The Banking Sector and Financing the Economy

The deterioration of public finance and the increase of Lebanon's debt have raised a problematic issue in terms of the ability of the financial sector in general, and banks in particular, to finance the growing needs of the State, without affecting their ability to finance the private sector at an affordable cost that does not constitute an impediment to investment.

To look into the financing structure prevailing in the Lebanese economy, this chapter tackles the following four pillars:

- Is there a funding gap in the Lebanese economy, which prevents us from reaching high levels of investment?

- Does the current distribution of bank financing lead to the best impact on the economy, in terms of sustainable and equitable growth?

- What are the required steps to reach an integrated financing system that stimulates growth and contributes to the achievement of social justice?

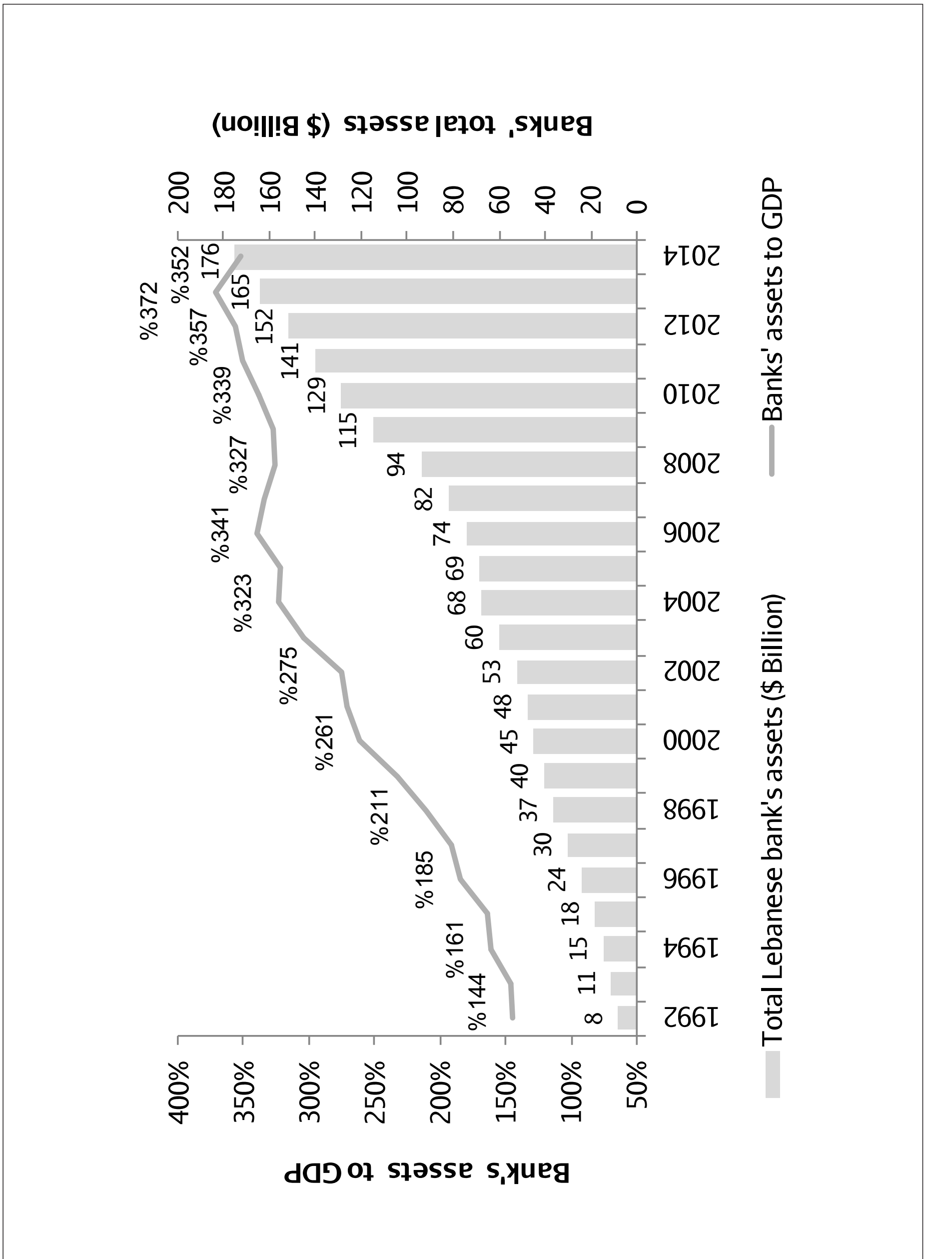
- What are the difficulties and the potential risks at the financing capacity level?

In dealing with these four topics, we will have a scientific and realistic picture of the situation of the Lebanese banking sector in terms of Strengths, Weaknesses, Opportunities and Threats (SWOT analysis).

The first topic is linked to the size of the banking sector, the size of loans to the private sector, and their proportion to the size of the national economy, or Gross Domestic Product.

One of the most prominent strengths of the Lebanese banking sector lies in its size compared to the national economy. In light of the volatile conditions witnessed by Lebanon in the last two decades, Lebanese banks have shown high flexibility and stable growth. Perhaps one of the most important factors that boosted this growth was that the

Chart 1: The evolution of the Lebanese banks' assets



Source: The Central Bank of Lebanon (BDL), IMF

The Lebanese banking sector has been among the largest in the world relative to the size of the economy. Despite the Lebanese civil war of 1975-1990, the banking sector was able to maintain its size, as the percentage of its total assets to the GDP reached 144% in 1992. It maintained a continuous growth in the last twenty years; banks' assets rose by an annual average of 15.5% to reach $175.7 billion in 2014, equivalent to 352% of Lebanon's GDP. With assets exceeding three times the size of the Lebanese economy, Lebanese banks are now not only a financial intermediary, but also a mainstay of the national economy.

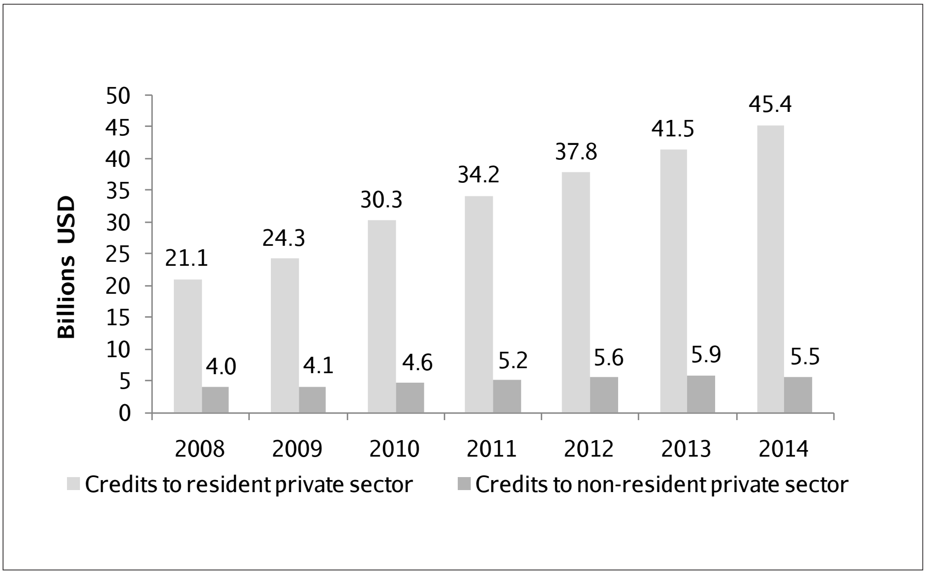
The first topic: The size of the banking sector and loans to the private sector

Comparison among Lebanon, the Arab region and the world shows that Lebanon's banking sector has one of the highest ratios of total assets to GDP, as it reached 352%, compared with an average of 161.9% for the world, 277.3% in the European Union, and 106.0% for emerging markets. This shows the sector's strength and proves that the Lebanese financial system is mainly based on banks, which play a key role in financing companies, individuals, and the public sector. For example, this high ratio of Lebanese bank assets to GDP can be compared to 179% in Jordan, 114% in the United Arab Emirates, 100% in Turkey, 306% in France, and 230% in Germany. The Lebanese banks' assets to GDP ratio has allowed them to fund the public sector, as banks have a large proportion of the total public debt, and the private sector as well, as loans to the private sector represented more than 102% of GDP in 2014.

The strong growth of the banking sector has allowed it to meet the needs of the public sector without creating a dangerous crowding out for the private sector loans. Banks continued to support the private sector through uninterrupted lending to both corporations and individuals.

Loans granted to the resident and non-resident private sector maintained their high level in spite of the decelerating economic growth in Lebanon over the past years, though at a lighter pace, as they reached $50.9 billion by the end of 2014, registering an annual growth rate of 7%, after rising by 9% in 2013 and 11% in 2012. Loans to the resident private sector represent a large part, with a share of 89%. The non-resident private sector obtained 11% of private loans. Most of those non-resident loans are set to fund Lebanese businessmen in overseas projects (especially in the Arab world and Africa).

