Banking industry 2014: an analysis of activity performance, risk profile and return indicators

By Dr. Marwan S. Barakat

General Operating Environment

Within the context of the recent cross border expansion of Lebanon's banks, the analysis of the performance of Lebanese banking in terms of activity growth, risk profile and return indicators, has to be read in conjunction with the overall operating environment in the different regions they are actually covering. The operating conditions of Lebanese banks over the past year were actually atypical in their different markets of presence, i.e. in Lebanon, in the MENA region and beyond.

The global economy has witnessed a relatively tough year in 2014, with a weak growth performance on the overall, marking another episode of slow recovery from the global financial crisis. The global recovery is widely uneven across the globe, with some major economies still hampered by the legacies of the global crisis including high private and public debt and persistently elevated unemployment, and others adjusting to lower growth due to lackluster domestic demand and the impact of rising geopolitical tensions. While the global economy is benefiting from receding headwinds from fiscal tightening, consumer and business confidence remains fragile in some parts of the world. Slow growth left its imprints on global trade activity with external demand of locally produced goods weighed down by private consumption and investment patterns. Across the world, investment turned out to be weaker than expected for some time and remains quite subdued, resulting into low global growth. On the overall, the International Monetary Fund estimates global real GDP growth to remain broadly unchanged from the previous year at 3.3% in 2014.

Amidst slow growth and a lingering slow recovery phase, global financial sector regulators have kept on providing support to their respective economies during the year 2014 through widely accommodative monetary policies to support demand and provide markets with liquidity, also allowing the pursuit of balance sheet repair. The global financial sector is now faring better, and witnessing favorable funding conditions and ameliorated asset quality metrics. At the same time, and after abiding by regulatory initiatives, banking institutions are now much better capitalized than they were a scant few years ago. But with interest rates lower and new regulations capping risk-taking, banks' profitability is still being dampened. With the US economy experiencing faster growth than others, the Federal Reserve has lifted its foot off monetary easing throughout the year and is likely to start considering some monetary tightening soon. But the global economic recovery is not yet fully self-sustaining, and major Central Banks around the world continue to work towards ensuring favorable liquidity conditions and supporting the global economy until private sector activity starts picking up noticeably.

Within this environment, the performance of the MENA region in 2014 is even more mixed, and in some cases, more disappointing. According to the IMF, the region as a whole is set to grow by 2.6% in 2014, but this average masks a big difference between the high-income and developing countries of MENA. The former has a projected growth rate of 4.9%, while the latter is expected to grow at 0.7%, a bit faster than the previous year's 0.4% as per the World Bank.

The weak performance of developing MENA this year is due to two ongoing phenomena in the region. The first are the violent conflicts, including the civil war in Syria, now in its fourth year, with its attendant effects on its neighbors, the recent dramatic security developments in Iraq since mid-last year, a devastating war in Gaza in June-July 2014, and ongoing insurgencies in Libya and Yemen. The second are the political transitions in Egypt and Tunisia, as well as political openings in Morocco and Jordan which, accompanied by large macroeconomic imbalances and a huge and unfinished reform agenda, have kept these economies' output well below potential.
It should be mentioned that while the high-income countries in MENA (all hydrocarbon exporters in the Persian Gulf), have been growing at a rapid clip, they also face structural problems that may constrain their growth. Given current projections for the price of oil in the aftermath of the recent drop, budget surpluses are expected to disappear in most oil producing countries, probably affecting the expansionary stance in those countries.

At the banking level, the MENA region has been reporting a satisfactory performance on the overall. The annualized growth rates in deposits of 8.7% and in loans of 7.6% in 2014 remain sound. But such a banking sector growth in the MENA region is mainly driven by oil exporters while most oil importers barely saw their deposit and loan bases growing. Not less importantly, the latter's net banking profitability remained under pressure within the context of relatively tough operating conditions in their respective economies underlined by narrowing net interest margins, growing provisioning requirements and slow fee income growth generation at large.

Banking sectors' deposits in the Arab MENA region

in US$ billion	Dec-13	Dec-14	Var 14	Var 13
Algeria	110.4	114.2	3.8	8.1
Bahrain	39.6	41.4	1.8	5.2
Egypt	189.2	218.2	29.0	17.8
Jordan	38.9	42.7	3.8	3.8
Kuwait	129.1	128.4	-0.7	9.6
Lebanon	164.3	178.4	14.1	14.2
Libya	58.7	*62.9*	4.2	14.7
Morocco	106.7	102.7	-4.0	7.0
Oman	40.5	44.9	4.4	3.7
Qatar	150.7	165.1	14.5	24.8
Saudi Arabia	373.9	420.2	46.3	37.7
Sudan	7.7	9.0	1.2	-1.3
Tunisia	24.7	23.9	-0.8	-0.1
United Arab Emirates	348.2	387.0	38.8	30.2
Yemen	10.4	10.4	0.0	2.0
Arab MENA	**1,793.1**	**1,949.1**	**156.1**	**177.3**

Sources: Central Banks, Bloomberg. Figures in italic are the latest available.

Banking sectors' loans in the Arab MENA region

in US$ billion	Dec-13	Dec-14	Var 14	Var 13
Algeria	34.8	35.5	0.7	6.3
Bahrain	19.0	18.9	-0.1	0.9
Egypt	79.1	88.0	8.9	-2.1
Jordan	26.7	27.2	0.5	1.6
Kuwait	110.3	111.6	1.3	7.1
Lebanon	61.9	68.8	6.9	8.0
Libya	14.7	*15.7*	1.1	2.2
Morocco	95.9	88.9	-6.9	6.1
Oman	34.5	38.2	3.7	2.2
Qatar	158.1	178.6	20.6	18.3
Saudi Arabia	287.0	321.3	34.3	30.9
Sudan	6.6	7.4	0.8	-0.3
Tunisia	30.4	30.0	-0.4	0.4
United Arab Emirates	347.3	375.2	27.9	24.2
Yemen	2.4	2.4	0.1	0.6
Arab MENA	**1,308.8**	**1,408.0**	**99.2**	**106.3**

Sources: Central Banks, Bloomberg. Figures in italic are the latest available.

In Lebanon, economic performance remains much lower than its potential capacity within a precarious domestic/regional environment. Real GDP growth remains modest, estimated at 2% by the IMF. Likewise, the average growth in BDL coincident indicator, which reported 2.7% in 2014, reflects the average modest performance of main real sector indicators during the year.

At the monetary level, Lebanon’s foreign exchange market witnessed further resilience over the past year, with Central Bank reserves at a record high in absolute terms, covering close to 80% of LP Money Supply and 22 months of imports. BDL’s foreign currency assets actually grew from US$ 35.3 billion at year-end 2013 to US$ 37.9 billion at year-end 2014. Notwithstanding gold reserves which reached US$ 11.0 billion at year-end 2014, leading to BDL’s foreign assets in excess of LP Money Supply, which corresponds to a full currency board situation. The balance of payments closed the year 2014 with a deficit of US$ 1.4 billion, following a deficit of US$ 1.1 billion for the year 2013.

The year 2014 has seemingly reported a relative improvement for Lebanon’s public finances. Fiscal statistics outline a drop in fiscal deficit by 27.2%, as a result of a 15.5% rise in revenues, while expenditures increased by 2.3% over the year. The significant increase in revenues comes within the context of significant one-off telecom revenues, in addition to the effects of an improvement in tax collection. The mild rise in expenditures is tied to the postponement of a number of spending dues by the government. In parallel, public debt continues to grow, closing the year at US$ 66.6 billion, the equivalent of 133% of GDP.

