الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & FINANCIAL SECTOR OVERVIEW

Lebanese Republic

December, 2018

TRUST . TRANSPARENCY . INDEPENDENCE

ECONOMIC OVERVIEW[1]

Neighboring on the east and north with Syria, on the south with Palestine, Lebanon (or 'the Country') is a Mediterranean country in the Middle East and North African (MENA) region. Lebanon has a unique political structure, wherein the 3 major roles are divided on religious/sectarian grounds; as per this structure, the President must be a Maronite Christian, the Prime Minister, a Sunni Muslim and the speaker of the Parliament must be a Shiite Muslim. The complexities of this structure have historically resulted in long-standing deadlocks within the parliament. Following a 2-year deadlock, the parliament finally elected a President and Prime Minister in 2016, whilst the parliament passed its budget in 2018, after a period of 13 years since the last budget was issued. After being postponed 3 times since 2013, the Lebanese elections were finally held in May'18.

Lebanon has a GDP of USD 56.41bn during 2018 (2017: USD 53.29b), which, with a population of 6.1mn, translates in per capita GDP of USD 9,257; the World Bank classifies Lebanon amongst the upper middle-income economies. A large population of Lebanese nationals outside the country translates into strong support to the economy through remittance inflows, comprising slightly less than a fifth of the GDP, and in this relation, being one of the highest in the World. In this regard, the inflow of foreign deposits, which has been a key source of financing for fiscal & current account deficits, depicted subdued growth in 2017. Lebanon's economy is largely service oriented, contributing about three-quarters of the GDP. Notable sectors of the services industry, which have been the primary drivers of economic growth in the past, include retail, financial services, real estate and tourism. With a small-sized agricultural and industrial sector– and the latter mainly involved in assembling imported parts, the country runs a very high current account deficit. In recent years GDP growth has been low being 0.6% in 2017 and 0.2% in 2018. In 2018 the real sector of the Lebanese economy witnessed relatively tough conditions due to the war in Syria while the financial sector continued to grow slightly. The ongoing Syrian conflict has had serious implications for the economy. Besides the direct economic impact, the country has been faced with sizable refugee inflows, which has created a burden on the country's already strained resources and increased the rate of unemployment; the country is presently hosting close to ~1mn registered Syrian refugees, comprising roughly a quarter of its own population, which is the highest per capita count of refugees in the World.

In order to meet the infrastructure development efforts and limit the refugee influx burden, the government has embarked on a large Capital Investment Program (CIP) to raise up to USD 16bn. In the CEDRE conference held in Paris in Apr'18, the government raised USD 11bn in concessional facilities from the World Bank in addition to gaining grants of USD 800mn. These sizable inflows, and growth arising as a result of the new projects initiated from these funds, may be deemd a key driver for the economy's positive growth outlook.Forecasts point to a 2.0-2.5% real GDP growth for 2019 following the recent Cabinet formation and based on slow progress in CEDRE reforms and implementation. Nominal growth is expected to be driven mainly by growth in private consumption, while private investments are likely to be stagnant at its 2018 level amid politico-economic uncertainties weighing on private investors' initiatives.

On the fiscal side, a net deterioration was reported in public finance conditions in 2018with the deficit risng by 2.5bn over the first nine months of 2018 over the 2017, YoY. Public debt rose to USD 84 bn, the equivalent of 149% of GDP. The high debt levels is accounted for by a sizable amount of resources that have had to be spent on infrastructure reconstruction historically, following internal and external conflicts. FCY-denominated debt is 38%[2] of aggregate and still considered high in view of the strained external account position. With weak economic growth limiting tax revenue, the fiscal balance is considerably burdened by debt servicing, sizable salary base of government workers and subsidies to power sector. The impact of the debt servicing on fiscal balance is evident from the fact that the country runs a primary balance of ~1.4% (surplus) of GDP, whilst the government's budget deficit has increased significantly to -11.0% of GDP during 2018 (2017: -8.6% of GDP) , with expectations to increase further during 2019 .

Domestic political uncertainties, along with emerging market weaknesses put a lot of pressure on capital markets as well, and consequently, equity and bond markets were highly volatile in 2018. On the Lebanese Eurobond market, the weighted

