, to around 1.3% in the past three years. Spillovers from war-torn Syria suffocated tourism, a key driver for the Lebanese economy, and hindered exports. Large influx of Syrian refugees, nearing the quarter of Lebanon's population, necessitated higher public spending and larger imports. The fiscal deficit surged back to 9% of GDP, and the balance of payments slipped into the red for the first time since 2006.

However, and amidst all the trouble, the Lebanese banking sector remained poised, posting impressive results given the situation. Activity and profitability indicators were still heading upwards, as seen through the banking sector's consolidated assets that grew by 8.5% during 2013. Lebanese banks also succeeded in attracting an additional 4% of foreign deposits during the year and remained profitable posting a return on equity of 12% and a return on assets of 1% in 2013.

THE MYSTERY BEHIND THE GROWTH OF THE LEBANESE BANKING SECTOR

The banking sector is renowned for being one of the most resilient sectors in Lebanon. It survived many economic and financial crises, maintaining a solid reputation and positively acting as a shock absorber for the economy. Some of the shocks were so hard that they put back real growth near ground zero, like for instance the Israeli "Grapes of wrath" military operation in Lebanon in 1996, the assassination of Prime minister Rafic Hariri in 2005, and the July war led by Israel in 2006, without mentioning the repercussions of the global slowdown following the 2008 credit crisis.

The main component of survival during the tough times was, and continues to be, a large depositors' base. Lebanese diaspora estimates vary between 10 to 18 million, compared to 4.2 million residents. This loyal base contributed to over 20% of the country's GDP through annual remittances, and only slightly declined to 16% in the past couple of years. But still, Lebanon's solid flow of remittances has long floated its dual trade and fiscal deficits and resulted in a cumulative balance of payments surplus nearing US$16.7bn between 2007 and 2010. The banking sector, a progressive agent of the economy, was well positioned to manage the diaspora's money as well as regional and foreign money well before the neighbouring countries could embark on modern banking. The secrecy law promulgated in Lebanon since 1959, was an attractive element too. All this has unsurprisingly led deposits at Lebanese banks to reach over three times the country's GDP by the end of 2013.

The current portrait of the banking sector depicts a powerful actor in the economy, with a contribution of 6%-7% to Lebanon's GDP estimated at US$43bn in 2013. Around 42 commercial banks, 11 foreign banks, and 17 investment banks constitute the banking sector. Lebanese banks employ more than 22,000 employees, 72% of them are university graduates, with an important representation of Lebanese women reaching 46%, well above the country's average of 25%.

PERFORMANCE ANALYSIS

Lebanese banks activity. The consolidated results of Lebanese banks show that their growth activity remained on track during the past three years. Their combined deposits achieved an 8.9% growth in 2013 to reach US$136bn, a solid advance despite being lower than the pre-2011 double digits growths. Lebanese banks especially focused on attracting foreign funds, which are an important source of reserves at the Central bank. The latter holds around US$35bn of gross foreign reserves that constitute an important hedge against the country's high public debt in addition to acting as a shield for the Lebanese pound peg against the US dollar.

Lebanese banks successfully attract deposits, namely thanks to their interest rates and sound reputation. Lebanese banks offered deposit rates over 5% on LBP accounts and close to 3% on US dollar accounts at a time when rates in advanced economies neared zero. The sound reputation of Lebanese banks largely contributed in waiving the risk associated with the country's sovereign rating especially that a considerable portion of depositors is Lebanese.

Lebanese banks also maintain the culture of catering for the individual needs of clients, abiding by high professional standards and offering modern banking features, in addition to benefiting from the secrecy law. In parallel, Lebanese banks exercise a high due diligence and implement a strict regulatory framework to fight money laundry and avoid reputational risk.

Lending activity. Countering the slowdown of economic activity, lending activity to the resident and non-resident private sectors has increased by 9% in 2013 to reach US$47.38bn, exceeding the country's GDP for the first time. Banks were encouraged by the central bank to fund the productive sectors and housing for middle income citizens, and even to invest in technology startups. The central bank's incentives would in return exempt banks from some of their reserves requirements, and lend them funds at very low rates.

Loans quality. Lebanese banks enjoy a good asset quality. In 2010, prior to the deterioration of circumstances in the region, net doubtful loans to equity stood at 4%, and net doubtful loans to gross loans were at 1.2%. Three years later, the ravaging wars in several countries where Lebanese banks have exposure only slightly increased their doubtful loans to 1.44% of total loans. Lebanese banks were quick to allocate provisions against their non-performing loans, covering a considerable 76% of their value.

Profitability. Banks, profits were particularly affected by the war in Syria, which caused their subsidiaries there to suffer losses. Moreover, increased amounts of provisions further squeezed the banks' profits especially in 2011 and 2012, when they decreased by 3.4% and 2.5% respectively. However in 2013, and with all measures already put in place, banks retuned to achieve a 5% growth in their consolidated profits to reach US$1.6bn. From this point onwards, freeing up provisions remains possible upon the reversal of situation in troubled areas. Such was the case in Egypt following the restate of order after President Sissi's election, which relieved pressures off of the income statements of Lebanese banks operating there.

Liquidity. Lebanese banks have traditionally maintained high liquidity ratios, mostly as a safe practice to sustain the high risks of the country. This strategy permitted them to remain afloat in crises and absorb rushes and liquidity flights. Under the same logic, the central bank imposes high rates of legal reserves (15% and 10% respectively for US dollar and Lebanese pound deposits). Lebanese banks rest assured about their compliance with international regulations in this area. Basel III is looking deeper into the size and structure of liquid assets to judge the soundness of the financial systems. In Lebanon, banks are ahead of these requirements with 30% average liquidity placed in foreign currency and more than 53% in aggregate liquidity.

