



Like any other system in the world, Lebanon's financial sector has its particularities and its vulnerabilities. While it's good to expose and discuss the risks our financial system can encounter, it is important to understand the extent to which each risk is realizable. With that being said, we relate in here the IMF's key points mentioned in their recent **Financial Sector Assessment Program (FSAP) for Lebanon**.

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Recent regional and local developments have adversely impacted Lebanon. The eruption of the Syrian war in 2011 and the paralyzed local political scene amplified Lebanon's imbalances and left many crucial issues to accumulate and remain un-addressed. These factors have stifled economic growth which the IMF estimates will reach 1% in 2016. However, the end of over two years of political deadlock over the presidential elections in October 2016 creates room for the execution of much-needed reforms.

Lebanon has historically been resilient in the face of numerous and sizeable challenges. As the IMF notes in its recent Financial Sector Assessment Program (FSAP), the stable peg of the Lebanese Pound against the dollar, hefty remittances, deposit inflows from the Lebanese diaspora and non-residents and sound crisis management are the factors that allowed Lebanon to weather so many shocks and to preserve confidence.

The BDL has Been Playing a Central Role in Preserving Stability...

The Central Bank's monetary policy has proven to be successful in winning Lebanon a vote of confidence locally and internationally. The BDL has a long list of objectives enumerated by the IMF as such: "maintaining a fixed exchange rate, purchasing government debt, maintaining high gross international reserves, providing economic stimulus and addressing weak banks."

However, the BDL's intervention on foreign exchange markets, debt markets and stimulus measures expand its Balance Sheet. In parallel to purchasing government debt which is not bought by banks, the BDL issues long-term certificates of deposits and term-deposits and in doing so incurs carry costs. The BDL also incurs carry costs when it accumulates deposits from banks to maintain its international reserves at a high level. The BDL also carries the cost of boosting lending for key economic sectors by providing commercial banks with soft loans through several stimulus packages.

...but its efforts need to be complemented with macroeconomic adjustments

Efforts towards restoring fiscal imbalances need to accompany the stability measures taken by the BDL. The IMF forecasts medium-term fiscal deficits at 9% to 10% of GDP. Today, Lebanon's debt to GDP ratio is one of the highest in the world with an IMF estimate of 144% of GDP in 2016. The IMF highlights that this ratio has reached higher peaks in the past, but Lebanon nonetheless needs to put debt back on a downward, more sustainable path or else the BDL will be strained further with its stability function.

Only Severe Scenarios can reveal the Risks facing the Financial System

The Lebanese banking sector is large and has maintained both growth and profitability despite regional and local turmoil. Banks account for 97% of Lebanon's financial sector and their assets are four times Lebanon's GDP. The IMF notes that Lebanese banks adopt almost the same business model with "long-term exposures to the government, the BDL and the private sector with their "financial structure leaving them exposed to **sovereign, interest rate and real estate risks**. " It is however, worth mentioning that Lebanon has never defaulted on its debt and BDL policies have so far succeeded at keeping interest rates low and steady and at containing lending risks.

Under the IMF' baseline scenario, bank resilience is confirmed. The IMF defines its baseline scenario with GDP growth of 1% in 2016 which will increase modestly to 3% in 2019. The baseline scenario assumes no macroeconomic policy changes. Under this scenario, the banks' robustness is confirmed with an aggregate Capital Adequacy ratio of 13.8% and "modest capital needs" of 0.9% of 2015's GDP.

It's only in the case of severe shocks that risks can materialize and expose vulnerabilities.

The severe scenarios are ones that entail an extended period of low growth, a rise in interest rates and a fall in real estate prices. A realization of any of those risks will require significant liquidity for the banking sector and BDL will be needed to provide funding.

Lebanon's large foreign-currency financing needs have been covered by foreign deposit inflows. The IMF forecasts current account deficits to remain above 15% of GDP over the next five years. However, Foreign Direct Investments (FDI) have slowed, leaving deposit inflows to account for the bulk of capital inflows. The recent slowdown in non-resident deposits starting mid-2015 and the balance of payments deficit of \$3.35B at end 2015 compelled once again the BDL to step in by conducting a swap operation with Lebanese banks. The IMF notes that international reserves reached \$41B following the operation, "just under 100% of the IMF reserves adequacy metrics." **However, deposits have been historically stable and have recovered swiftly from shocks.**

The real estate sector has slowed and that initially can pose a risk to banks. However, the non-performing loans for housing loans are low at 1.6% and that, according to the IMF, is partly the result of the BDL's economic stimulus program which supports the real estate sector. Moreover, non-performing loans are well provisioned according to the IMF with loan-loss reserves covering 86% in June 2016. The IMF also highlights that the BDL has enforced "prudent loan-to value ratios for housing, car loans, and commercial real estate" and that "debt-to-income requirements for households and restriction on overdraft facilities for firms limit the scope for excessive private indebtedness. Average household debt-to-income ratios have been stable at around 45%."

The IMF concludes that Lebanon's banking supervision is broadly in alignment with international standards. The financial system has remained resilient in the face of local and regional challenges and came out unscathed from the 2008 global financial crisis mainly because the conservative regulation forbids the use of financial derivatives. The IMF notes that the Banking Control Commission (BCC) employs high caliber staff, enjoys good communication channels and has clearly defined responsibilities in line with the Basel Core Principles of Effective Supervision (BCP).

The role of capital markets in Lebanon remains marginal but the Capital Markets Authority (CMA) has emerged as a "well-established", "independent" regulatory authority according to the IMF. The IMF states that over the past five years, the CMA has "prepared regulations in line with international best practices". However, the IMF states that capital markets development should establish a strategy that would regard both supply and demand challenges, ensure that the investor is protected, that the financial system is sound, all without creating barriers to entry.

An extended period of non-reform will amplify Lebanon's macroeconomic and financial vulnerabilities.

The banking system, i.e. the financial system, headed by the Central Bank is sound and resilient. However, if policymakers allow for macroeconomic vulnerabilities to deepen, the financial system's ability to remain robust will be stretched. Reforms are inevitable.

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