[1] Numerical abbreviations used in the report are as follows: Thousands = k, Millions=mn, Billions=bn
[2] Source: Republic of Lebanon - Ministry of Finance

average yield rose by 341 bps in 2018 to reach 9.95%, falling from a peak level of 11.23% mid-September 2018. Lebanon's five-year CDS spreads closed the year at 750 bps, up by 249 bps, after crossing above the 800 bps threshold several times during the second half of the year. The Banque du Liban (or "BdL") maintains substantial FCY reserves, roughly equivalent to about two-thirds[3] of the country's debt. The strong deposit inflows in the country – mostly from the sizable Lebanese diaspora–allows management of weak external and fiscal position. However, a slowdown in deposit inflows post-2014 has resulted in a declining trend in FCY reserves. In response, BdL initiated a debt swap transaction in 2016, with the Ministry of Finance, swapping LCY-denominated T-Bills with FCY-denominated Eurobonds. BdL sold these newly acquired Eurobonds and additional FCY denominated CDs to commercial banks, thus squeezing FCY liquidity and propping up gross FCY reserves, whilst at the same time increasing its FCY liabilities. BdL initiated a new program in Dec'17; which mainly focuses on incentivizing banks to attract longer term LCY denominated deposits on the back of attractive returns (about 2-3% higher) on long term placements with BdL. On the external front, the country's positioning remains weak and the current deficit is expected to be in excess of 20% in next years as well. The projected weakening in external position can be attributed to the expected continuation of adverse movement in exports to GDP and a persistently strong import bill, owing to the higher oil prices. Given the increase in import costs, inflation surged to 5% in 2017. The twin deficit is expected to persist in the foreseeable future.

The future outlook for the economy remains uncertain, as the recurrent deficits will continue to translate in higher debt to GDP for the country, which, according to IMF estimates[4], will reach 180% by 2023. These expectations are nonetheless subject to several upside and downside risks. In case of an early settlement of Syrian conflict, Lebanon could reap the benefits of reconstruction efforts, in addition to benefiting from the regional stability, improved investor confidence. Negative risk factors include upward volatility in oil price trends, with implications for the external balance. Furthermore, any deceleration or decrease in foreign deposits inflow will impact the reserve adequacy.

Banking Sector Review

In 2018, BdL's's foreign assets slightly narrowed by USD 2.3 billion in 2018 to reach USD 39.7 bn. BDL's foreign assets-to-LP money supply coverage ratio recorded 77.1% at end-2018, remaining well above the average of reserve adequacy in similarly rated countries (41.6%). The overnight rate fluctuated over the second half of 2018 amid a lack of local currency liquidity on the money market, reaching a high of 75% in December, before sliding to regular single-digit levels towards the end of January 2019 following Gulf support pledges and successful Cabinet formation.

Like the real sector, Lebanese banks have gone through a difficult year in 2018, too, amid domestic political tensions and the lack of a government formation for a long time. Nonetheless, confidence in the banking system and the sticky deposit base, coupled with banks' sound liquidity at hand, have allowed the sector to withstand difficult times and post a net growth in deposits, its traditional engine of growth. Customer deposits, accounting for 70% of the total balance sheets, rose by a moderate 3.3% in 2018, the equivalent of USD 5.6 billion.In particular, non-resident deposits grew by USD 2.6 billion, against USD 1.2 billion in the previous year. At the level of lending however, banks loans to the private sector almost stagnated in 2018, against a growth of USD 2.5 billion in 2017 and an average growth of USD 3.2 billion in the past five years.

On the back of a sizable offshore diaspora, attractive interest rates and the USD pegged exchange rate, the country's banking sector has consistently been able to attract significant foreign deposit inflows. As a result, the sector has become considerably large, by regional standards, given an asset base of more than 3.5x of the country's GDP. Historically, the sector has depicted remarkable resilience and stability in the face of extreme political and financial shocks.

The sector is considerably saturated, with more than 140 banks operating in the country. Regardless, data from the World Bank depicts that less than half of the country's population has bank accounts. Even though overall financial inclusion compares favorably to other countries in the MENA region, it remains lower than other countries with similar GDP per capita.

[3] *Including gold reserves*
[4] *Assumes no increase in interest rate*

The banks operating in the country have significant exposure to the sovereign. As of Dec'17, the holdings of sovereign securities and deposits with BdL constituted about ~62%[5] of the sector's assets. As the sovereign securities portfolio carries considerable duration, with BdL securities having maturities of up to 30 years, the sector is exposed to significant interest rate risk. Although, the sovereign securities are generally held to maturity, the secondary market for these securities is relatively illiquid. In overview of the same, any potential attrition pressures could significantly stress the sector's liquidity position. The sector is also exposed to market risk on account of the sizable real estate exposure.

As majority of the sector assets are deployed in sovereign securities/ placements with BdL, and also partly due to subdued demand, the sector's loan to deposit ratio is low at around 35%. On the liability side, even though the deposits trend has broadly remained stable, the proportion of FCY denominated deposits is notably high, as illustrated in table 2.