Compliance with international financial regulations. Lebanese banks have always followed the strictest of regulations regarding financial compliance, with the purpose of maintaining a sound international standing and mitigating reputational risk. Long before Basel III came to impose a Capital Adequacy Ratio (CAR) of 12%, the Central Bank of Lebanon had set this floor for Lebanese banks. While most international banks will take a few years to move from the previous 8% CAR requirement, the Lebanese banking sector is already enjoying a CAR over 12%.

Basel III also introduced supplemental measures regarding liquidity and leverage that account for off balance sheet items. In this matter too, the Lebanese banks are less sensitive than international banks, as their exposure to derivatives, the main off balance sheet threat that unfolded magnified losses during the credit crisis, remain subdued. In fact, the central bank had imposed laws against investment in derivatives on Lebanese banks to maintain high liquidity and hedge against additional risks. This has shielded the banks from the credit crisis, leaving them immune to the international fracas following the 2008 credit crash.

Banks capitalisation. Lebanese banks are well capitalised. Their combined capital funds exceed US$15bn, representing 8.9% of total assets. Moreover, six banks are listed on the Beirut Stock Exchange (BSE), making up 74% of the stock exchange market cap

(June 2014). Lebanese banks have also listed Global Depository Receipts on the London Stock Exchange for further exposure and foreign reach. Both Lebanese banks and the BSE are deemed to be undervalued compared to their peers in the region given the exceptionally rough operating conditions. The BSE has been experiencing a low turnover and limited market depth, with a P/E ration of 8.5 in 2013. It is worth noting here that the increased sovereign risks will require an increase in capital funds for banks. This might come at the cost of dividends distributions, slightly decreasing the banks' high dividend payout ratio which averaged 28% in 2012.

CHALLENGES AHEAD

Despite having fared well in the recent delicate period, the Lebanese banks stand to face important challenges in the longer term, if the current political and economic circumstances persist.

Funding the private and/or the public sector. Domestically, the scale back of economic growth will have considerable repercussions on the fiscal deficit, and consequently, the public debt. To this day, Lebanese banks are the main financier of the government, holding 59% of Lebanon's TBs and Eurobonds. The government resources are squeezed by the slash of tourism by 41% since 2010, and the lower revenues from taxes. Meanwhile, government expenditures are expected to rise to accommodate for the influx of refugees to Lebanon as well as to respond to social pressures from the labour force in the public sector. Hence, the fiscal deficit might hit back high again noting that it is currently touching 10% of GDP, dragging along the public debt which ended 2013 at 142% of GDP after being contained at 135% of GDP by 2011.

In this context, Lebanese banks will face the dilemma of achieving sufficient growth to meet both the rising needs of government financing, and to avoid the crowding out of the private sector. If the banks were to maintain their current share of sovereign exposure, which is around 59%, a 6% growth in deposits will be needed to continue to finance both sectors. So far in 2014, the numbers are in check, however, in the long term and under any change in public deficit, the risk will rise. Lebanese banks have had limited investment opportunities in the past and their liquidity ratios were high and well above the domestic market's capacity. This has turned them towards investing in Lebanese sovereign debt especially that the Lebanese govemment regularly offered attractive yields and has never defaulted on its payments. Yet, financing the private sector remains detrimental to the soundness of the financial system and the economy.

Risky sovereign exposure and regional expansion. Lebanese banks' large exposure to sovereign risks takes two dimensions: the first is being capped by Lebanon's own credit rating; and the second is additional risks from their exposure to countries under turmoil.

Lebanon itself is a highly indebted country, with a credit rating moving in the non-investment grade especially now after the spillovers from neighbouring countries. To escape this limitation which prevents them from receiving a higher credit rating, Lebanese banks started a geographical diversification in several countries in Africa, Europe and the Middle East. However, many of the natural markets where they chose to expand are presently in a troubled state. Meanwhile other markets retain high barriers to entry or require aggressive capitalisation to launch operations. Lebanese banks thus face the challenge of finding new markets to boost their performance and grow further.

Tighter international legal regulations. Another challenge awaiting Lebanese banks stems from the increased international cautiousness level regarding correspondence with the region's banks. International banks are closely monitoring terrorism and money laundering activities. Imposed sanctions on several countries have already cost international banks more than US$200bn in various fines and penalties. The central bank and the Lebanese banks made it a front concern to abide by laws and followed a strict framework to adapt to these new regulations;

However, the US crackdown on tax collection through FATCA law, and the US Congress laws aimed at prosecuting the international financial network of Hezbollah, the Lebanese party blacklisted by the USA and more recently in 2013 by the EU, will impose new costs on the Lebanese banking sector. In 2011, a quick response was adopted by the banking sector to clear the issue of a bank linked to Hezbollah and reach a settlement with the US government. This is also making the Lebanese banks' precious banking secrecy more costly under the spreading of regulations promoting transparency.

Consolidation pressures. Compliance with the stricter regulations entailed increased costs on correspondent banks that now require higher volumes to maintain dealership with Lebanese banks. This might put pressure on smaller Lebanese banks, and increase the need to consolidate in order to survive, a step encouraged by the central bank, but necessitating an equilibrated approach and a smooth transition.

CONCLUSION

So far into 2014, the outlook for Lebanese banks remains undisturbed. Although the Lebanese economy hasn't improved much, the return of the balance of payments to surplus is a considerable advancement. Banks' activity also remained positive posting another 8% growth during the first five months of the year. The Lebanese financial systems' strong fundamentals continue to serve banks well in facing unforeseen contingencies. We believe that the Lebanese financial sector retains a lot of potential that is currently put down by the regional turbulences. Once the situation settles down, the sector is sure to rebound on opportunities.

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