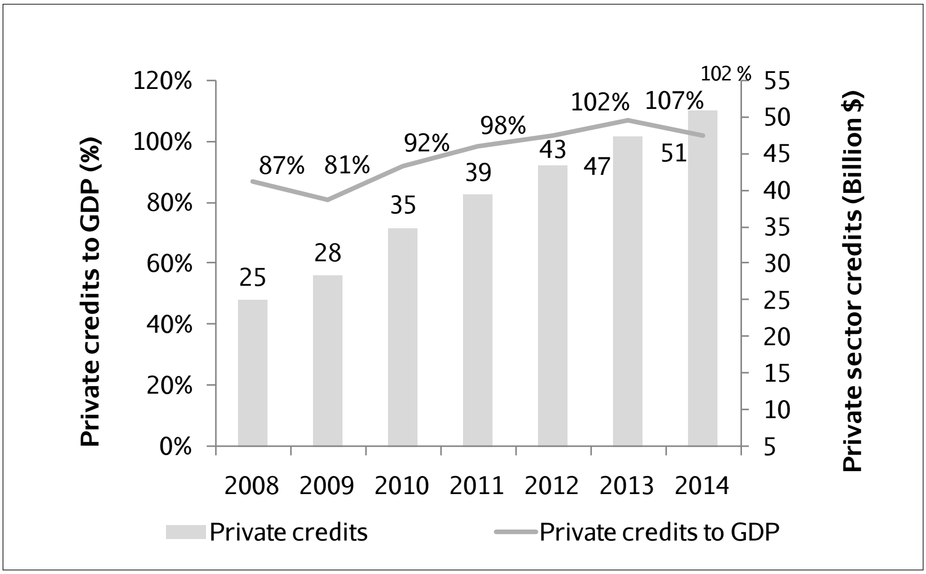
Chart 2: Loans to the private sector



Source: The Central Bank (BDL) and Association of Banks in Lebanon (ABL)

Therefore, banks play a key role in financing private individuals and companies at an affordable cost as the average interest rate on Lebanese lira (LL) loans registered 7.3% in 2014, and the average interest rate of loans in foreign currencies 7% in the same year. The ratio of private sector loans to the GDP, which amounted to 102% as mentioned, is considered high compared with emerging countries such as Jordan (72%), the UAE (59%), and Turkey (57%). The banking sector constitutes, through its advances, the main backer of the driving sectors of the Lebanese economy, whether for investment or consumption. The high ratio of private loans to the GDP is related to the fact that the banking sector is the basic recourse for corporations and individuals to obtain financing. For two reasons: First, the lack of sizable stock and bond markets that could have been, if they were available, a substitute for companies to get financing. Second, Lebanese companies are characterized by their individual and family nature, resulting in weak capitalization and limited ability to self-finance.

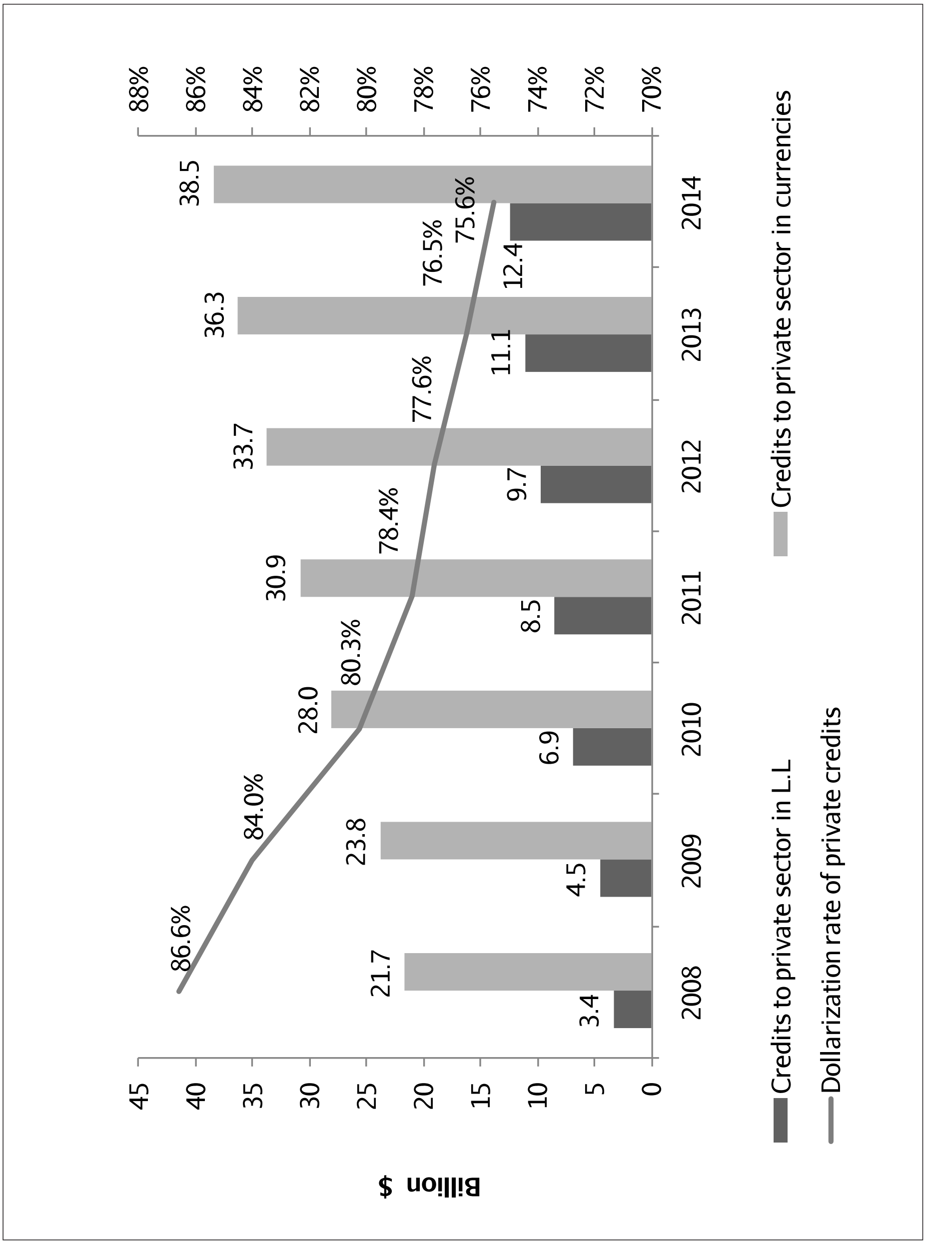
Chart 3: Private sector loans to GDP



Source: The Central Bank (BDL), Association of Banks in Lebanon (ABL), IMF

Advances to the private sector in Lebanese liras have witnessed a growth exceeding the increase in foreign currency loans. Between 2008 and 2014, lending in Lebanese liras rose by an annual average of 25.1%, while foreign currency loans increased by an annual average of 10.1% in the same period. So, the loan dollarization ratio decreased from 86.8% in 2008 to 75.6% in 2014. This decline was due to the incentives provided by the Central Bank of Lebanon for some types of loans, in addition to subsidized loans in Lebanese liras. The Central Bank launched in early 2013 a program to incite banks to grant credits benefiting most economic sectors, in order to push economic growth forward. As part of this initiative, about 1.4 billion US dollars were made available to banks at an interest rate of 1% to lend companies and households after the fulfillment of the reserve requirement mechanism. Banks responded positively to this initiative, as a large portion of the amounts earmarked for corporate and residential lending was used. Banks also benefit from partnerships for the private sector financing with the European Investment Bank (EIB), the French Development Agency (AFD), the International Finance Corporation (IFC), the Arab development funds, and the Arab Monetary Fund.