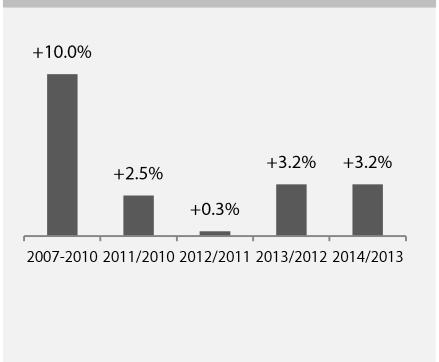
At the level of Lebanon’s capital markets, an improving activity was reported in their two components of equity market and fixed income market. Prices at the Beirut Stock Exchange rose by a mild 0.6% in 2014, yet on the back of stronger trading activity. The trading value surged by close to 80%, moving from US$ 345 million in 2013 to US$ 619 million in 2014, raising the annual turnover ratio from 3.4% to 5.9%, though still low by international standards. In parallel, Lebanon’s 5-year CDS spreads closed the year 2014 at 394 bps, maintaining its level of the previous year’s closing, following a 57 bps contraction in 2013 underlining a relative improvement in credit risks at large.

Banking industry 2014: an analysis of activity performance, risk profile and return indicators

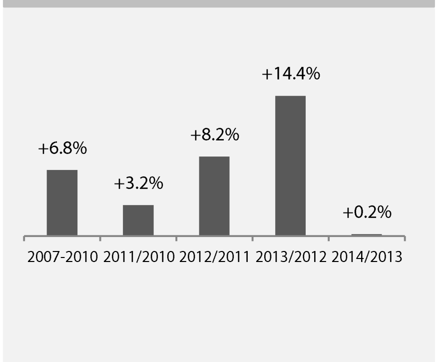
Lebanon's major economic indicators

US$ million	2013	2014	Var 14/13
Macroeconomy			
GDP	47,598	49,919	4.9%
Real GDP growth (%)	2.5%	2.0%	-0.5%
GDP per capita (US$)	10,655	11,068	3.9%
Monetary sector			
Var M3	7,147	6,518	-8.8%
Velocity	0.55	0.53	-4.2%
Average CPI inflation (%)	4.8%	1.9%	-2.9%
Public sector			
Gross domestic debt	37,349	40,963	9.7%
Foreign debt	26,113	25,601	-2.0%
Total gross debt	63,462	66,564	4.9%
Gross debt/GDP (%)	133%	133%	0.0%
Deficit	4,220	3,073	-27.2%
Deficit/GDP (%)	8.9%	6.2%	-2.7%
External sector			
Imports	21,228	20,494	-3.5%
Exports	3,936	3,313	-15.8%
Trade deficit	17,292	17,181	-0.6%
Gross financial inflows	16,164	15,773	-2.4%
Balance of payments	-1,128	-1,408	24.8%

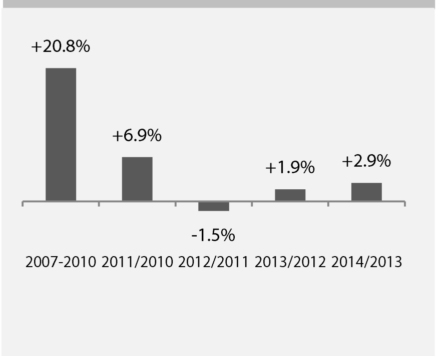
BDL coincident indicator



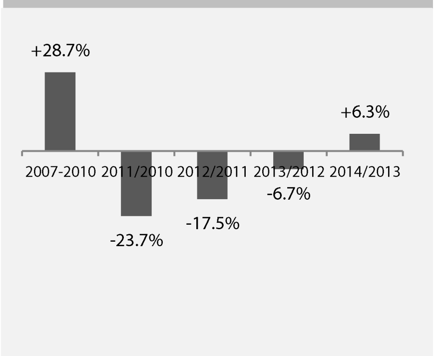
Merchandise at the port



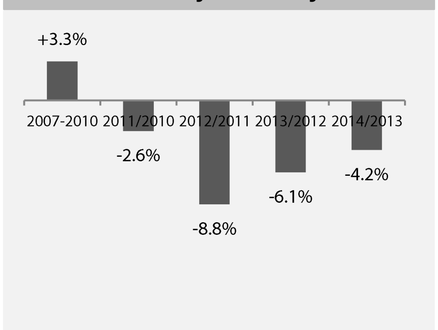
Cleared checks



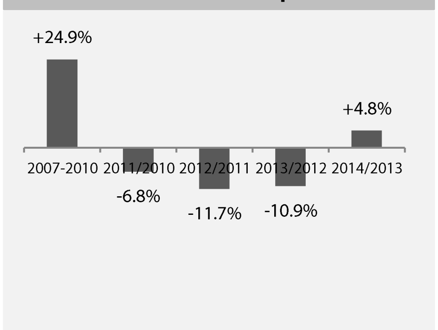
Number of tourists



Velocity of money



New construction permits



Sources: Lebanon Ministry of Finance, BDL & concerned public & private entities.

Banking industry 2014: an analysis of activity performance, risk profile and return indicators

Lebanese banks activity

Within this atypical global, regional and domestic environment, Lebanese banks continued their positive growth in Lebanon and abroad. While their domestic growth has somehow slowed down relative to the previous couple of years, foreign growth was increasingly favorable, triggered by the successful recent expansion of large banks to captive markets.

Meanwhile, Lebanese banks continue to bear witness to a sound risk coverage, ensuring good performance and risk metrics in absolute and relative terms. Following is a thorough analysis of Lebanese banks operating conditions, profitability and risk metrics in 2014. It starts with the analysis of the pace and type of activity growth in 2014, to move to the analysis of liquidity and sovereign exposure, followed by lending quality and provisioning, then capital adequacy and solvency, profitability and efficiency and finalize with investment considerations at large.

Consolidated activity growth

The year 2014 was a good year for Lebanese banks, with consolidated growth rates of major banking aggregates proving to be in line with the previous year. Measured by total assets of Lebanese banks, consolidated banking activity grew by 9.3% in 2014, moving from US$ 198.9 billion at end-December 2013 to US$ 217.5 billion at end-December 2014. Activity growth was driven by both domestic and foreign activity, though the latter proved to be more vigorous over the past year. Domestically, Lebanese banks witnessed a 7.7% growth in 2014, while their foreign activity grew by 17.1% over the year. It is important to mention that, by end-2014, 71.9% of Lebanese banks branches and 72.8% of staff were located in Lebanon.

Customer deposits remain the main driver of activity growth. Customer deposits accounted for 82.6% of total activity and grew by 8.5% in 2014. In particular, foreign deposits grew considerably, increasing by 22.4% between December 2013 and December 2014, while domestic deposits grew by 6.1% over the same period. The US$ 8.5 billion growth in domestic deposits over the course of 2014 proved to be 25% lower than during the previous year, yet remains sound and more than enough to finance the private and public sector components of the Lebanese economy. The share of foreign entities deposits to total deposits increased from 15.0% in December 2013 to 16.9% in December 2014. It is worth mentioning that LL deposits grew by 7.1% and FX deposits grew by 9.1%, raising slightly deposit dollarization at large.

In parallel, consolidated lending activity growth slowed down when compared to the year 2013, as private sector loans registered a sound 11.0% increase that was yet lower than the 15.1% growth rate recorded in the previous year. Loans moved up by US$ 6.8 billion last year to reach US$ 68.8 billion, proving around 16% lower than the volume growth in 2013. It is worth noting that foreign currency lending accounted for about 77% of total lending growth last year, close to their contribution in 2013. The share of foreign entities loans to total loans increased from 25.4% in December 2013 to 27.9% in December 2014.

The analysis by group of banks according to their size shows that growth was realized at different paces by the different bank groups. Bilanbanques divides the banking sector into four groups by size, the first being the Alpha Group (Banks with customer deposits above US$ 2 billion), then the Beta Group (Banks with customer deposits between US$ 500 million and US$ 2 billion), then the Gamma Group (Banks with customer deposits between US$ 200 million and US$ 500 million) and finally the Delta Group (Banks with customer deposits below US$ 200 million). The fastest activity growth in 2014 was realized by the group of large banks, with the Alpha group displaying a growth rate of 9.8% and the Beta Group reporting a growth of 5.4%, while the Delta Group grew by 4.3% and the Gamma Group rose by 3.6%. But banking activity continues to be significantly concentrated, with no significant changes in the shares of the different bank groups. The Alpha Group's share remains highly dominant at 87.1% of the sector's domestic assets (86.8% in 2013), followed by the Beta Group with 9.6% (9.8% in 2013), the Gamma Group with 1.6% (1.7% in 2013) and the Delta Group with 1.6% (1.7% in 2013).

