

LEA Position Notes

Lebanese banking sector faces new challenges in 2010

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ABOUT LEA

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Introduction

The banking sector remained the backbone of the Lebanese economy in 2009. Bank assets are equivalent to 334% of GDP and deposits equivalent to 274% of GDP, among the highest such ratios in the world. The sector displayed its resilience to global financial shocks and domestic political instability, and proved it can finance the private sector while supporting the public sector's needs, at a time when governments around the world have been forced to bail out their banking systems. But the sector faced different challenges in 2009 and is likely to face new ones in 2010 with the rapidly changing global and regional financial landscape. Therefore, it will face different priorities.

Risk Management to become increasingly important

The credit crisis has revealed glaring gaps in risk management, as banks around the world learned at their peril that the underestimation of liquidity created severe systemic risk. Commercial banks in Lebanon have a fiduciary responsibility to conserve capital, safeguard deposits and minimize depositors' risk. In the current global and regional climate, most Lebanese banks have focused on increasing liquidity, minimizing risks and increasing the level of quality assets. In the past, risk management at many commercial banks consisted mainly of reassuring large depositors that their money is safe during the political instability and security shocks that have characterized the Lebanese economy. Indeed, the structure of bank deposits is concentrated, as between 70% and 80% of deposits are held by nearly 20% to 30% of depositors. As such, reassuring large depositors that their money is safe was the main risk management approach of many banks. However, with the regional expansion of banks in recent years, there has been a tangible focus on developing advanced risk management systems. This trend has particularly accelerated since the global crisis erupted. So banks that have risk management divisions allocated higher resources to this function. This included recruiting experienced and qualified professionals from abroad, expanding existing teams, and

investing in related technology, software and training. Further, banks with embryonic risk management units accelerated plans to develop such units. The crisis has clearly reflected the fact that the size of financial institutions is not the most relevant criteria, as some of the largest global commercial and investment banks expanded aggressively their balance sheets at the expense of proper risk management, with ensuing disastrous results. So the larger Lebanese banks are likely to increasingly focus on risk management, internal audit, corporate governance and transparency, rather than on the aggressive expansion of the balance sheet. Those who are still favoring size and scale over more fundamental issues are likely to be more affected by regional developments than other banks due to their increased exposure and aggressive risk taking.

Regional expansion to resume cautiously

Lebanese banks have embarked in recent years on a cross-border expansion strategy to take advantage of the opening of new markets and to diversify their assets and revenue base, with some banks following a more aggressive strategy than others. Lebanese banks are currently present in more than 20 markets through about 70 branches, affiliates and sister companies not only in the Middle East & North Africa, but also in Sub-Saharan Africa, Eastern Europe and Central Asia. But the global crisis led to a pose in late 2008 and early 2009, with banks taking a wait-and-see approach by consolidating their positions and assessing their exposure in the markets where they are already present. This applied to the operational expansion as well as to the credit portfolios, as banks generally favored liquidity over expanding the balance sheet during that period. But with global and regional conditions stabilizing, and with Lebanese banks emerging largely unscathed from the crisis, banks continued to lend abroad but most of them followed a more cautious approach, while they resumed their operational expansion in existing markets.

However, regional expansion inevitably has its risks, as one Lebanese bank tested positive to exposure to the Saudi Saad and Al Ghosaibi conglomerates that defaulted earlier this year on their obligations.

Also, the recent announcement by Dubai World that it is requesting a debt standstill on its obligations and that it will restructure its liabilities, in addition to pre-existing home grown crisis like the defaulting investment firms in Kuwait, reflects still existing regional risks and is a reminder to Lebanese banks about the need to remain cautious. Further, the slowdown in regional economic growth increases the risk of non-performing loans. Still, Lebanese banks have the liquidity, experience and skills to decide when and where to expand in 2010.

