The Strength of the Lebanese Banking

System in the Face of Political Instability

By

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To my parents,

For the person who has

always guided my way

and who made me the

person who I am now

and will become…to my

father

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Abstract

This thesis is a study of one of the leading sectors in the Lebanese economy, namely its banking sector. Actually it is an attempt to explain the strength of the Lebanese banking system in spite of the permanent political instability in general and after the Taif agreement in particular. It therefore analyzes the relationship between the Central Bank and the commercial banks, and the policies and laws that allow the banking sector to prosper and the state's actions to protect the banking system. The liberal economic ideology prevalent in Lebanon is also central to the explanation.

This paper analyzes how bank characteristics and the overall financial environment affect the performance of commercial banks and their relationship with the Lebanese Central Bank. Specifically, the purpose of the study is to give a closer look to the relationships between profitability and the banks' characteristics, after controlling for economic and financial structural indicators under the conditions of the Lebanese Central Bank. A variety of Lebanese banks were chosen, concentrating on the most profitable and the most effective banks in Lebanon. The intention is actually to make the decision about the important determinants of performance. In this way, the paper extends the literature in several ways (Abelson, 1983).

Politics in Lebanon has a major impact on the performance of the financial system. However, despite this impact, the banking system in Lebanon remains active and effective. Thus, despite the fact that the banking system in Lebanon is highly affected by politics, it remains to maintain solidarity and effectiveness.

For this purpose, a entire set of internal characteristics is examined as determinants of banks' net non-interest margin and productivity. These include bank size, liquidity, loans, deposits and some others. Also, while studying the relationship between banks' internal characteristics and

activity, I was able to detect the direct impact of external factors, such as macroeconomic inflation and exchange rates.

It was apparent from the results and the regression and correlation analysis that the ‘Return on Equity’ (ROE) of commercial banks is highly influenced by the independent banking variables determined. The existing relationship is both negative and positive. While some variables affect the profitability negatively, other variables affect it positively (Abelson, 1983).

The following empirical analysis allows me to highlight the relationship between banking characteristics and performance measures in commercial Lebanese banks. As a start, the Lebanese commercial banks profitability measures react positively to the increases in capital and loan ratios. This result is in harmony with previous studies. In addition, it shows that optimal capital ratios and loan portfolios are essential factors for determining the performance of Lebanese commercial banks, in addition to other factors such as customers’ deposits, non-interest earning assets and banks’ profits. Moreover, I noted that liquidity factors are even more vital for the determination of bank performance (Abelson, 1983, p. 15).

The 1975-1990 war destroyed most of the country’s economy. However, major economic changes accompanied the demographic changes in Lebanon and, despite this war the banking system remained powerful in Lebanon.

Finally, it should be recognized that the range of this paper is limited as several Lebanese commercial banks are not included and several interesting questions were left unanswered. These questions analyze more fully the interaction between the political and the banking system in Lebanon and show how banking stability could be influenced by the political stability of Lebanon. Also, because of the size of the sample and many missing observations, the results should be explained carefully. As has been the case of many recent studies, the results are not very robust and may be responsive to the type of measure of performance used. [1]

Thus, in general, the profitability determinants of Lebanese commercial banks are various and numerous in nature. The loans, size, growth, exchange rates, inflation, deposits, liquidity can have a direct impact on the profitability level. However, the ROE level is not limited to those variables. Other variables do have a direct impact on the profitability as well. As already noted, such variables seem to be Lebanese politics and state policies as well as other new economic and competitive regulations.

[1] Haslem, A. John. "A statistical Analysis of Member Bank Profitability Differences " *Banking Journal*. JSTOR Academic Database

Chapter One: Introduction

1.1 Introduction

"The banking sector is one of the most vibrant sectors in the Lebanese economy and has consistently outperformed the rest of the sectors. For example, bank assets more than quadrupled in the short span of six years, growing from US$7.96 billion in 1992 to US$36.48 billion in 1998.[2] Lebanese banks are highly liquid with aggregate deposits of more than US$30 billion and overall liquidity of almost 70% as of the end of 1998.[3] Lending is conservative and at a low level compared to banking sectors in other emerging markets.[4] Deposits in foreign currencies accounted for 66.43% of total deposits in 1998 and the dollar exchange rate in lending was at 88.90%"(Abelson, 1983:p24).

What is quite astonishing is that this vibrant banking sector is located in Lebanon, a country long cursed with political instability and, for periods of time, civil strife and a virtual lack of government. Lebanon, torn by its sectarian and political disputes, has also been invaded a number of times.