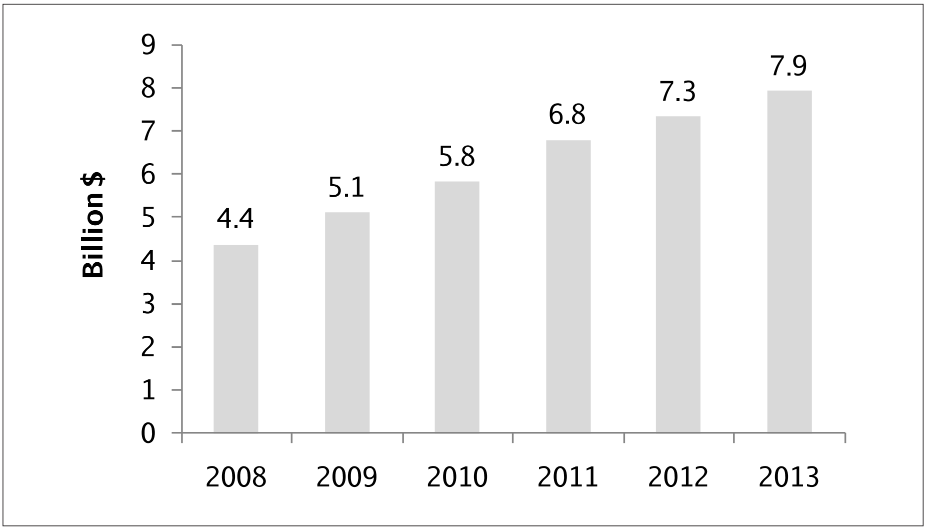
Chart 4: Dollarization ratio of private loans



Source: The Central Bank (BDL), The Association of banks in Lebanon (ABL)

Regarding loans granted to the private sector, companies obtained the largest share, as corporate loans represented 59% of private loans at the end of the year 2013. These loans are split between large companies at 32%, and small and medium-sized enterprises at 17%. It is worth mentioning that small and medium enterprises have gained a growing interest from Lebanese banks in recent times, as reflected by the loans granted to them having risen from $4.4 billion in 2008 to $7.9 billion in 2013. The BDL was instrumental in stimulating banks to offer credit to small and medium enterprises, in addition to the role played in this regard by Kafalat (a Lebanese financial institution that aims to help small and medium-sized companies to obtain financing from commercial banks). The latest of these stimulus measures was BDL's Circular No. 331, which aimed at supporting economic and social growth, and at contributing to job creation through backing intellectual and creative skills. The Circular urges Lebanese banks to contribute to the capital of local emerging companies. It complemented a series of decisions that aimed at financing corporations and pushing the economic cycle forward, in addition to providing quality jobs for the Lebanese youth with high competencies. This provides funding sources for knowledge-economy companies, which enjoy a high positive return, as these companies had faced financing challenges in the past.

Chart 5: Loans granted to SMEs

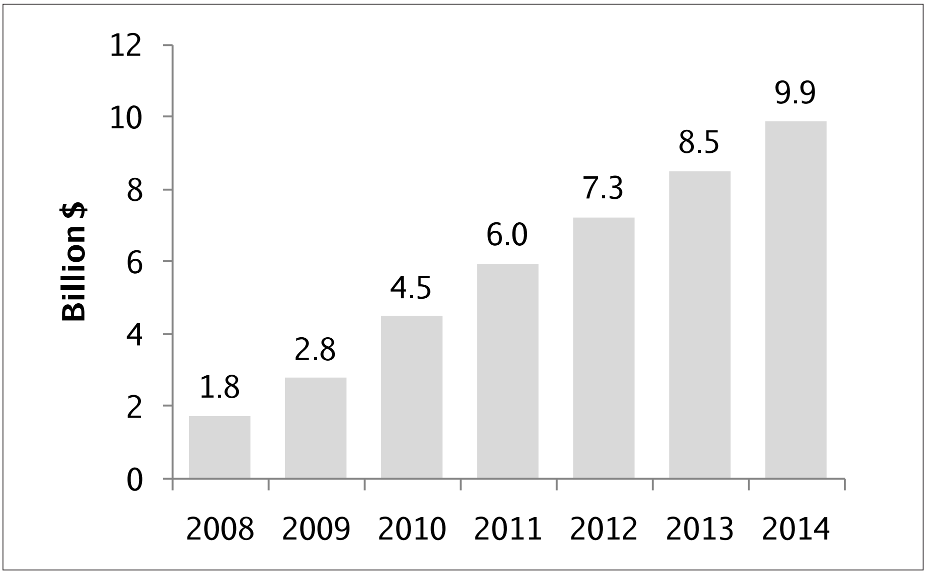


Source: ABL

The distribution of loans according to sectors has witnessed a structural shift over the last decade. Personal loans allocated to finance consumption have risen seven times. Their share of total private loans has doubled to reach about 28.8%. This increase in personal loans reflected the strategy pursued by Lebanese banks to grant fully secured loans with high interest rates. A large part of personal loans are those granted for housing, which rose at an average annual rate of 35% between 2008 and 2014, to reach $9.9 billion in 2014. BDL played a key role in stimulating bank lending for housing, especially for limited income families. BDL statistics show a remarkable rise in the number of borrowers who benefited from available exemptions, as the number of borrowers increased from 85,998 in 2012 to 94,305 in 2013. The Public Corporation for Housing (PCH) also plays a key role in this area. Since its inception in 1996, this institution aims to provide subsidized mortgages with maturities between 10 and 30 years for families with monthly income not exceeding 6.75 million Lebanese liras (US $ 4,500). In 2013 the PCH received 6,480 housing loan applications and approved 5701 loans, equivalent to 88% of total demand. Around 5,533 housing loan contracts were signed worth 1,061 billion Lebanese liras ($674 million) in 2013.

These subsidized loans have contributed not only to pushing forward the economic cycle, but also to achieving social stability, especially in relation to the residential loans that allowed home acquisition for many resident and non-resident Lebanese households. Educational loans also contributed to covering education expenses and securing a better future for many students. So, Lebanese banks played a role in improving the social conditions of families and individuals in Lebanon.

Chart 6: Housing loans



Source: The Central Bank (BDL)

It must be pointed out that although the size of private loans is large, the banking sector was still able to maintain a high liquidity ratio. The ratio of loans in foreign currencies to deposits in these currencies reached 40.5% in 2014, and the ratio of loans in Lebanese liras to deposits in that currency reached 25.1% in the same year. These low percentages are evidence of the high financing capacity of Lebanese banks, and reflect the opportunity for banks to continue to play a central role in the financing of institutions and individuals.

So, the Lebanese economy does not suffer from a lack of finance capacity because the size of the Lebanese banks and their cumulative ratio to GDP are factors that allow them to finance both public and private sectors, and maintain at the same time high liquidity levels, which is also important due to the political and security conditions that Lebanon is going through.

But the availability of liquidity and the ability to finance do not necessarily mean that loans are well distributed. Size is one thing and distribution is another, a topic which we will be addressing in the second part of this essay. In fact, the credit distribution in

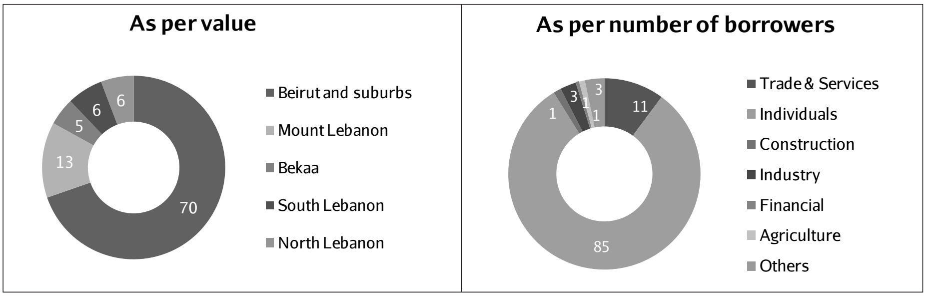
Lebanon is suffering on two levels, first on the macro level as we are witnessing a lack of diversity in sectoral lending, and secondly at the micro level where we notice a high level of concentration in loans.

Second topic: Weaknesses: The distribution of credit in Lebanon

One of the weaknesses of the banking sector is the lack of diversity in the sectoral credit. Loans granted to economic sectors are predominantly concentrated in the trade and services sector, as they accounted for 33.8% of the total private loans at the end of the first quarter of 2015, but represented only 11% of the total number of borrowers. Loans granted to individuals constitute 28.6% of the total value of loans, most of them being concentrated in the housing sector (approximately 61%). In the same period, construction and building loans accounted for 16.9%, benefiting only 1.4% of all borrowers. On the other hand, the shares of industry and agriculture in overall credits respectively reached 11% and 1.2% at the end of the first quarter of 2015. It must be pointed out that these bank credits to agriculture only include direct loans, and do not comprise indirect loans granted to agricultural cooperatives and importers, nor trade activity in agricultural and animal products, and in agricultural machinery and equipment.

We conclude from these facts that the trade and services sector has the largest share of loans among economic sectors, followed by individuals and construction, these sectors accounting together for about 80% of the loans. As these three sectors are directly affected by economic, political and security shocks, this makes banking loans vulnerable to the same risk factor.

Chart 7: Distribution of bank credits on sectors (March 2015)



Source: BDL

When we look at the evolution of the economic sectors' shares in banking credits, we find that the share of trade and services sector fell from 38.2% in 2009 to 34% in 2014. The share of individual borrowers increased from 22.2% in 2009 to about 29% in 2014; the share of construction and building increased by about two percentage points. In contrast, the manufacturing sector saw a stable share of loans at around 11%. The same goes for the agricultural sector, as the value of granted loans has increased, but did not succeed in exceeding 1% of the loans. In spite of the evolution in the sectoral distribution of bank loans, it is still the trade and service sector that accounts for the largest share of private sector loans while loans to industry and agriculture are still low. This is due to the fact that Lebanese banks adopted a conservative financing policy, upon which they mainly focused on short-term and medium-term loans, as are most of the trade, services and personal loans.