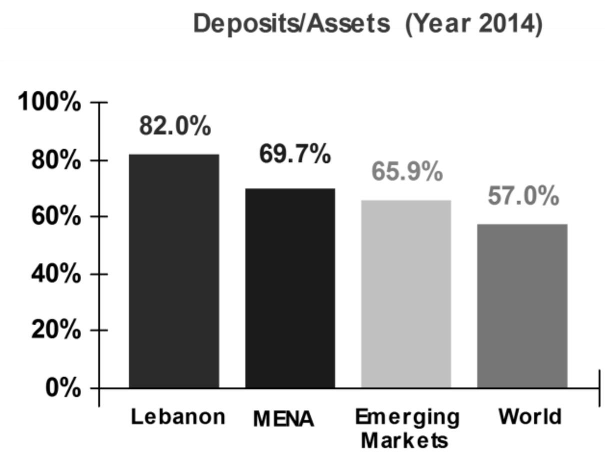
The analysis of Lebanese banks groups by dollarization ratios suggests that the group of small banks is the most dollarized in terms of deposits and the least dollarized in terms of loans. Deposit dollarization stands at 71.2% for the Delta Group, followed by 70.7% for the Alpha Group, 67.5% for the Gamma Group and 66.7% for the Beta Group. On the other hand, loan dollarization is the largest for the Alpha Group with 82.5%, followed by 73.5% for the Gamma Group, 78.0% for the Beta Group and 49.2% for the Delta Group.

Growth rates of banking aggregates

	2008	2009	2010	2011	2012	2013	2014	Var 14/13
Assets	12.8%	21.7%	11.9%	7.9%	8.4%	9.6%	9.3%	-0.3%
Loans to customers	24.9%	15.6%	25.2%	13.6%	11.4%	15.1%	11.0%	-4.1%
Deposits from customers	13.9%	23.4%	12.4%	7.4%	8.8%	9.6%	8.5%	-1.0%
Shareholders' equity	14.7%	24.0%	15.9%	1.9%	13.4%	8.5%	10.8%	2.3%
Total L/C openings of the year	55.2%	-21.4%	31.1%	-8.4%	-5.3%	-5.8%	2.6%	8.4%
Net profit for the year	26.6%	17.4%	28.6%	-4.7%	7.6%	0.0%	9.7%	9.7%

Growth Rates of Lebanese Banks' Groups (Year 2014)

	Alpha	Beta	Gamma	Delta
Assets	9.8%	5.4%	3.6%	4.3%
Loans to customers	11.2%	7.8%	20.6%	14.4%
Deposits from customers	8.9%	5.0%	7.3%	1.6%
Shareholders' equity	11.9%	6.0%	3.5%	0.9%
Total L/C openings of the year	-2.1%	28.5%	318.0%	-35.0%
Net profit for the year	8.9%	22.9%	-10.1%	21.5%



Sources: Bankdata Financial Services, IMF, Bankscope, Fitch rating, MENA central banks

Liquidity and sovereign exposure

While lending growth slowed down despite remaining sound, Lebanese banks continue to boast a large financial flexibility and low leverage conveying to them sufficient room to extend new waves of credit should local/regional conditions ameliorate. The low leverage is reflected in the loans/deposits ratio of merely 38.56% at end-December 2014 (against a regional average of 72.9% and a global average of 83.6%), and the financial flexibility is visible at the level of the primary liquidity of banks, i.e. the funds readily available and that are placed with the Central Bank and solid banks abroad, and which accounts for a relatively healthy 38.13% of foreign currency deposits. Nonetheless, it is worth noting that liquidity placed with foreign banks is contracting to the benefit of the Central Bank, as the share of the former in prime liquidity regressed from 34.5% in 2013 to 30.2% in 2014 to extend the trend that was reported over the previous couple of years.

Having said that, the Lebanese banking system maintains considerable buffers to weather substantial deposit outflows under periods of stress, which significantly mitigates liquidity concerns. It is estimated that Lebanese banks' investment-grade international placements and securities, combined with Central Bank foreign-currency reserves, represent around 55% of the system's foreign-currency deposits, and a third of total deposits.

The analysis of liquidity by Lebanese banks' groups in 2014 shows that liquidity is almost inversely related to the size of banks. The most liquid Group is the Alpha Group with a net primary liquidity to deposits ratio of 33.01%, followed by the Gamma Group with a ratio of 28.33%, the Beta Group with a ratio of 24.33% and the Delta Group with a low ratio of 9.75% as it holds a significantly large amount of government paper among its assets base.

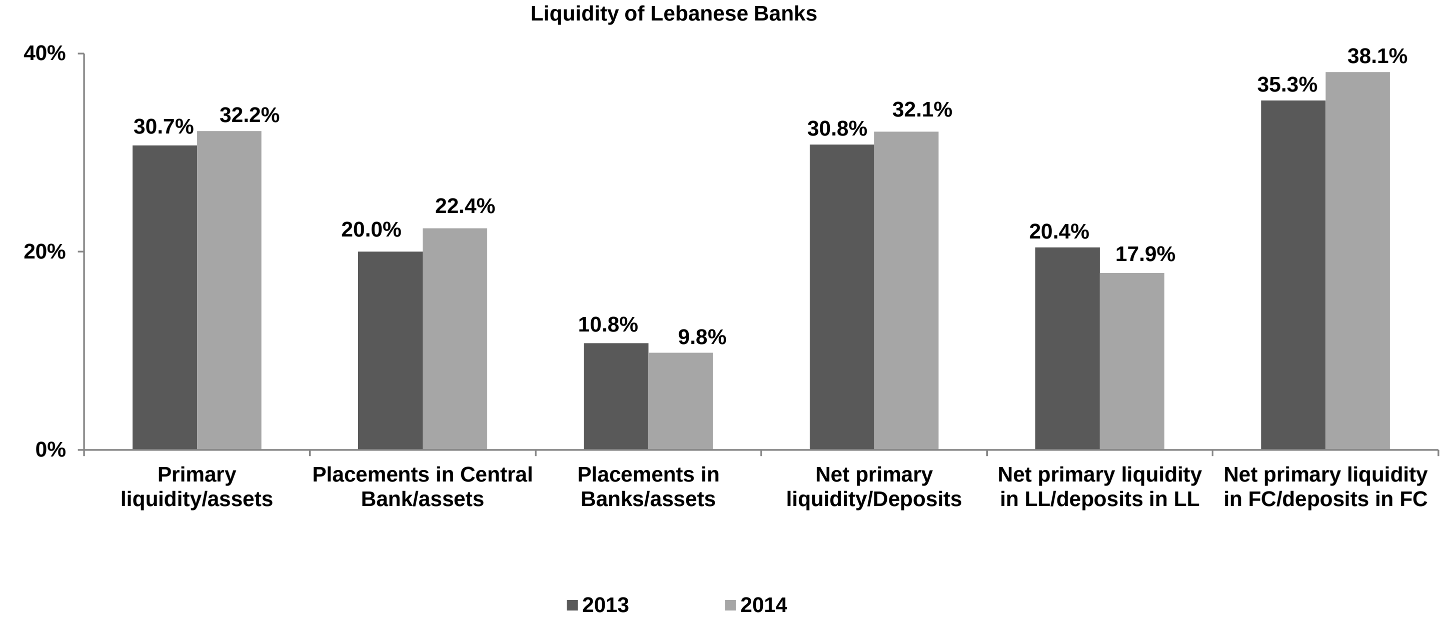
At the mirror image of liquidity lies the banks' exposure to the sovereign. It is worth mentioning in this context that banks' exposure to the sovereign was reduced last year, following their acquisition of the bulk of the FX sovereign bond portfolio of the BDL over the course of 2013. Banks' foreign currency sovereign bond portfolio reached 0.86x total equity at year-end 2014 (against 1.01x at year-end 2013) after an increase in banks' own funds accompanied the lower exposure to the sovereign. The aggregate portfolio securities (all currencies) consequently declined from 41.93% of deposits at end-2013 to 39.68% at end-2014.