> "Beirut suffered grievously between June 6, 1982, when Israeli troops first crossed the Lebanese border, and September 16, when they completed their seizure of West Beirut. Normal economic activity was brought to a standstill. Factories that had sprung up in the southern suburbs were damaged or destroyed, highways were torn up, and houses were ruined or pitted by artillery fire and rockets. Close to 40,000 homes--about one-fourth of all Beirut's dwellings--were destroyed. Eighty-five percent of all schools south of the city were damaged or destroyed. The protracted closure of Beirut's port and airport drastically affected commerce and industry. By 1984 the World Bank and the CDR agreed that Beirut would require some US$12 billion to replace or renovate damaged facilities and to restore services that had not been properly maintained since 1975" (Allen, 2005, p.15).

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[2] Fama, E., what's different about banks? J. Monet. Econ. 15, 29-39, 1985.

[3] Gertler, M. and S. Gilchrist, "Monetary Policy, Business Cycles, and the Behavior of Small Manufacturing Firms." Quarterly Journal of
Economics 109 (2): 309-40, 1994.

[4] Haslem, A. John. " A statistical Analysis of Member Bank Profitability Differences " Banking Journal. JSTOR Academic Database

However, despite the fact that the Lebanese economy has witnessed various difficulties and problems, the Lebanese banking sector has maintained its prosperity and remained one of the most successful and prosperous banking sectors in the Middle East due to a variety of reasons (Haslem, 2003).

1.2 Methodology

Despite the fact that the political situation in Lebanon is unstable, the Lebanese banking system still shows a state of prosperity. Given this paradox, I designed a methodology using data from 2001 through 2003 from *"Bilan des Banques 2004"*. All of the balance sheets, cash flows statements, and profit and loss accounts of the commercial banks operating in Lebanon are included and, a panel data model is used.

The time period for the study is be from 2001 through 2003 (at the date of writing, *"Bilan des Banques 2004"* has not yet issued the results for 2004). As for the number of banks, 16 commercial banks are included (domestic banks with domestic control, domestic banks with foreign control and foreign banks). All information needed (ratios, numbers, and industry overview) about the commercial banks used in this study are found in the *"Bilan des Banques 2004"*.

As for the statistical analysis, a regression equation is used using the SPSS statistical package where the following is analyzed:

ROE = ∫ (Liquidity, Profits, Loans, Deposits, Size, Growth, Inflation, Exchange Rate).

ROE is a profitability measure used to determine a company's profits that are generated by the money invested by shareholders. This ratio of net income to shareholders' equity is very useful in comparing shareholders' returns on companies operating in the same industry.

In this regression, ROE is the dependent variable and all the others are the independent ones. The results from SPSS are vital for this study as they determine to what extent each independent variable by itself will affects the ROE, through the t-score and r-squared. The SPSS statistical package is used in order to run regression and frequency analysis among the banks. The chosen banks are the best performing commercial banks in Lebanon (Abelson, 1983). In other words, my study concentrates on the best banks in Lebanon. These banks represent the banking industry in Lebanon.

Through the quantitative analysis, we will demonstrate if the Lebanese commercial banks' performance is related whatsoever to the political environment in Lebanon. We will use the ROE ratio as a determinant of banks' profitability and examine what are the variables that directly affect the balance sheet of the Lebanese banking industry.

Chapter Two:

A Political Economy History of Lebanon

Before discussing in detail the banking sector of Lebanon, a general understanding of the political economy of the country is needed.

Carolyn Gates in her 1989 article, "The Historical Role of Political Economy in the Development of Modern Lebanon," emphasizes a side of the Lebanese problem that has long being ignored, namely the distorted economic structure upon which the society has been established for over a century. The author claims in her introduction that the struggle in the country is far from being a struggle over political hegemony, but rather, "its intra-sectarian socio-economic nature is becoming ever more evident with the continued fluctuation, fractionalization and atomization of the combatant forces" (p. 4).

The origins of the Lebanese socio-cultural system originated in the 19^{th} century, when French and western influence began to show clearly in the country. Through their ability to penetrate Lebanon at the expense of the weak Ottoman Empire, the French established in Lebanon an economic structure that was based on capitalism, and whose major goal was to supply the French markets with cheap silk products, with cheap labor.

The orientation towards the silk industry was a major revolution in Lebanon, leading to a prosperity that the Lebanese had long dreamt of. However, the problem was that the French wanted to prevent the Lebanese economy from developing further such that this small capitalist economy would not be able to harm the French silk markets. In other words, if the Lebanese silk industry were to develop quickly and effectively, this could lead to increasing the price of silk and to the improvement of the prospects for the Lebanese silk industry. Such a possibility would be detrimental to the French. Accordingly, France continued to push Lebanon towards more economic dependence upon the French economy. This was reflected in the emphasis of Lebanese industries on silk production, while at the same time, other major production and domestic industries suffered heavily (Abelson, 1983).