Table 1: Evolution of bank credits according to sectors

Evolution of bank credits according to sectors				
	2009		**2014**	
	Value ($ billion)	**Share (%)**	**Value** ($ billion)	**Share (%)**
Trade & services	12.1	38.2 (%)	19.5	34 (%)
Individuals	7	22.2 (%)	16.5	28.8 (%)
Construction	4.8	15.3 (%)	9.6	16.7 (%)
Industry	3.7	11.8 (%)	6.2	10.8 (%)
Financial intermediation	2.6	8.2 (%)	3.4	6 (%)
Agriculture	0.3	0.9 (%)	0.7	1.1 (%)
Others	1.1	3.4 (%)	1.5	2.6 (%)
Total	**31.6**	**100 (%)**	**57.3**	**100 (%)**

Source: BDL

The lack of diversity in sectoral credits is also due to the lack of diversity in economic production in Lebanon. The Lebanese economy is mainly based on trade and services which combine to about 54.8% of the GDP, one of the highest ratios in the world. The most prominent sub-sectors covered by this sector are the trade sector (29.3% of GDP), financial services (14.5%), and tourism (11.7%). Over the last two decades, each of the tourism sector and the financial sector constituted basic pillars of the national economy, and were the largest contributors to GDP growth and to employment. Following the trade and services sector in terms of contribution to the gross domestic product, the real estate and construction sector comes second, representing about 19.8% of the national income as it benefits from steady and strong capital flows. What contributed to the growth of this sector is the real demand for housing, not for speculation. While trade-services and real estate-construction were growing, the role of the industry and agriculture sectors was shrinking. Today industry represents about 11.3% of the GDP, while the agriculture sector only contributes to about 4.1%. Regarding the industrial sector, Lebanon faces many challenges that hinder its growth, most notably the policies and regulations which do not incite to industrial investment, in addition to the political instability prevailing. We add to these obstacles the high production costs in manpower and energy which pushed the Lebanese industry towards transformation and assembling industries. The agriculture sector is facing similar challenges, such as high production cost, in addition to the fact that agriculture is vulnerable to climate change and foreign competition through agricultural imports. Therefore, the agricultural sector has also moved towards commercial crops which are meant for export.

It is worth mentioning that in order to improve the diversity in sectoral credits, BDL incited banks to offer subsidized loans to industry and agriculture. These include: medium and long-term subsidized loans, subsidized loans guaranteed by Kafalat, subsidized loans granted on the basis of the protocol signed with the European Investment Bank, subsidized loans granted by the International Finance Corporation, subsidized loans granted by the French Development Agency (AFD), and others. Loans subsidized by the central bank to economic sectors reached about 2.73 billion US dollars at the end of 2014, most of which are industrial loans, followed by tourism and agricultural loans. Industrial loans acquired the largest share of subsidized loans, reaching about 1.45 billion US dollars, or 53.1% of total loans. The tourism sector came in second place in value of subsidized loans, and acquired 0.92 billion US dollars between 2011 and 2014, representing 33.7% of total backed loans. The agricultural sector obtained between 2011 and 2014 subsidized loans worth 0.36 billion US dollars, equivalent to 13.2% of total backed loans. In conclusion, the measure taken by the Central Bank of Lebanon gradually contributes not only to the activation of the economic cycle, but also to the balancing-out of sectoral lending in an improved way.

Another weak point concerning bank loans lies in their distribution among single beneficiaries. At the end of the first quarter of 2015, the value of loans worth less than LL25 million amounted to about 4.3% of the total value of the private sector loans, but were distributed to 62.8% of the beneficiaries. Also, for example, 21.8 percent of borrowers benefited from loans in the LL25-100 million range, which formed only 6.2% of the total value of the private sector loans. In contrast, loans exceeding LL10 billion accounted for approximately 46.5% of the value of banking loans, benefiting only 0.23% of the total number of borrowers. The high ratio of concentration of loans in Lebanon reflects the close links between major Lebanese banks and large corporations and economic groups. Many important sectors such as small and medium-sized companies are still relatively excluded, as they are not benefiting enough from banking services. The high concentration of loans reveals the need to activate the lending to small businesses and the development of the microfinance industry.

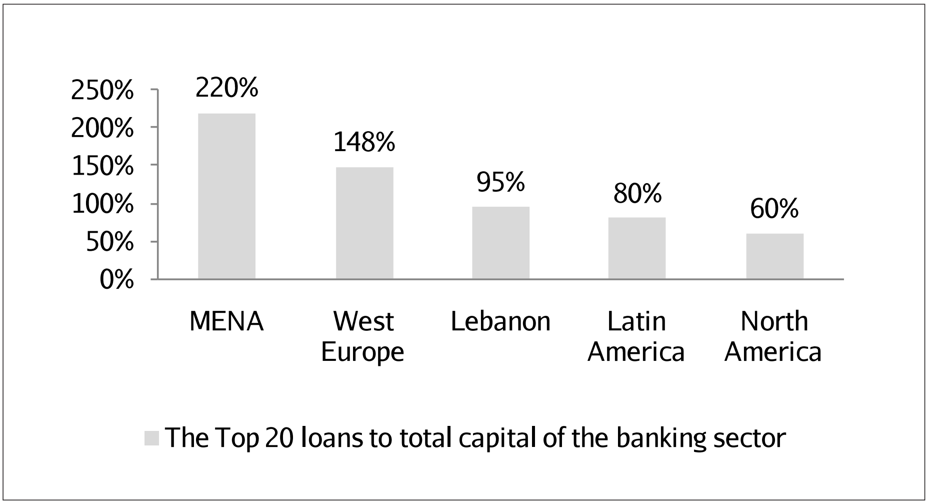
Table 2: Distribution of bank loans as per value and beneficiaries

Distribution of bank loans as per value and beneficiaries (March 2015)		
Loans value (LL million)	**Distribution by value (%)**	**Distribution by number of borrowers (%)**
Less than 25	4.29 (%)	62.81 (%)
25-100	6.16 (%)	21.8 (%)
100-500	15.24 (%)	12.66 (%)
500-1,000	5.09 (%)	1.22 (%)
1,000-5,000	13.53 (%)	1.5 (%)
5,000-10,000	9.13 (%)	0.21 (%)
More than 10,000	46.54 (%)	0.23 (%)

Source: BDL

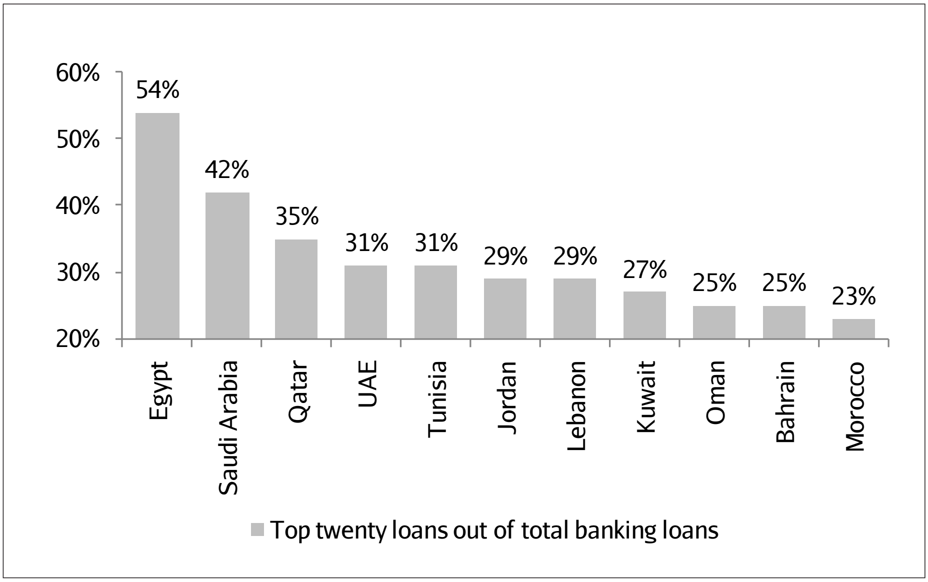
Perhaps the most notable indicators that show the level of credit concentration is the Top Twenty Loan Exposures-to-Equity Ratio and the Top Twenty Loan Exposures-to-Loans Ratio. In 2010, the top twenty loans represented 95% of the Lebanese banks' capital, compared to 60% in North America, 80% in Latin America, and 220% in Middle East and North Africa. This shows that Lebanon has a loan concentration ratio just like neighboring countries. The top twenty loans accounted for 29% of the total loan advances in Lebanon in 2010, compared with 54% in Egypt, 42% in Saudi Arabia, 27% in Kuwait, and 25% in Morocco. Most countries of the Middle East and North Africa region, including Lebanon, are characterized by a high loan concentration due to limited opportunities for small and medium-sized companies and individuals to obtain financing.