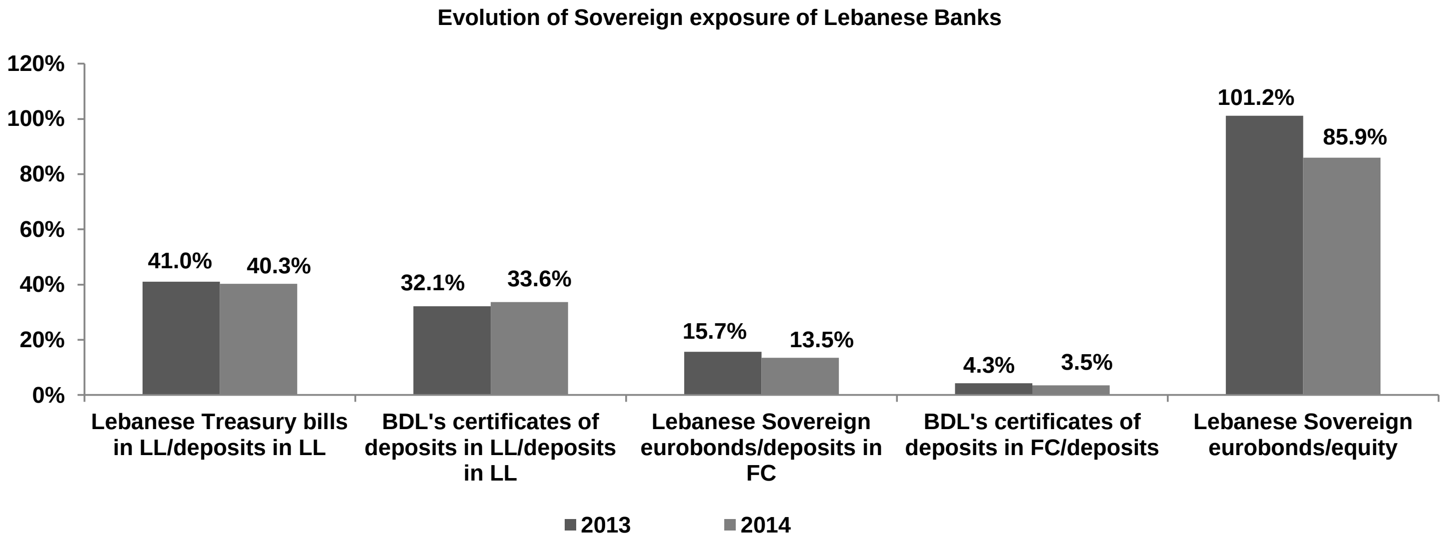
The analysis of sovereign exposure by Lebanese banks' groups in 2014 shows that the Group with the highest exposure in Lebanese Pounds is the Delta Group with a ratio of Lebanese Treasury bills in LL to deposits in LL of 69.61%, followed by the Beta Group with 52.28%, the Gamma Group with 44.68% and the Alpha Group with 38.78%. In parallel, the Group with the highest exposure in foreign currency in 2014 is the Gamma Group with a ratio of Lebanese sovereign Eurobonds to deposits in foreign currency of 37.00%, followed by the Delta Group with 24.79%, the Beta Group with 13.30% and the Alpha Group with 13.17%.

As such, sovereign exposure in relative terms seems to be almost inversely related to the size of banks. However, the large banks tend to have the largest Central Bank exposure in relative terms. As a percentage of their asset base, placements at the Central Bank represent 22.98% for the Alpha Group, followed by the Gamma Group with 20.95%, the Beta Group with 16.60% and the Delta Group with 16.10% in 2014.

Liquidity of Lebanese Banks' Groups (Year 2014)

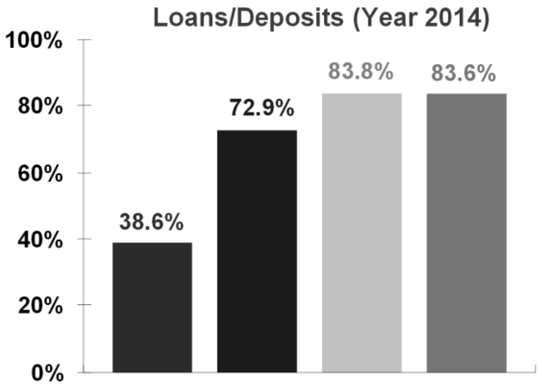
	Alpha	Beta	Gamma	Delta
Primary liquidity/assets	**32.62%**	**25.05%**	**39.83%**	**36.53%**
o.w. Central Bank/assets	22.98%	16.60%	20.95%	16.10%
o.w. Banks/assets	9.64%	8.46%	18.88%	20.42%
Net primary liquidity/Deposits	**33.01%**	**24.33%**	**28.33%**	**9.75%**
o.w. net primary liquidity in LL/deposits in LL	18.77%	9.09%	26.24%	-1.40%
o.w. net primary liquidity in FC/deposits in FC	38.92%	31.94%	29.34%	14.25%

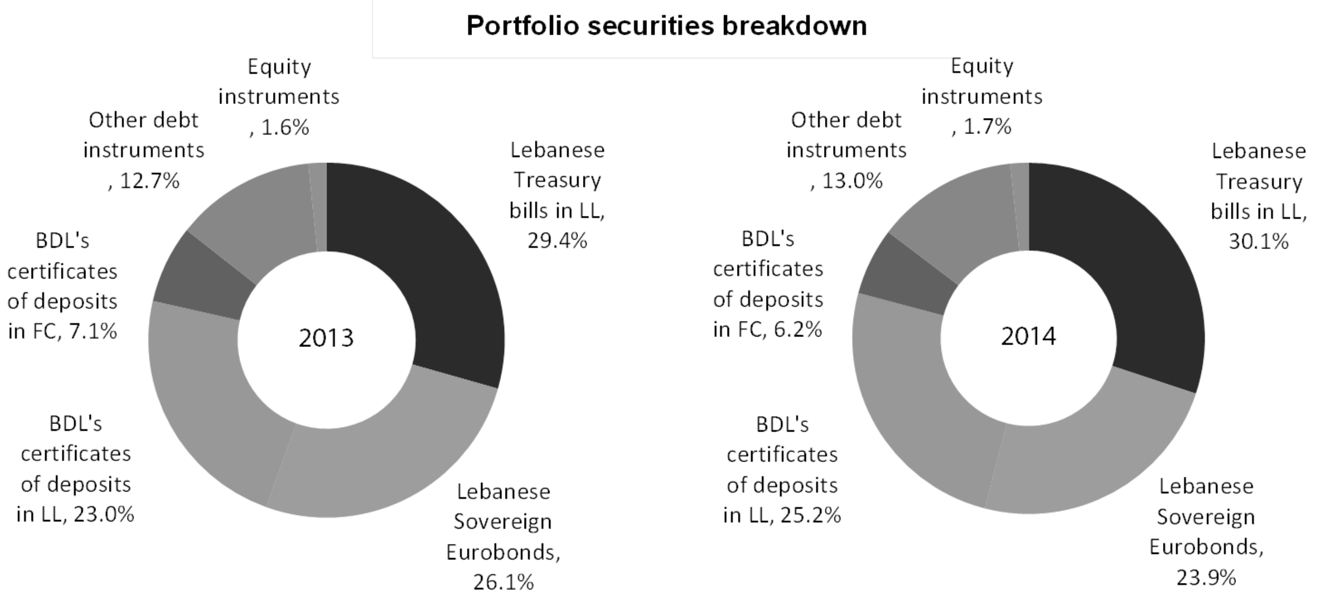




Sovereign exposure of Lebanese Banks' Groups (Year 2014)

	Alpha	Beta	Gamma	Delta
Lebanese Treasury bills in LL/deposits in LL	38.78%	52.28%	44.68%	69.61%
BDL's certificates of deposits in LL/deposits in LL	35.15%	20.31%	35.33%	9.88%
Lebanese Sovereign eurobonds/deposits in FC	13.17%	13.30%	37.00%	24.79%
BDL's certificates of deposits in FC/deposits in FC	3.44%	3.97%	4.11%	4.38%
Lebanese Sovereign eurobonds/equity	87.29%	92.36%	105.67%	28.04%





Lending Quality and Provisioning

Lebanese banks have sustained their good asset quality metrics. Within the context of a lower growth in gross doubtful loans (6.8%) than that of total gross loans (10.6%), the ratio of gross doubtful loans as a percentage of total gross loans shrank from 6.81% in December 2013 to 6.58% in December 2014. When adding substandard loans, the ratio drops from 7.76% to 7.41%. Within the context of loan loss reserves equivalent to 77.45% of doubtful loans, the ratio of net doubtful loans to gross loans stabilized at 1.48% over the past year, while its ratio relative to equity registered 5.52% at end-December 2014. It is worth mentioning that beyond specific provisions, Lebanese banks hold collective provisions of US$ 682 million, the equivalent of 0.99% of net loans.