The results were traumatic. In the short run, this strategy oriented many Lebanese families to work in the silk industry, making all investments and workforce moves in that direction, while at the same time, ignoring other sectors of the economy. Eventually, Lebanon's exports and economy were all based on the French market and on economic exchange with France. Those who were not involved in these industries that tied Lebanon with France were eventually reduced to poverty and neglect. Subsequently, the Lebanese economy came to depend on France and the outside for most of its imports which grew heavily, while at the same time, the silk production was the only major source of income from exports.

In the long term, this strategy was detrimental to the Lebanese economy and society at the same time, because it created a class of feudal families that were able to take advantage of the developments in the markets, whereas most others were either involved in serving the industry, or in struggling in other declining sectors of the economy (Traboulsi, 2002).

With the advent of the formation of Lebanon, the Lebanese economy was basically based on services and on the silk industry, which in turn was totally dependent on France. Such economic dependence favored only those Lebanese who were closely connected to the French economy, while neglecting other sectors of the population and the economy. "Without a firm industrial base, it was impossible to organize sufficient and effective economic development in the country, a reality which in turn impacted social development, making it uneven and ineffective" (Gates, 2004).

Lebanon for the French was seen as a capitalist market and a commercial exchange center. This put Lebanon and specifically the Lebanese bourgeoisie in a dependent relationship with the western and French capitalist markets, and at the same time, it isolated Lebanon from the rest of the Arab world.

In other words, the Lebanese economy did not focus on self-development in the region, but rather, it was oriented towards a constant state of restricted development that was aimed towards promoting services to the west in general and France in particular. While it is true that the French made heavy investments in Lebanon, these investments only targeted those sectors that paid the French back, not those which would have enabled Lebanon to become economically developed (Gates, 2004).

The city of Beirut eventually became the center of trade and commerce, and its port became one of the most important in the region. Similarly, the city itself became very well-developed, as it was seen as the capital of commerce and trade in the region, but this was also at the expense of other cities such as Tripoli and Sidon, neither of which was taken into consideration by the system. In other words, the developments in Lebanon are biased towards specific cities only and this is reflected in the political stability of Lebanon (Frederick, 2003).

The agricultural and other industrial sectors in the country were also ignored, resulting in underdevelopment in the country as a whole except for the silk industry and the financial service sectors that began to emerge. In Lebanon, due to the large number of emigrants and their financial contribution to the Lebanese banking system, it was very important to organize the huge inflow of cash into a well-organized financial system and this boosted the creation of the financial service sector in Lebanon. Eventually, the financial and other service sectors replaced the silk industry, but the capital only shifted focus, without any shift in the structural developments in the country. Socially and economically, most of the country remained in poverty and underdevelopment.

Obviously, Lebanon could be considered as an executor to the plans of others and has proven its loyalty and its ability to succeed even if it was at the expense of the Lebanese society itself. Focusing on Lebanese industry, Gates concludes that the Lebanese industries were generally weak and lacking in strong basis for development. This is due to the intensive concentration and efforts that were presented to impress the west, and at the same time, to meet the needs of those whose interests were tied to the west (Abelson, 1983).

By the same token, the main issue of building a structure to this country was neglected even after independence. Actually, the focus was put on the plan that mutual exchange with the west was going to pay off to Lebanon in terms of major economic development. However, this idea itself was superficial because it ignored the fact that the west was actually oriented by its own interests and not by the interests of Lebanon as a whole. Those who represented the capitalist interests of the west benefited most, but those who did not, either did not benefit or suffered heavily (Gates, 2004).

All the features of the Lebanese system are the result of the inequalities that were implanted in society, resulting in the ability of the few to enjoy political power that in turn created economic power or vice versa. These included political leadership and the bureaucratic elite who were able to monopolize the country's resources for many years. This class was too interest-oriented in undertaking commercial and financial profitable activities, and there was no demonstration of knowledge or awareness of the underlying dangers, nor was there a sense of responsibility to find the elements for a united country and an integrated economic and political system.

In addition to the structural deformities of the economic system, Gates, among others, discusses the economic inequalities that have long plagued Lebanese society. The Christians in general were seen as the upper and middle classes, whereas the majority of the Muslims were reduced to working class. This discrimination in religious and sectarian applications played a serious role in the formation of the state as it was portrayed on the eve of the civil war. The Lebanese population has had a long history of emigration, mainly resulting from frustration with the system and from the inability of the youth and the poor to improve their human condition in a country that was built on a system of discrimination (Abelson, 1983).