Chart 8: The top 20 loans to total capital of the banking sector



Source: Standard & Poor's, the World Bank

Chart 9: The top twenty loans out of total banking loans



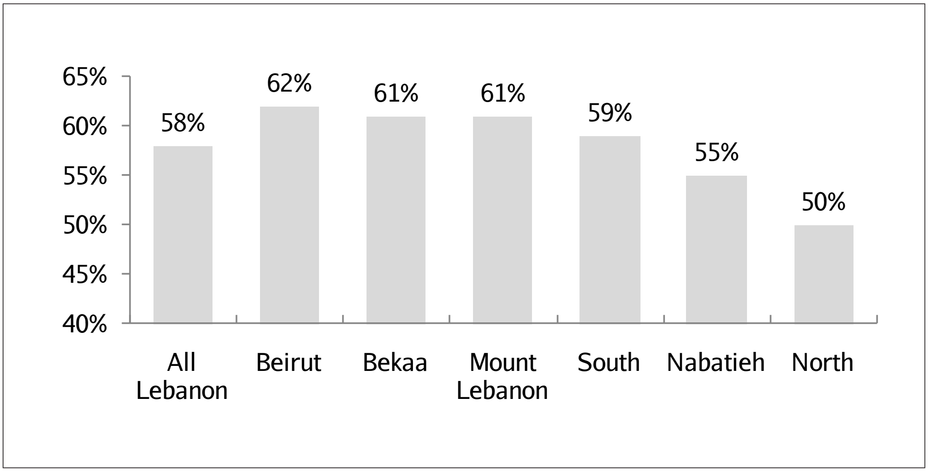
Comparison between Lebanon and other countries in the Arab region in terms of loan concentration ratio shows that the banking sector in Lebanon, as in most countries in the Arab region, lends to a small group of companies and individuals. The relationship between the number of loan accounts per 1,000 citizens and loans-to-GDP ratio indicates that Lebanon lies under the Simple Regression Line, which shows the value of loan accounts that you would expect from the loans-to-GDP ratio. Although the loans-to-GDP ratio in Lebanon is around 102%, the number of loan accounts per 1,000 citizens is only 314. This indicates that the Lebanese banking sector still lags behind some countries in the Middle East, where the number of loan accounts per 1,000 citizens reaches a high level, such as in Turkey (875) and the United Arab Emirates (650), while loans-to-GDP ratio is considered low in these countries compared with Lebanon.

The third topic: Opportunities or required steps to reach an integrated financing system that contributes to achieving sustainable and equitable growth.

First, promote parity in the distribution of banking activity among regions.

In spite of the remarkable growth of the Lebanese banking sector, and in spite of the development of banking services in Lebanon during the last decade, there are still many areas in Lebanon that are not benefiting enough from banking services. They are considered fertile ground that Lebanese banks can take advantage of to expand their business inside Lebanon. A study conducted by InfoPro Research in 2010 showed that about 58% of Lebanese citizens benefit from banking services, meaning that 42% of citizens do not use any of the banking services. The study also showed that out of those who do not benefit from banking services, there are about 85% of them who are seriously thinking about getting at least one banking service. Bankerization Rate differs among Lebanese regions. In Beirut, around 62% of the population use banking services. Likewise in each of Mount Lebanon and the Bekaa, where 61% of the population benefit from the presence of commercial bank branches. In contrast, only 55% of the Nabatiyeh residents and 50% of the north residents have an account or a bank loan. Such a difference in the banking inclusion among Lebanese regions shows that there is still an opportunity for Lebanese banks to deliver local banking services, providing further growth in their assets, deposits, credits, and consequently profits.

Chart 10: Bank inclusion rate in Lebanese regions



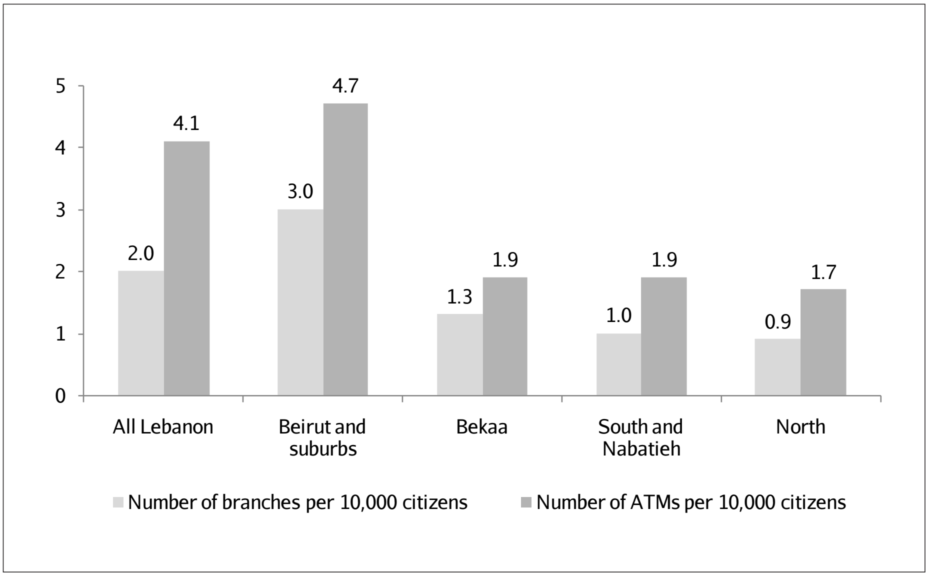
Source: InfoPro Research

The difference in the distribution of banking activity among regions is also visible through the unequal distribution of bank branches across the Lebanese territory. At the end of 2014, Beirut and its suburbs comprised 548 banking branches, equivalent to

53.7% of the total branch network. The Mount Lebanon area got in the same year 19.0% of the branches (the equivalent of 194 branches). In contrast, only 9.9% of commercial bank branches are established in northern Lebanon and 6.7% in the Bekaa.

As for the banking inclusion ratio in Lebanese regions compared to the number of their inhabitants, according to the InfoPro study, Beirut and Mount Lebanon enjoy about 3.0 bank branches and 4.7 ATMs per 10,000 citizens. South and Nabatiyeh regions have about 1.0 branch and 1.9 ATM for every 10,000 citizens. In northern Lebanon, there is 0.9 bank branch and 1.7 ATM per 10,000 citizens. That's why commercial banks operating in Lebanon have an opportunity to attract more customers in these areas, who do not benefit from banking services, by opening new branches and installing ATM machines there.

Chart 11: Distribution of branches and ATMs in the Lebanese regions



It should be noted that the expansion of operating banks into the different areas of the country largely depends on the improvement of the development conditions in these areas. Lebanon suffers from unbalanced development and from the geographical concentration of economic and social development. Therefore, there is a fundamental need to establish plans and development projects to achieve territorial development, which in turn would lead to more employment opportunities in peripheral regions and develop their economy. This balanced development would also encourage banks to engage in all Lebanese regions and enable them to contribute to their development and the activation of their economy. The benefits will then be shared, as peripheral areas would benefit from banking services that were not previously available, while banks would benefit from an opportunity to expand their domestic presence, which would lead to the growth of their turnover and profits.

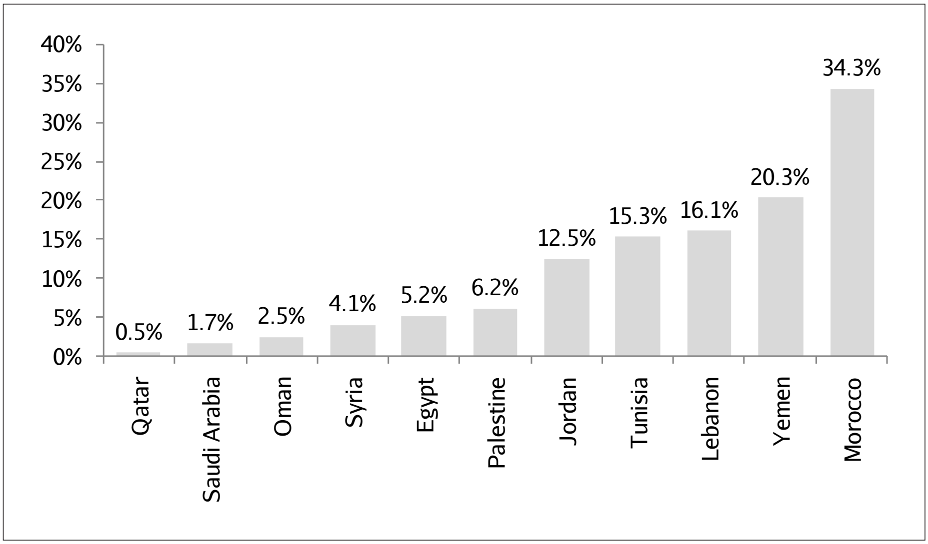
Secondly: To strengthen the financing of small and medium enterprises.