It is worth mentioning that the breakdown of the sector's loan portfolio by various types of loans shows that loans secured by commercial real estate reported the most significant growth of 43.8% in 2014, followed by housing loans with 17.8%, retail loans with 16.4%, loans to SMEs with 12.2%, and corporate loans with 3.2%. Still, corporate loans continue to represent the bulk of the loan portfolio, with 39.3% of total loans in 2014, against 42.3% in 2013. The analysis by Group of banks suggest that corporate loans represent the most significant share in the loan portfolio in the Beta group with 52.8%, followed by the Gamma Group with 39.5%, the Alpha Group with 38.0% and the Delta Group with 32.0% in 2014.

As such, housing loans grew by a rapid 38.8% from end-2012 to end-2014 as they were the main beneficiaries of the Central Bank's stimulus package, much faster than the total rate of loan growth in the system over the last two years. In addition, loan maturities have lengthened from an average of 30 months prior to 2009, to over 50 months in 2014, while retail loan maturities exceeded 70 months indicating a deterioration in loan affordability. BDL's recent macro-prudential measures and additional collective provisioning requirements will help ensure better loan affordability, collateral coverage and thus contain asset quality risks for loans newly extended going forward.

Breakdown of loans and advances to customers (as a % of total loans) in 2014

	All Banks	Alpha Group	Beta Group	Gamma Group	Delta Group
Corporate	39%	38%	53%	39%	32%
SMEs	18%	19%	12%	32%	1%
Housing	14%	14%	13%	9%	48%
Retail	12%	12%	12%	7%	8%
Secured by commercial real estate	9%	9%	10%	8%	0%
Other loans	8%	8%	1%	4%	11%
Public sector	0%	0%	0%	-	-

Banking industry 2014: an analysis of activity performance, risk profile and return indicators

The analysis of lending quality by group of banks shows that lending quality is almost tied to the size of banks, suggesting that larger banks have better asset quality. This is noticed as banks of the Alpha Group reported the lowest doubtful loans to gross loans ratio of 5.76% at year-end 2014, followed by the Beta Group with 8.07%, the Delta Group with 20.12% and the Gamma Group with 31.82%. When adding substandard loans, the ratio of doubtful and substandard loans to gross loans reported a low of 6.44% for the Alpha Group, 10.05% for the Beta Group, 21.89% for the Delta Group and 32.68% for the Gamma Group. On the other hand, middle sized banks are the best provisioned. The ratio of loan loss reserves on doubtful loans as a percentage of doubtful loans reported considerably high ratios of 91.20% and 82.77% for the Gamma and Beta Groups respectively, while the Alpha Group registered a ratio of 76.14% and the Delta Group recorded a ratio of 69.36%. When accounting for both doubtful loans and provisioning, Alpha banks still enjoy the best asset quality, with a net doubtful loans to equity ratio of 5.11%, followed by Gamma banks with 5.98%, Beta banks with 7.22% and Delta banks with 11.87%.

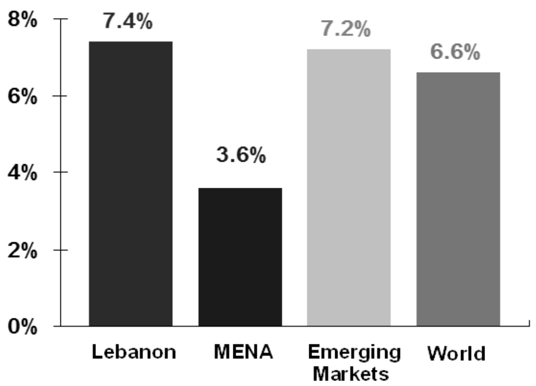
Asset Quality of Lebanese Banks

	2008	2009	2010	2011	2012	2013	2014	Var 14/13
Doubtful loans/Gross loans	10.67%	9.44%	7.29%	6.85%	7.07%	6.81%	6.58%	-0.23%
Substandard loans + doubtful loans/Gross loans	11.97%	10.42%	8.24%	7.66%	7.80%	7.76%	7.41%	-0.35%
Net doubtful loans/Gross loans	1.32%	1.06%	1.23%	1.25%	1.44%	1.48%	1.48%	0.00%
Loan loss reserves on doubtful /Doubtful loans	87.66%	88.76%	83.46%	81.67%	79.61%	78.30%	77.40%	-0.90%
Net doubtful loans/Equity	4.35%	3.23%	3.88%	4.53%	5.08%	5.50%	5.52%	0.02%

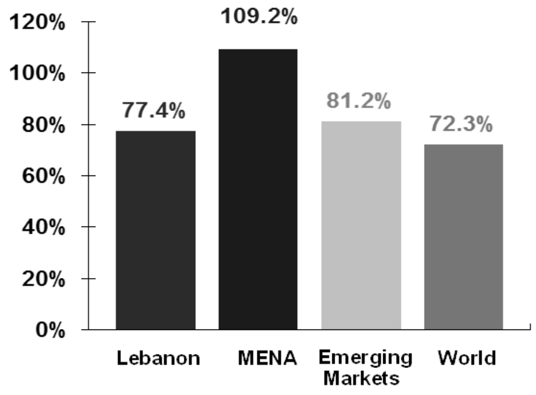
Asset Quality of Lebanese Banks' Groups (Year 2014)

	Alpha	Beta	Gamma	Delta
Doubtful Loans/Gross loans	5.76%	8.07%	31.82%	20.12%
Substandard Loans + Doubtful Loans/Gross loans	6.44%	10.05%	32.68%	21.89%
Net Doubtful Loans/Gross loans	1.37%	1.39%	2.80%	6.16%
Loan Loss Reserves on Doubtful Loans/Doubtful Loans	76.14%	82.77%	91.20%	69.36%
Net Doubtful Loans/Equity	5.11%	7.22%	5.98%	11.87%

NPLs/Total Loans (year 2014)

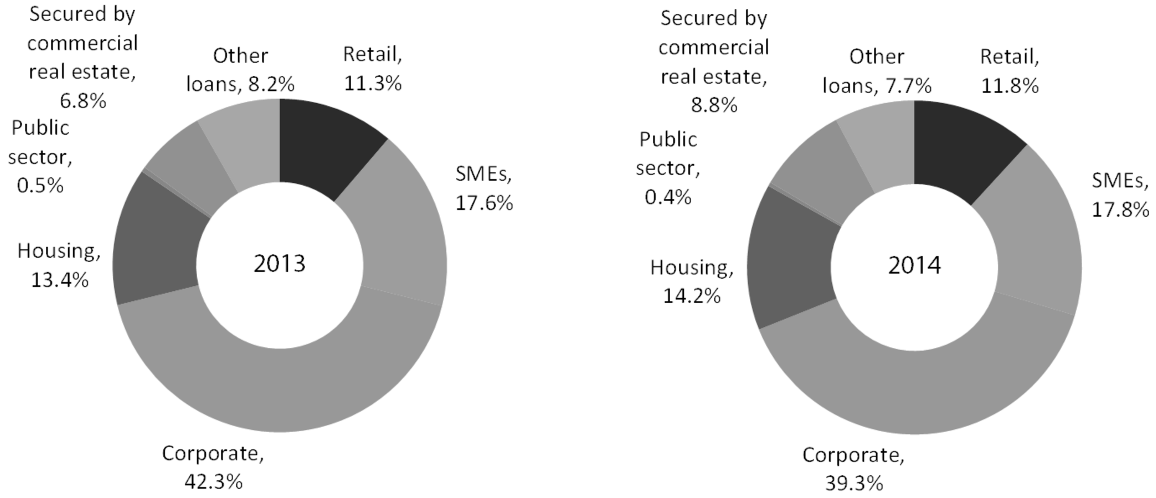


LLRs/NPLs (year 2014)