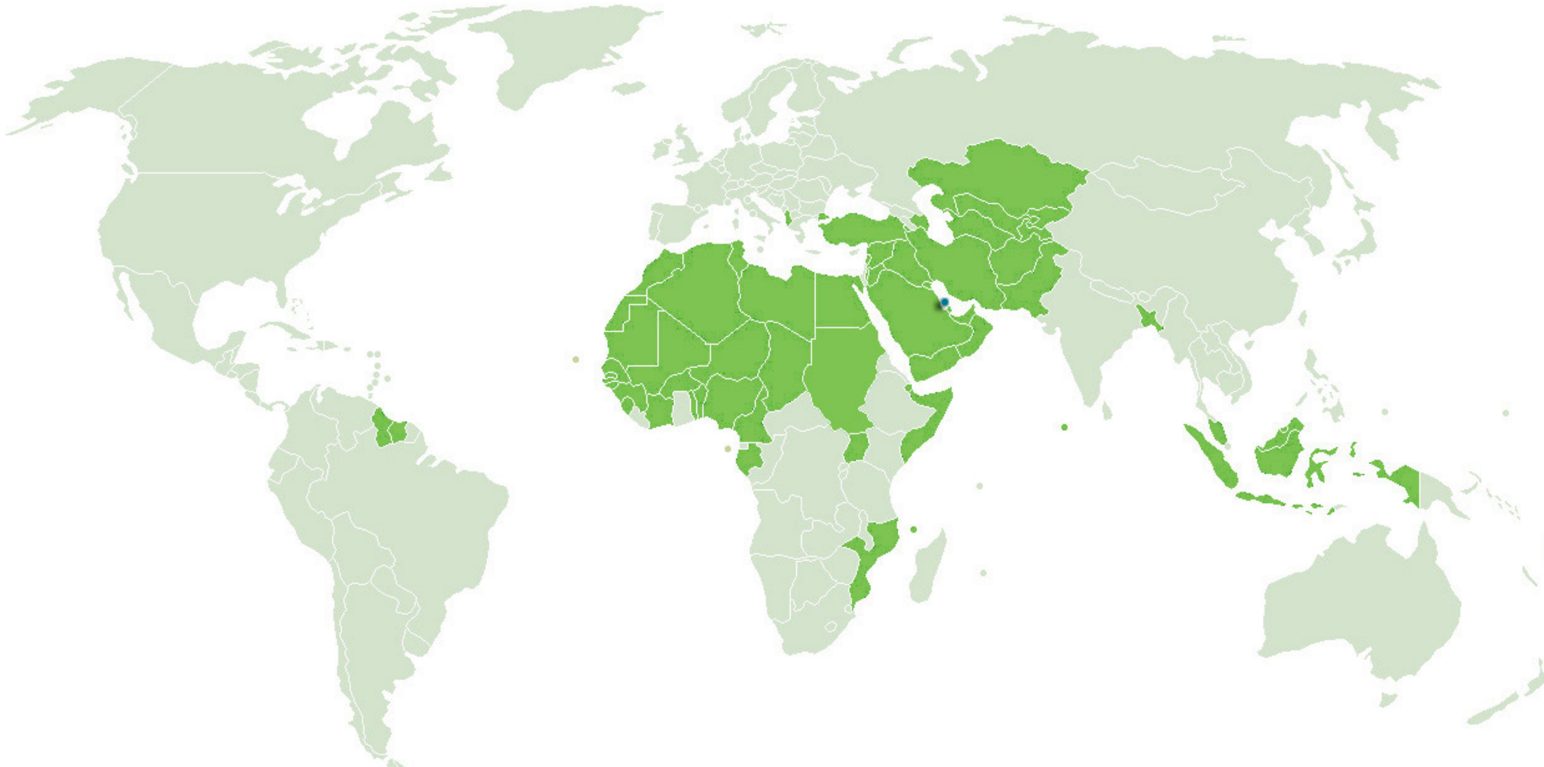
As per IMF, banking supervision in Lebanon is effective. As of 2018, the sector has completely adopted the IFRS 9, while BASEL III Core Principles have also been fully implemented. BdL adopted anti money laundering/combating the financing of terrorism (AML/CFT) legislation in 2015, however, the banking secrecy laws in the country pose challenges for effective implementation of AML/CFT framework.

Islamic Banking

The first Islamic bank in Lebanon was incorporated in 1992 and as of now the total number of Islamic banks operating in the country stands at 5. Initially the sector was operating under the Fiduciary Contracts Law; subsequently,BdL introduced the Islamic Banking Law in 2004, following which the larger franchises in the localbanking sector also ventured into the arena. The current regulatory framework in Lebanon allows provision for Islamic banking services, through independent subsidiaries/entities, and prohibits window operations.

Overall, however the Islamic banking niche remains underdeveloped and also given the absence of Sukuk rules and regulations, growth potential of the sub-segment remains limited restricting Islamic banks' capital access. Islamic banking has a share of less than 1% in system assets.

[5] *Source: BdL*



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Islamic International Rating Agency

, P.O. Box 20582, Kingdom of Bahrain

Tel: +973 17211606, Fax: +973 17211605

Website: www.iirating.com | Email: iira@iirating.com