Deposit growth to remain a double-edged sword

Early concerns about the impact of the global financial crisis on deposit inflows to the Lebanese banking sector turned out to be unfounded. Indeed, while the growth of deposits slowed down and displayed some volatility in the fourth quarter of 2008, there were no material deposit outflows from the system. But the first 9 months of 2009 saw unprecedented capital inflows to the sector, with private sector deposits growing by a monthly average of \$1.5bn in the first three quarters of the year and averaging a more impressive \$1.8bn in the third quarter of 2009, constituting record averages for the sector. Indeed, private sector deposits have grown by 17.2% from the end of 2008 and by 21.6% year-on-year, with non-resident deposits rising by 40% year-on-year. The massive inflows are attributed to the resilience of the sector in the face of the crisis, but also to the interest rate differentials on US dollar and Lebanese pound deposits at local banks compared to global rates. Further, the relative political stability in the country since June 2008 encouraged depositors to convert their funds into Lebanese pounds to take advantage of higher interest rates, leading to a marked decline in the dollarization rate of deposits from 77% at

end-2007 and 70% at end-2008 to 66% at the end of September, a still elevated rate. Despite the slight reduction in deposit rates earlier this year, interest rates on deposits in Lebanon are unlikely to decline substantially until the structural imbalances represented by the high fiscal deficit and public debt are addressed, and until long-term political stability is sustained. As such, banks are likely to continue to attract deposits, but since part of these deposits is speculative in nature, they will face the challenges of the high cost of funds as well as volatility and the risk of outflows from a potential revaluation of risks for the region as a whole.

Profits growth to slow down

Banks have been faced with a high level of liquidity in both the national currency and in foreign currencies, with not enough outlets to place this liquidity since the start of the crisis. The Certificates of Deposits issued by the Central Bank to absorb local currency excess liquidity and its measures to encourage lending in Lebanese pounds have helped somewhat. But the sector's cautious lending approach, fewer lending outlets abroad, record-low interest rates in global money markets, the decline in demand from the non-resident sector, and the high cost of funds are likely to combine to affect the banks' profits and profitability ratios this year. To be sure, banks will continue to be profitable in 2009, unlike many banking sectors in advanced and emerging economies, but the growth rate of their profits will be slower than the 25% rise posted last year. Further, the profitability ratios are likely to stagnate, as the sector's average return on assets reached 1% as at July 2009 relative to 1.1% in 2008, while the average return on equity was 13.9% in July on an annualized basis relative to 14% in 2008. Still, such ratios are solid relative to banking sectors in the region and in emerging markets.

Ratings could be reviewed

The ratings on the long and short-term foreign currency debt obligations of Lebanese commercial banks have long

been constrained by the sovereign ceiling. Indeed, international rating agencies have argued that the banks' exposure to the sovereign continues to keep their ratings at the sovereign level, even though rated banks are well managed, profitable, liquid and well capitalized. But recent trends and a closer analysis of the banks' sovereign exposure warrant a different conclusion. The consolidated balance sheet of commercial banks shows that the banking sector's exposure to foreign currency-denominated sovereign bonds was at \$11.7bn at end-September, which accounts for less than 11% of the sector's total assets. Further, the sector's total exposure to the public debt in Lebanese pound and foreign currencies accounts for less than 25% of the sector's assets, which is slightly lower than the banks' lending to the private sector that represents 25.4% of the asset base. Further, rating agencies consider the banks' reserve requirements at the Central Bank as part of the sovereign exposure.

However, the Central Bank places these reserve requirements in the global money markets, similar to what the banks do themselves to the 15% liquidity requirement on their foreign currency deposits. More importantly, the Central Bank has not utilized these reserves to maintain the stability of the currency and its reserves have reached the equivalent of 100% of GDP. So it is not clear why rating agencies continue to consider reserve requirements as part of the sovereign exposure. The share of foreign currency sovereign bonds to the sector's assets is likely to decline further, depositors have proved to be resilient to domestic political shocks and external financial shocks, and the banks' share of revenues from foreign operations is increasing as a share of total income. As such, it may be time for rating agencies to reconsider their ratings of Lebanese banks to a level above the sovereign, even though it is way too premature for any Lebanese bank to claim regional status.