Sources: Bankdata Financial Services, IMF, Bankscope, Fitch rating, MENA central banks

Loans and advances breakdown



Capital Adequacy and Solvency

The year 2014 witnessed a growth in capitalization as well. Lebanese banks' shareholders' equity grew by 10.8%, moving from US$ 17.8 billion at end-December 2013 to US$ 19.7 billion at end-December 2014. As such, with the growth in equity outpacing activity growth, the equity to assets ratio rose from 8.9% in December 2013 to 9.1% in December 2014, one of its highest levels ever.

The reinforcement of capitalization actually strengthened the banks' capital adequacy, with a sound coverage of all types of credit, market and operational risk by shareholders' own funds. The total Basel II capital adequacy ratio stood at 14.61% as at end-December 2014 (14.23% as at end-December 2013), higher than the minimum requirement and thus providing banks with adequate buffers to withstand potential pressures on their capital base. The banking sector's capital ratios improved in 2014 also as a result of an amendment in the calculation of RWAs whereby Lebanese banks' foreign currency placements and foreign currency CDs with the Central Bank are now risk-weighted 50% (from 100% previously).

Having said that, it is worth mentioning that more than 70% of the total capital at Lebanese banks is made up of common equity Tier 1. The total capital ratio is broken down over a Tier 1 ratio of 13.48% and a Tier 2 ratio of 1.13% at year-end 2014. In turn, the Tier 1 ratio is broken down over a common Tier 1 ratio of 10.34% and an additional Tier 1 ratio of 3.14% at year-end 2014.

The analysis of capital adequacy by Group of banks suggests that the small banks are the most highly capitalized. Capital adequacy (as per Basle II requirements) reported a high of 40.87% for the Delta Group, followed by a ratio of 21.18% for the Gamma Group, 14.24% for the Alpha Group and 13.80% for the Beta Group in 2014. Likewise, the equity to assets is the highest for the Delta Group with 24.40%, followed by the Gamma Group with 14.49%, the Alpha Group with 8.83% and the Beta Group with 8.12% in 2014.

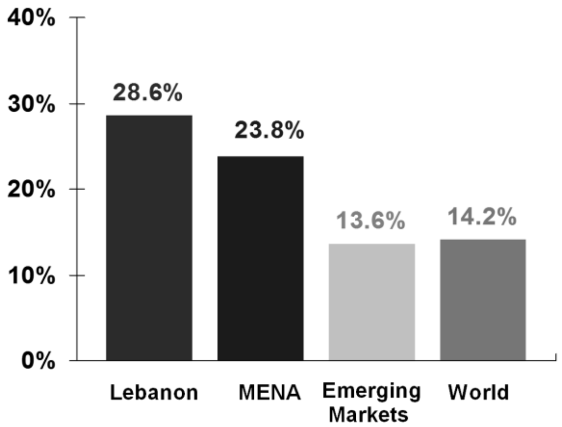
Capitalization of Lebanese Banks

	2008	2009	2010	2011	2012	2013	2014	Var 13/12
Capital adequacy (as per Basel II requirements)	12.01%	12.81%	13.13%	11.75%	13.83%	14.23%	14.61%	0.38%
Equity to assets	8.65%	8.81%	9.13%	8.62%	9.02%	8.93%	9.06%	0.12%
Leverage	11.65%	11.45%	11.14%	11.28%	11.32%	11.14%	11.11%	-0.03%

Capitalization of Lebanese Banks' Groups (Year 2014)

	Alpha	Beta	Gamma	Delta
Capital Adequacy (as per Basel II requirements)	14.24%	13.80%	21.18%	40.87%
Equity Assets	8.83%	8.12%	14.49%	24.40%
Leverage	11.43	12.36	6.90	4.03

Equity/Net Loans (Year 2014)



Profitability and efficiency

In parallel, the past year saw a 9.7% growth in Lebanese banks consolidated net profits following a standstill over the previous year, leading to a 6.4% growth in the Banks' common earnings per share. Indeed, net profits amounted to US$ 2,067.6 million in 2014, against US$ 1,885.0 million in 2013. Their profit growth was actually generated by a 9.3% growth in net operating income, exceeding that of operating expenses of 8.6% and leading to a 10.6% growth in profit before taxes. In turn, the growth in net operating income was driven by a 9.4% growth in net interest income in 2014 coupled with an 11.9% growth in net fee and commission income.

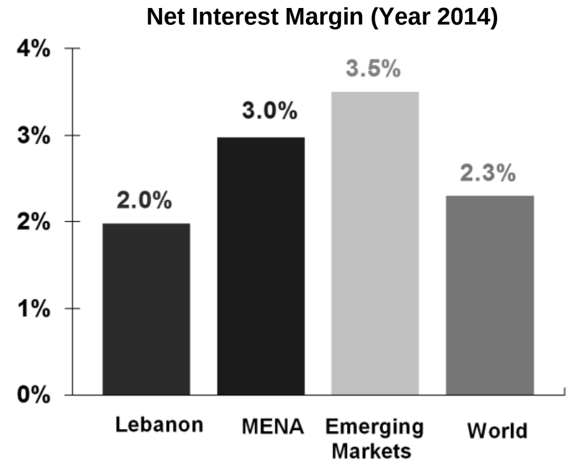
It is worth mentioning that the ratio of non-interest income to total income has slightly regressed in 2014 relative to 2013, from 33.85% to 33.69% respectively. The breakdown of non-interest income shows that net fee and commission income grew by 11.9% in 2014, while net gain on financial assets and/or investments rose by 12.1%, other income increased by 20.9%, all counterbalancing a 20.8% contraction in net profits on foreign exchange. Still, net fee and commission income held the lion's share with 49.9% of non-interest income in 2014, followed by net gain on financial assets and/or investments with 30.1%, net profits on foreign exchange with 9.4%, while other income reported 10.6% of the total.

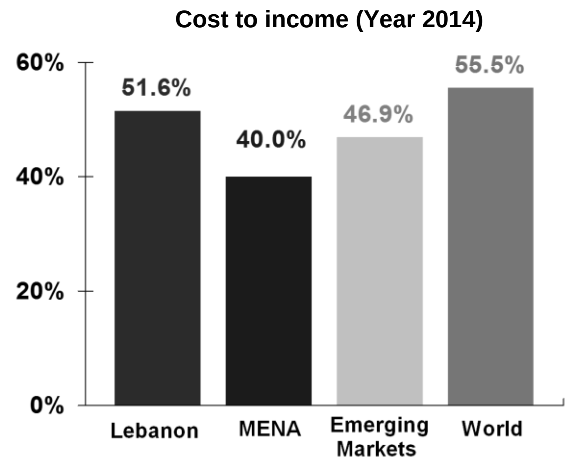
As profit growth was close to that in total assets and equity, a stability in return ratios was recorded in 2014. The return on average assets hovered around 0.99% in 2014, maintaining its previous year's level, while the return on average equity stood at 11.04% (12.06% for the return on average common equity). Key performance metrics suggest a stability in spread at 1.92% in 2014, a relative stability in non interest income to average assets at 0.97%, leading to a stability in asset utilization at 2.89%, in conjunction with a slight rise in net operating margin from 34.20% to 34.37%, while cost to income has declined from 51.82% to 51.57% and credit cost contracted from 6.71% to 6.45%. Looking ahead, Lebanese banks are apt to benefit from rising spreads and interest margins on the back of the expected rise in foreign benchmark rates, thus improving the yields on their liquid uses, which could ultimately support their profitability at large.