Banks have a real opportunity to expand their activities toward the financing of small and medium-sized enterprises. These companies play a key role in the Lebanese economy, although there are no accurate statistics about their contribution to the GDP. This is partly due to the lack of a clear and established definition of SMEs. The European Commission defines SMEs as establishments, regardless of their legal form, which employ less than 250 people and/or have assets that do not exceed 50 million euros and an annual turnover that does not exceed 43 million euros. The European Commission, the Organization for Economic Co-operation and Development (OECD), and some governments in the Middle East and North African countries tend now to amend this definition, separating small enterprises and medium-sized enterprises. For example, small businesses are defined as those that employ less than 50 people and have annual turnover and/or total assets that do not exceed 10 million euros. This definition naturally differs in many of the Middle Eastern economies due to the small size of the local companies. In Lebanon, the Ministry of Economy and Kafalat (the previously-mentioned Lebanese financial institution that aims to help small and medium-sized companies to obtain financing from commercial banks) define small and medium-sized companies as those that employ a maximum of 200 employees. A report issued by Kafalat said that if the European definition for small and medium-sized enterprises was applied in Lebanon, then these companies would make up 95% of the total operating companies and provide about 80% of the jobs. The majority of these companies are classified in the category of 'micro companies' because they rely on retail, and focus mainly on meeting the needs of the local market.

SMEs are essential for the activation of the Lebanese economy, as they follow innovative business models and play an active role in the development of traditional industries. They also lead the growth in Knowledge-Based Sectors, such as information technology, telecommunications and media. In spite of their large scope and position in the Lebanese economy, they have hard time obtaining financing from commercial banks. This is due to many considerations, notably that small and medium-sized enterprises often provide incomplete and irregular information due to the lack of adequate accounting and financial management and forecasting systems, unlike large institutions that can resolve this problem more easily. This lack of information in the small and medium enterprises is more noticeable in family businesses where the boundaries between personal and professional credit are not clear. Banks are not able to assess the capacity of the enterprise/family to reimburse the loan. Another problem lies also in the guarantees that these companies provide on loans, and which are often rejected by banks. In addition, banks face high fixed costs in the evaluation of credit for small and medium-sized enterprises because of inadequate disclosure and poor quality of the financial information that they provide.

For these reasons, the financing environment for small and medium-sized companies is not yet considered flawless. Commercial banks have an opportunity to increase their advances to this sector. It is worth mentioning that the difficulty faced by these companies in obtaining financing in Lebanon are the same as those faced in most neighboring countries. Many of Middle Eastern countries are confronting what is known as the “financing gap”, this meaning that there is a large number of small and medium-sized companies that can use money in a productive way whenever it is available, but face difficulties in obtaining financing from the official financial system. Lebanon is therefore not alone in SMEs confronting financing challenges, despite the abundant liquidity in the banking system. On the contrary, the share of banking loans granted to SMEs in Lebanon is comparatively high reaching up to 16.1%, whereas this share is 1.7% in Saudi Arabia, 5.2% in Egypt and 12.5% in Jordan.

Chart 12: Share of credits granted to SMEs out of all loans



Source: The World Bank

Due to the size of SMEs in Lebanon, it is important that banks direct their policies and growth plans towards funding this sector, as it would constitute an opportunity for them to expand locally, without significantly affecting credit risk. When we look at the distribution of doubtful loans, we find that 4.7% of these loans are related to loans worth less than 100 million Lebanese liras (which are often granted to small and medium enterprises). In addition, doubtful loans make up about 3.2% of loans that are less than 100 million LL. In contrast, 60.4% of doubtful loans originate from loans in excess of 10,000 million Lebanese liras (which are often granted to large companies); and doubtful loans constitute about 9.1% of this category of advances. This is an incentive for commercial banks to activate the financing of small and medium-sized enterprises. This can be achieved through better knowledge from banks about this sector, its customers, and the potential revenues that banks may expect from SMEs financing. Also, banks could find an effective way to reduce operating costs related to the study of small enterprises' credit files, through new and innovative ways to assess the credit (i.e. the establishment of loans, monitoring, and collection).

Supporting small and medium businesses has been taken into serious consideration by the Lebanese authorities. That's why Kafalat was created in 2010. It is owned at 75%

by the National Deposits Guarantee Institution, while fifty banks own the remaining 25%. Kafalat supports small and medium enterprises as it guarantees loans granted by the participating banks, based on studies supplied by applicants that show the sustainability of the proposed economic activity. Guarantees are granted to the concerned bank, which in turn may request additional collateral, in order to make the loan safer for the bank. Kafalat programs are directed to small and medium-sized enterprises in one of the following economic sectors: Industry, agriculture, tourism, craft production, and advanced technologies. Loans secured by Kafalat have contributed to activating many small and medium-sized enterprises and increasing their productivity. In detail, since 1997 until the end of the year 2014, Lebanese banks have issued loans worth 1.26 billion US dollars to support emerging projects by taking advantage of loan guarantees secured by Kafalat. These loans are distributed as follows: 53% for the industry, 19% for tourism, and 27% for agriculture.

Table 3: Kafalat programs to support SMEs

Kafalat programs to support SMEs				
Program	**Investment type**	**Max. loan amount (million LL)**	**Max. loan duration (years)**	**Guarantee (%)**
Kafalat Basic	Investment in fixed assets and operating capital	300	7	75 %
Kafalat Plus	Investment in fixed assets and operational needs	600	7	85 %
Kafalat Innovative	Financing fixed assets and operating capital needs	300	5	90 %

Source: Kafalat

BDL also plays an active role in inciting banks to finance small and medium enterprises. It is in the process of promoting a law for secured lending, which aims to encourage lending to small and medium enterprises, when they do not have enough immovable collateral to get funding. They are not able to take advantage of their current assets as collateral for the loans, because banks and other financial institutions refrain from taking these assets as collateral, due to the absence of centralized records for them. This law aims to promote lending in exchange for movable collateral through a legal mechanism that allows banks to provide credit to industrial, agricultural and commercial projects in exchange for movable guarantees as is the case now with immovable guarantees. The Central Bank is pushing towards adopting a modern legal framework for secured transactions, which entitle SMEs to access credit on the basis of movable collateral.

All this would create new opportunities for commercial banks to expand their domestic activity in the financing of small and medium enterprises sector, which does not benefit enough from banking services. Mutual benefits will be assured as banks would have a broader diversity in their loan portfolio, while productive sectors would benefit from a better activity which would be reflected positively on the country's economic growth.

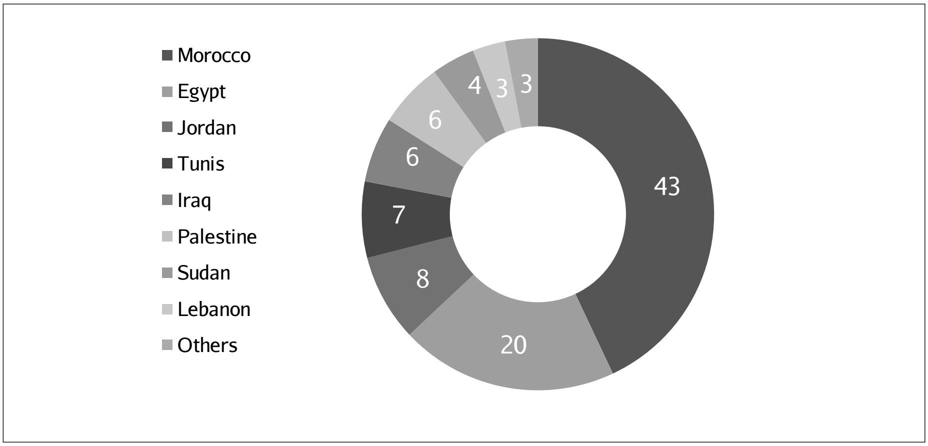
Third:

Lebanese banks have the opportunity to develop microfinance services which are marginally available so far. The microfinance industry started in Lebanon in the nineteen nineties, but despite some growth achieved the sector is still an emerging market with a low access rate. The term "microfinance" refers to the provision of financial services on a sustainable basis to low-income people and small projects. It includes not only granting loans, but also providing deposit and money transfer services and insurance as well as business development services. In Lebanon, Micro Finance Institutions (MFIs) so far focus almost exclusively on credit, granting small loans to individuals with limited income in an attempt to improve their financial position and reduce poverty levels in Lebanon.

Eight years ago, according to the IFC (International Finance Corporation), the microfinance sector in Lebanon consisted of 11 institutions, with a total loan portfolio of about $33 million. Today, the number of MFIs exceeds 20, with granted loans of about $62 million. So, there still are a limited number of local microfinance institutions, or rather micro lending institutions (as most of them focus on providing lending service, versus a small number of other financial and non-financial services). Among the most prominent of these institutions: Lebanese Association for Development (Al-Majmoua), Amin, Al-Qard Al-Hasan, Makhzoumi Foundation, Imkan, Association for the Development of Rural Capacities, as well as some commercial banks. Most of these institutions have been established by local and international organizations to provide various social and economic development services, including microloans, often offering loans at lower interest than those available in the market. These institutions currently serve about 38,000 customers. Despite the progress of the microfinance sector in Lebanon, it remains limited as it supports only 12% of the citizens who really need microcredits.