The comparative global analysis shows that return on average assets and return on average equity are underperforming relative to global benchmarks. Lebanese banks' return on average assets reported 1.0% in 2014, against an average of 1.6% for the MENA region, an average of 1.9% for emerging markets and an average of 1.6% for the global return. In parallel, Lebanese banks' return on average equity reported 11.0% in 2013, against an average of 12.3% for the MENA region, an average of 16.9% for emerging markets and an average of 15.0% for the global return. As to cost to income, it reported 51.6% in Lebanon, versus 40.0% in the MENA region, 46.9% in emerging markets and 55.5% in the world at large.

The analysis by group of banks suggests that while Beta and Delta banks have reported respective rises of 22.9% and 21.5% in their bottom line in 2014, Alpha banks reported a smaller rise of 8.9%, and Gamma banks reported a net contraction of 10.1%. But return ratios seem to be almost directly proportional to the size of banks, with the return on average equity registering the highest ratio of 11.53% for Alpha banks, followed by Beta banks with 9.79%, Delta banks with 5.62% and Gamma banks with 5.16% in 2014. This is realized despite a drawback in spread generation by larger banks, with the interest margin inversely related to bank size, yet compensated by a strong fee income generation for most groups. Interest margin reported a low of 1.98% for Alpha banks, followed by 1.99% for Beta banks, 2.39% for Gamma banks and 3.26% for Gamma banks. The share of non-interest income to total income reported 33.74% for Alpha banks, quite higher than Beta and Gamma groups within the context of better business diversification.

In parallel, the large banks displayed the highest efficiency because of economies of scale, with a cost to income ratio of 49.92% for Alpha banks, followed by Beta banks with 62.99%, Delta banks with 64.67% and Gamma banks with 69.21%. Similarly, the cost to average assets is inversely proportional to the size of banks, with the Alpha Group reporting the lowest ratio of 1.43%, followed by the Beta Group with 1.76%, the Gamma Group with 2.16% and the Delta Group with 3.31% in 2014.





Banking industry 2014: an analysis of activity performance, risk profile and return indicators

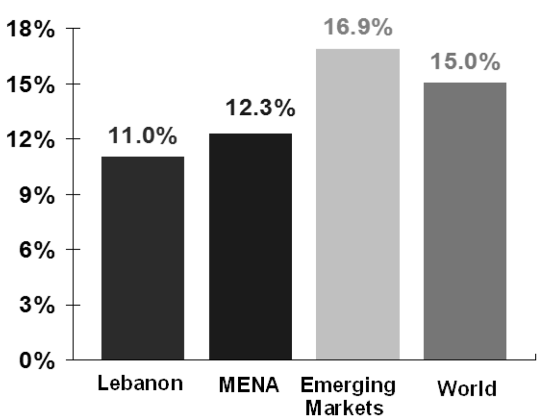
Return Ratios of Lebanese Banks

	2013	2014	Var 14/13
Yield on earning assets	5.50%	5.63%	0.13%
o.w. in LL	*6.97%*	*6.79%*	*-0.17%*
o.w. in FX	*4.83%*	*5.10%*	*0.28%*
- Cost of earning assets	3.50%	3.64%	0.13%
o.w. in LL	*4.77%*	*4.73%*	*-0.04%*
o.w. in FX	*2.92%*	*3.14%*	*0.22%*
= Interest margin	2.00%	2.00%	0.00%
o.w. in LL	*2.20%*	*2.07%*	*-0.14%*
o.w. in FX	*1.91%*	*1.97%*	*0.06%*
x Average interest earnings/Average assets	95.90%	95.88%	-0.01%
o.w. in LL	*95.70%*	*95.30%*	*-0.40%*
o.w. in FX	*95.99%*	*96.16%*	*0.16%*
= Spread	1.92%	1.92%	0.00%
o.w. in LL	*2.11%*	*1.97%*	*-0.14%*
o.w. in FX	*1.83%*	*1.89%*	*0.06%*
+ Non-interest income/Average assets	0.98%	0.97%	-0.01%
= Asset utilization	2.90%	2.89%	-0.01%
x Net operating margin	34.20%	34.37%	0.17%
o.w. cost to income	*51.82%*	*51.57%*	*-0.25%*
o.w. credit cost	*6.71%*	*6.45%*	*-0.27%*
o.w. other provisions	*-0.01%*	*-0.05%*	*-0.03%*
o.w. tax cost	*7.28%*	*7.66%*	*0.38%*
= ROAA	**0.99%**	**0.99%**	**0.00%**
x Leverage	11.14	11.11	-0.03
= ROAE	**11.04%**	**11.04%**	**-0.01%**

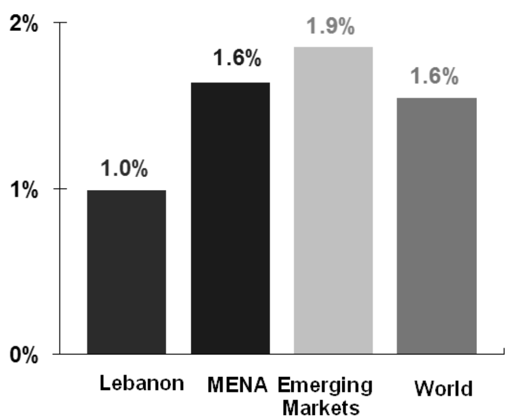
Profitability of Lebanese Banks' Groups (Year 2014)

	Alpha	Beta	Gamma	Delta
Spread	1.90%	1.89%	2.30%	3.01%
Interest margin	1.98%	1.99%	2.39%	3.26%
Non interest income/total income	33.74%	32.16%	26.55%	41.17%
ROAA	1.01%	0.79%	0.75%	1.39%
ROAE	11.53%	9.79%	5.16%	5.62%

Return on Average Equity (Year 2014)



Return on Average Assets (Year 2014)



Management efficiency of Lebanese Banks

	2008	2009	2010	2011	2012	2013	2014	Var 13/12
Cost per average branch (US$ million)	1.65	1.73	1.88	1.89	2.01	2.11	2.19	4.11%
Staff expenses per average staff (US$ 000s)	40.35	40.34	42.24	42.97	45.64	48.78	51.38	5.34%
Staff expenses to general operating expenses (%)	53.90%	53.64%	54.03%	55.61%	54.64%	55.58%	56.21%	0.62%
Cost to income (%)	52.85%	51.87%	48.23%	49.66%	49.65%	51.82%	51.57%	-0.25%
Cost to average assets (%)	1.64%	1.54%	1.52%	1.46%	1.51%	1.50%	1.49%	-0.01%

Management efficiency of Lebanese Banks' Groups (Year 2014)

	Alpha	Beta	Gamma	Delta
Cost per average branch (US$ million)	2.27	1.61	2.12	2.78
Staff expenses per average staff (US$ 000s)	52.54	42.11	53.92	49.26
Staff expenses to general operating expenses (%)	56.81%	50.79%	60.96%	52.89%
Cost to income (%)	49.92%	62.99%	69.21%	64.67%
Cost to average assets (%)	1.43%	1.76%	2.16%	3.31%

Investment Considerations

With the moderate increase in their bottom lines, Lebanese banks have continued to issue more capital, whether through common or preferred shared issuances. Common shares outstanding rose by a further 1.6% in 2014 and preferred shares outstanding by 1.3%. With net profits improving and their growth exceeding share issuance growth, banks' common earnings per share rose last year (+6.4%) to reach LL 680.0. Likewise, banks' capitalization efforts have bared their fruits and favored a further rise at the level of the common book per share, which grew by a healthy 10.0% to LL 5,777.37.