Compared with the rapid growth of the microfinance industry in the Arab region over the past ten years, this sector is still lagging behind in Lebanon, and is far from meeting all potential demand for microloans. Lebanon's share of the total value of microloans in the Arab world constitutes only 3%. In contrast, Morocco's share of these loans reach 43%, Egypt's share 20%, Jordan 8%. In terms of the penetration rate, the ratio of borrowers who obtained a microloan out of the total potential micro-borrowers is only 12%. This is also to compare with the penetration in Jordan which reached 54%, Tunisia 46%, and Morocco 36%. This proves that microfinance services in Lebanon do not meet all the demand, and that there are still many opportunities for banks to develop this sector and reach various categories of Lebanese citizens.

Chart 13: Market share of selected Arab countries in the microfinance industry



Source: Sanabel Institution

Table 4: Inclusion rate in microfinance

Inclusion rate in microfinance	
Country	**Ratio (%)**
Jordan	54 (%)
Tunisia	46 (%)
Morocco	36 (%)
Mauritania	25 (%)
Egypt	24 (%)
Lebanon	12 (%)
Palestine	10 (%)
Iraq	3 (%)
Syria	3 (%)
Yemen	3 (%)
Sudan	2 (%)

Source: Sanabel Institution

According to the Economist Intelligence Unit, Lebanon is ranked 40th out of 55 developing countries, and 11th out of 15 countries in the Middle East and Africa region according to the Global Microfinance Index. This index evaluates the microfinance environment through two components: (1) The regulatory framework and practices, which assess market access and regulatory matters, and (2) The supporting institutional framework, which handles institutional and commercial practices. The index also takes into account the impact of political shocks on the microfinance sector. Lebanon received a score of 33.3 points in 2013, registering a decline from 33.5 points in 2012. Lebanon's score is less than the global average of 44.4 points, as well as the Middle East and North Africa region's average of 41.1 points. The Economist Intelligence Unit considered that the supervision on the microfinance sector in Lebanon is weak and ineffective, as the authorities do not have the ability to regulate the financial operations of MFIs. It also notes that the political instability and lack of interest from the authorities led to a delay in introducing reforms in the microfinance sector.

Table 5: The Global Microfinance Index

The Global Microfinance Index 2013			
Country	**Score**	**Rank in Middle East Africa**	**Global rank**
Kenya	61.1	1	5
Uganda	53.8	2	8
Ghana	53.3	3	13
Rwanda	48.4	4	22
Nigeria	45.2	5	24
Tanzania	47.9	6	25
Mozambique	44.0	7	30
Morocco	38.3	8	35
Madagascar	35.9	9	37
Senegal	34.4	10	39
Lebanon	33.3	11	40
Cameroon	31.7	12	43
Yemen	31.0	13	44
Congo	28.4	14	46
Egypt	27.3	15	49

Source: Economist Intelligence Unit

The limited microfinance services are due, to a large part, to the restricted capacity of NGOs to expand. Although they grant microloans, most of these non-governmental organizations are involved in a number of other development activities, and therefore are not heavily capitalized to increase investment in their microfinance portfolio. Most microfinance institutions in Lebanon lack the financial and operational capacity for sound large-scale money management. Even those which are specialized in microfinance and have a large number of customers are still limited compared with similar microfinance institutions in the region. This is due to the hesitation of these institutions to expand rapidly in the unclear political environment. In addition, micro lending is not regulated by any formal legal text, as it is the Ministry of Interior and Municipalities, rather than the Ministry of Finance or the Central Bank, which currently supervises all microfinance institutions that operate in this sector. The only form of support the sector received from BDL is a directive issued by the latter that allows local commercial banks to use 5% of their mandatory reserves for microfinance initiatives. Also, MFIs have weaknesses related to the restrictions imposed on charitable institutions, and therefore have limited ability to obtain money because they are not allowed to accept deposits. As such, microfinance institutions are largely dependent on donor funds, which translates into a lack of stability in access to credit. This constitutes an opportunity for commercial banks that have ample liquidity thanks to private sector deposits – which would enable them to offer microfinance services.

Commercial banks in Lebanon can therefore take advantage of the weaknesses of microfinance institutions and turn them into a funding opportunity in the following form:

- Capacity building: It is clear that there is still room for significant growth in the microfinance industry in Lebanon, due to the failure to meet the large demand for microloans. The current microfinance institutions need to improve their internal capacity and to come up with more innovative schemes in order to promote their products and services.

- Activate competition: In other countries in the region (such as Morocco and Jordan), one of the main driving factors of the microfinance sector growth is competition among institutions. In Lebanon, the level of competition in this sector is very low because there are no many players in it. Therefore, commercial banks can play a role to ignite competition, which would develop the services offered by this sector.

- Facilitate financing: Despite the excess liquidity in the banking system, this surplus has not yet been translated into investment in microfinance. This is due to the relatively short record of success in this sector. Therefore, Lebanese banks should facilitate the financing of microloans by using their excess liquidity.

- Provision of new services: The microfinance sector in Lebanon is expected to expand further. While microloans dominate the microfinance services, micro-savings are absent due to the organizational structure of MFIs; likewise, micro-insurance services are also inexistent in this sector, in spite of the instability climate that dominates in Lebanon. Lebanese banks have the opportunity to develop modern services, especially in view of their structure allowing them to offer these services.

It should be noted that the Lebanese government should play a decisive role through the implementation of effective policies to ensure the safety of micro financial service providers and to put MFIs under the supervision of the regulatory requirements of the Central Bank. The government should develop an appropriate legal environment through suitable and feasible credit laws. Lebanese authorities have an important role in the provision of information through the establishment of a credit office or a central risk bureau. These offices/centers would enhance practices in the context of better information provision and policy implementation that encourage the granting of short maturity microloans.

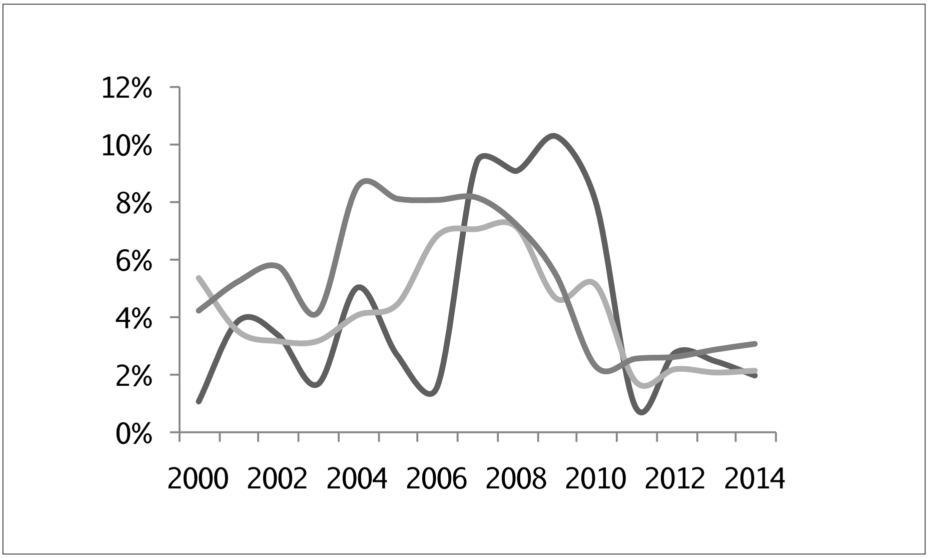
Topic IV: Threats that the financing structure may face in Lebanon

The two primary risks for the financing structure in Lebanon are: The ongoing weakness in economic growth, and the continual degradation of public finances.

Lebanese banks are facing the risk of the persistence of the present economic situation in Lebanon. Since 2011, the Lebanese economy is going through a period of slow growth and macro-economic weakness as a result of several internal and external factors. This situation has started gradually to affect growth levels in the Lebanese banking sector because banks are forced to work under difficult economic conditions. Therefore, there is a concern that the lack of improvement in economic conditions may add more challenges for the banking sector, specifically with regard to the growth of corporate and personal loans.

GDP in Lebanon registered an average growth rate of 8.5% between 2007 and 2010; one of the highest growth rates in the world, but this rate fell to below 2% between 2011 and 2014. This is due to many external factors, such as the ongoing Syrian crisis, as well as internal factors, such as the degradation of the security and political situation, which led to a decline in consumer and investor confidence in the economy. Furthermore, the high growth witnessed in the past few years was not accompanied by bold decisions to implement reforms that address key sectors, such as energy and telecommunications. This has led to a sharp deterioration in the macro-economic framework when the country entered in a phase of political and security instability. When comparing with other countries relatively affected by the regional crisis, we notice that the economic performance in Lebanon was more volatile than other countries', precisely because it was impacted by significant internal security shocks.