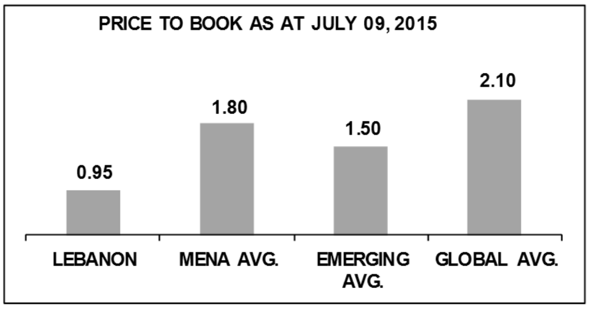
With the Beirut Stock Exchange activity remaining mostly dull throughout the year 2014 and turnover reaching a mere US$ 619 million which, although surging from the previous year's even lower level, only accounts for 5.9% of total market capitalization at year-end, bank management strived to compensate shareholders. Banks actually increases dividend distribution, especially amidst a near standstill in equity prices which grew by a tiny 0.6% in 2014.

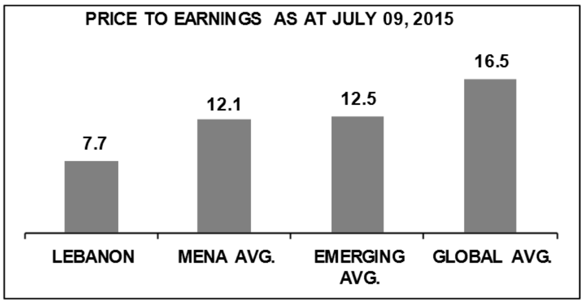
The latter accompanied the increase in banks' bottom lines and thus, dividends distributed by banks to common shareholders grew by 2.6% and those to preferred shareholders rose by 10.7%. Consequently, dividends per share to common shareholders rose by 0.9% last year to attain LL 220.19. Nonetheless, dividend distribution did not fully keep pace with the increase in net earnings, as banks retained some earnings and the payout ratios slightly declined (from 33.0% to 30.9% for common shares and from 40.7% to 38.9% for common and preferred shared altogether year-on-year).

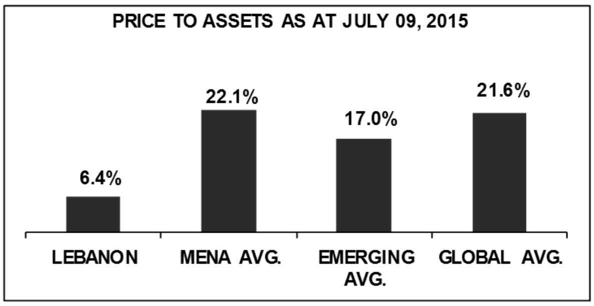
What is quite interesting is that dividend distribution growth, coupled with the very limited price appreciation on the local bourse mainly tied to the delicate politico-security conditions and lackluster investor mood, favored the dividend yield measure to remain quite attractive in relative terms. As a matter of fact, the average dividend yield on banking stocks for all listed Lebanese banking institutions (common and preferred altogether) reached 5.5% in 2014, comparing to lower banking sector averages for emerging markets (3.1%) and the world at large (2.8%).

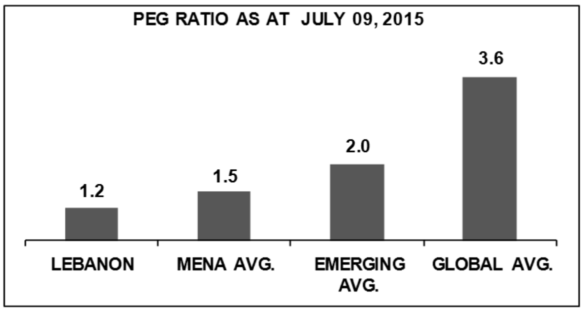
Dividend yields are not the only attractive market measure that Lebanese banks benefit from. Given their sound fundamentals and financial standing, they also boast enticing market valuation ratios. Large listed Lebanese banks' shares traded at a P/E of 7.7x at the closing of July 09, 2015, much lower than the MENA banks average of 12.1x, and the emerging and global market averages of 12.5x and 16.5x respectively. Similarly, they traded at a P/BV of less than 1x (0.95x at the same date), comparing to higher benchmarks of 1.8x for MENA banks on average, and 1.5x and 2.1x for emerging market and global averages, respectively. Large listed Lebanese banks' price to assets ratio averaged a mere 6.4%, against similar regional and international benchmarks in the 17%-22% range.

When considering the PEG ratio, dividing the P/E by the compounded earnings per share growth of the past six years, Lebanese bank shares once again appear attractive relative to peers. The large listed Lebanese banks' PEG ratio stood at 1.2x, trading at a discount of nearly 20% to MENA banks' and at larger discounts of around 40% and 67% to emerging market and global averages. All in all, Lebanese banks, which boast attractive dividend yields and enticing market pricing ratios coupled with a solid financial standing, are noteworthy to keep on investors' radar screens.









Sources: Bloomberg, Zawya Investor, Citigroup, IMF, Beirut Stock Exchange, Bank Audi's Group Research Department

Conclusion

Lebanon's banking sector has continued its sound moderate consolidated growth over the past year, almost similar to the growth reported since 2011. While it is true that recent growth rates are of single digits, below the double digit growth rates that were witnessed in prior years, current rates are considered quite healthy enabling banks to assume their financing engagement towards the domestic economy and foreign markets of presence, to play an adequate financial intermediation role and to cater to its growing franchises in Lebanon and regional countries. Domestically, funding growth is more than sufficient to meet the financing needs of the local economy in both its components of public and private sectors, notwithstanding the external sector.

While Lebanese banks that adopted cross border expansionary policies to neighboring markets have been impacted by the regional turmoil and its adverse effects on banking operating conditions, this did not put at stake the rationale of the overall expansion policies. As a matter of fact, despite the changes in operating conditions in regional markets of presence, the fundamentals of the diversification strategies launched more than a decade ago have not changed and Lebanese banks continue to adapt to arising challenges and opportunities, mitigating the impact of the former and turning the latter to their advantage. The long term objectives of the expansion strategies focus on building profitable customers and accounts portfolios in a number of high value added markets witnessing exponentially growing yearly inter-trade turnovers and hosting millions of regional citizens and expatriates which offers great opportunities in cross selling corporate and retail banking products and services.

The past year's banking sector performance indeed confirms once again the soundness of the banks' diversification strategy, efficiently driving a sustained growth in spite of the persisting challenging operating environment particularly in Arab Countries in Transition. The strong business and financial growth highlights the Bank's capacity to attract new customers, and to expand its range of services. The banks' results also confirm their good financial flexibility resulting from the diversification of activity and profit sources while bearing witness to the commercial growth momentum that represents a source of future recurrent revenues. They are bearing witness to reinforced efficiency measures anchored over cost control efforts within the context of rising revenue and cost optimization strategies amidst tough operating conditions at large.

This is not to say that there are no challenges to the near term outlook. Return ratios of Lebanese banks are now relatively low when compared to their average weighted cost of capital although justified by the persistent tough operating conditions in their main markets of presence. Operating environment is set to remain tough in the absence of a regional political settlement scenario. Credit exposure to the weakened Lebanese sovereign, as well as dampened profitability, are also key challenges. Lower new business generation and elevated loan-loss provisioning needs will continue to weigh on banking sector profitability. On the other hand, Lebanese banks are apt to benefit from rising spreads and interest margins on the back of the expected rise in foreign benchmark rates, thus improving the yields on their liquid uses, ultimately supporting their earning power. The banking system's funding strengths are also likely to remain, supported by sustainable inflows of remittances from abroad. At the same time, capital levels will continue to improve, driven by the phasing-in of Basel III rules at large.

In a longer term perspective, and on the basis of universal banking profiles and wide cross border presence, Lebanese banks are apt to adequately benefit from a trend reversal in the operating environment in due time when current transitory challenges gradually dissipate looking ahead. Lebanese banks' strong fundamentals and financial soundness with a persistently high liquidity and a solid funding profile, a favorable asset quality and an adequate capitalization are apt to provide, within the context of strong business diversification, ample room for healthy financial intermediation and enticing growth prospects looking ahead both in the domestic market and in under-banked markets of presence.