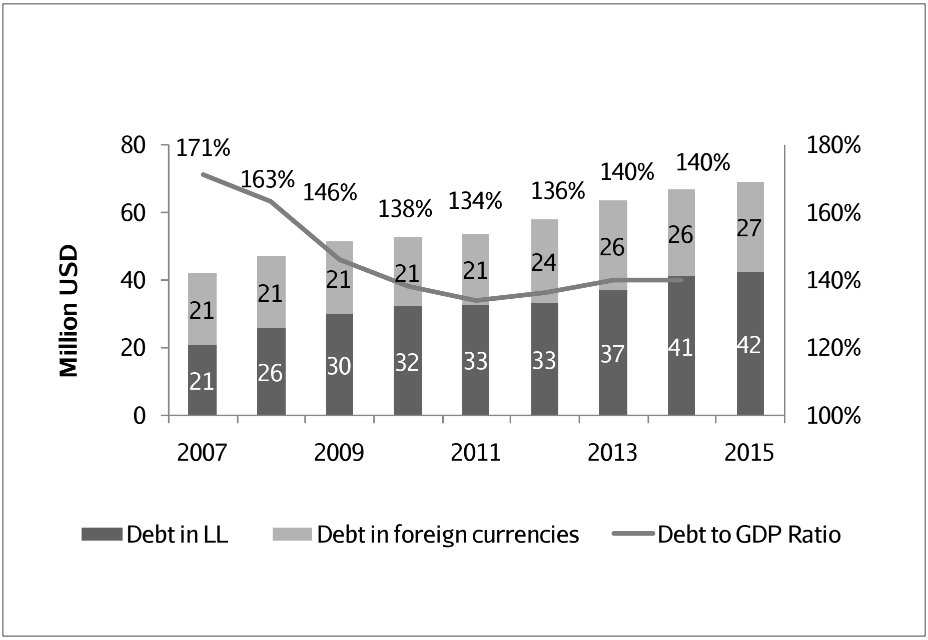
Chart 14: GDP growth



Source: IMF

Moreover, the decline in economic growth in Lebanon has had a direct impact on the State budget. With the slowdown in GDP growth, government revenues slowed down as well, while government spending rose due to the failure of the successive governments to follow a proper spending policy. All this led to higher fiscal deficits combined with low growth, which impacted negatively on the debt to GDP ratio, after a period of relative improvement since 2007. The dynamics of public debt in Lebanon started to recover significantly after 2006, precisely thanks to the high economic growth in that period. But the slowdown in economic activity, the fiscal deficits, and the increased Interest Rate Risk Premium due to the crisis in Syria inverted the remarkable progress in reducing the debt to GDP ratio. This ratio rose from 134% in 2011 to 140% in 2014. It should be noted that Lebanon's inability to contain the public debt and make it sustainable (i.e. reducing the debt to GDP ratio), may reflect negatively on the credit rating of the sovereign debt. As Lebanese banks carry more than half of this debt, the downgrade of the sovereign debt has a negative impact on the credit rating of Lebanese banks.

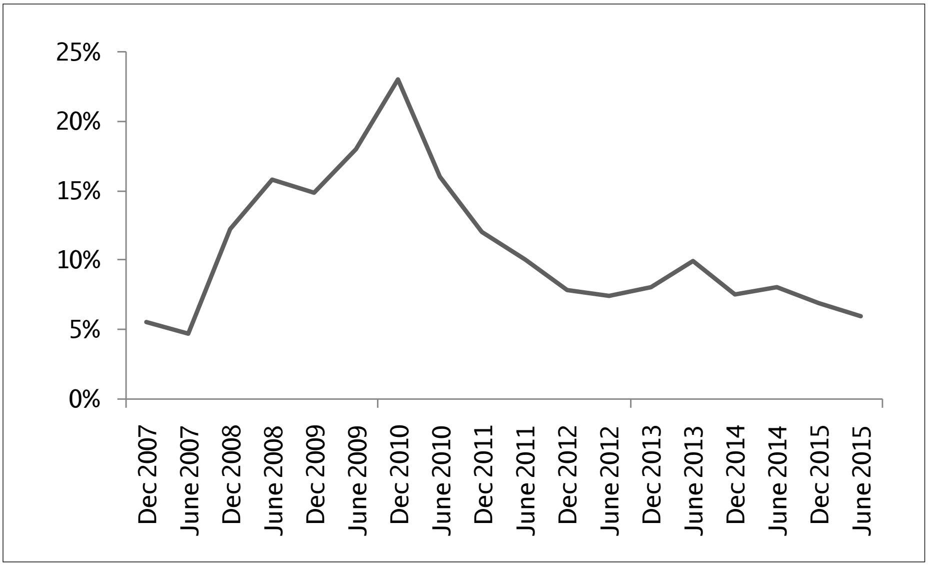
Chart 15: Lebanese public debt



Source: BDL, IMF

If the unfavorable economic situation continues in the coming period, this may cause further slowdown in the growth of bank deposits. After a growth in private deposits by an annual average of 15.4% in the period from 2007 to 2010, deposit growth fell to an annual average of 7.7% in the 2011-2014 period. This situation continued during the first half of the year 2015; where the deposit growth (5.9%) was lower than the growth in the first half of the previous year (7%). This decline in growth occurred despite the fact that Lebanese banks pay higher interest rates on deposits compared to regional and global markets. If this slowdown in the growth rate persists, the balance sheet of Lebanese banks may weaken, especially that the private sector deposits constitute the main source of funding for the Lebanese banking sector.

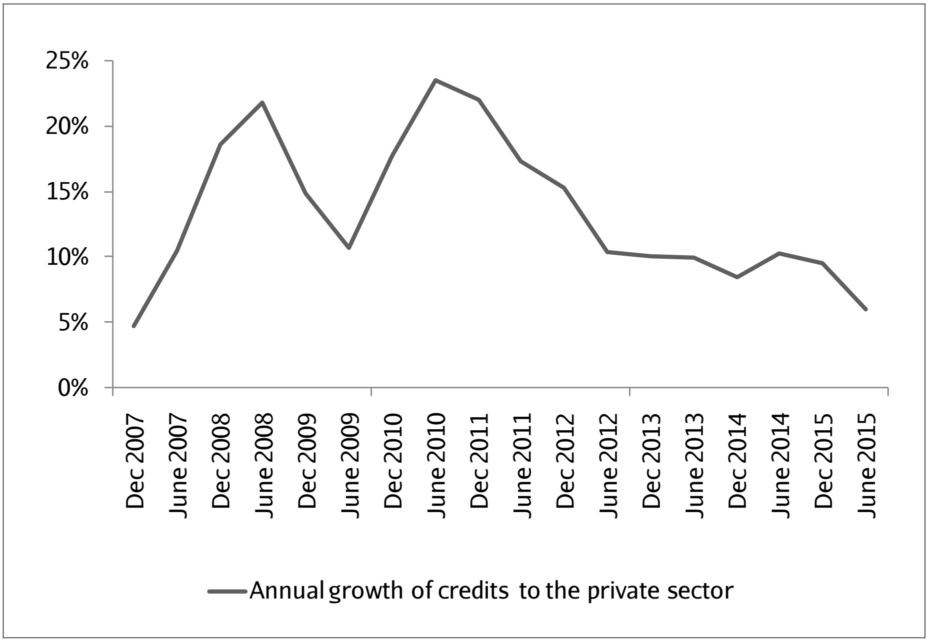
Chart 16: Annual growth of private deposits in banks



Source: BDL

Likewise, bank loans to companies operating in Lebanon witness a decrease in growth level due to instability in the country. The economic slowdown had a negative effect on many productive and service sectors, which found themselves unable to run their activities as before. This was reflected in corporate lending levels, primarily due to lower loan demand as companies hesitate to take a decision on the expansion of their business, and secondly because Lebanese banks were hesitant to grant these loans due to the increased risks, as the operating environment was declining. After a period where bank loans to the private sector witnessed a growth at an annual average of 15%, in 2007-2009, the growth of loans fell to an annual average of 14.2% in the 2010-2014 period. This trend continued during the first half of the year 2015 as loan growth (7%) was lower than the growth in the first half of the previous year (10%).

Chart 17: Annual growth of credits to the private sector



Source: BDL

Conclusion:

This chapter presented in a scientific and objective way the strengths, weaknesses, opportunities and threats in the financing scheme of the Lebanese economy, which is an acceptable and effective scheme to a large extent. But the political and economic risks began to infiltrate the system through lower growth rates in bank deposits and in private sector loans, a drift which requires better attention and treatment. The best handling may be done through, first of all, structural reforms needed to expand the productive capacity of the economy, and secondly through active measures to reform public finances and rationalize spending.