Relating the economy with the banking sector in Lebanon, it is highly important to shed light on investment banking as a crucial element of the banking sector in Lebanon. Investment banking is one kind of modern specialized banking. It is an activity that is directly related to securities and securities' markets. “Investment banking has been narrowly defined as those financial services associated with the issuance, called floatation, of new (principally corporate) securities. Such securities are issued for the purpose of providing financing for the issuing institution” (Marchal, 2000, p41). Technically, investment banking means helping supply companies and institutions with long-term funds for capital expansion through the sale of securities such as debt securities, preferred stock, and common stock directly to the public. Moreover, “investment banking involves enormous amounts of capital, highly trained export personnel, a very small profit margin and a great level of risk” (Marchal, 2000, p107).

Investment banking performs many functions, some of which are primary market making, secondary market making, financial engineering, corporate restructuring and many others. Recently, the introduction of Beirut Stock Exchange (BSE) has given investment banking the opportunity of a good start by reanimating the Lebanese economy through the opening new opportunities for the growth of local businesses. The BSE enables various investors around the world to invest in the Lebanese shares and this boosted the economic and banking performance in Lebanon since it opened the opportunity for foreign investment. The thesis now turns to analyze the rules governing the banking sector, its characteristics, and the benefits and drawbacks of the industry in light of the chronic political instability in Lebanon.

Chapter Three:

The Banking Sector – A Literature Review

As already noted, investment banks help companies and governments raise new capital either through raising equity (i.e., common stocks, preferred stocks, etc) or debt (i.e., bonds), usually for growth purposes.

3.1 History of Investment Banking (Commercial Banking)

Investment banking in Lebanon does not occupy a large portion of the economy, although its importance has recently increased. Merrill Lynch is the oldest of all investment banking firms in the country, operating in the Middle East since 1962 in Beirut. In recent years, the Lebanese government's need for debt through issuance of debt security has increased the importance of investment banking. The *Bank Libano-Francais* is also another important investment banking firm operating in Lebanon, for example.

3.2 Functions of Investment Banking

Investment banking performs a number of important functions which include:

Primary market making: Investment banks act as the intermediary between the issuer of the securities and the investors in the primary markets.

Secondary market making: This involves the organization and handling of the operations and transactions in the secondary market, that is, where securities have been previously issued (Abelson, 1990).

Trading: This includes speculation and arbitrage. Speculation involves selling and buying securities according to the price behavior expectations. Arbitrage is buying stocks in a market where the price is lower and selling them in another market where the price is higher.

Corporate restructuring: This involves expansion such as mergers and joint ventures; contraction where a company tends to liquidate some of its assets; and the ownership and control of another company through takeover.

Financial engineering: This involves the development of financial products and instruments like zero-coupon securities and other derivatives. It also includes future contracts and swap deals such as interest rate, equity, currency and commodity swaps.

Clearing: This refers to the process by which payment is collected from a securities' purchaser and transferred to the securities' seller, and the securities are transferred from the seller to the purchaser. Clearing is also called settlement.

Research and development: This involves seeking new potential markets by introducing new types of financial products and instruments. It also involves creating and developing new trading strategies, particularly complex arbitrage strategies (Abelson, 1990).

3.3 Benefits of Investment Banking in Lebanon

Reintroducing investment banking in Lebanon has provided a number of important benefits.

A- Capital Formation and Economic Progress:

All types of businesses need capital to run their operations and transactions. Capital includes productive assets such as machines, plants, equipment, buildings, and labor. The business can support the capital either through debt finance, that is, through bonds, debentures[5], commercial paper[6] and many others, or through equity finance, that is, common stock, preferred stock[7], and others. However, this cannot be successfully done without the intervention of investment banking which facilitates the mobilization of the surplus funds from savers through financial institutions.

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[5] A long-term debt instrument similar to a bond, but that is unsecured in case of a company's default.

[6] A money-market debt security, that is maturing in the short term, issued by a company to finance inventory and other current organizational operations.

[7] A share that has no voting right as opposed to a common share, but that is at a higher position in terms of dividend distribution.

Consequently, there will be the possibility of making these savings available to the business enterprises and the public sectors in order to expand output, raise living standards, foster economic growth, and hence increase the level of employment, leading to an overall gross national product (Abelson, 1990).

B- Push and step-in for BSE:

Recently, the Beirut Stock Exchange (BSE) was been re-introduced in Lebanon. The Lebanese government hopes that this will help the country to become a successful regional financial center one day in the future. However, the Beirut Stock Exchange has always been a place for trading securities where only investment banking firms and experts can manage such operations and transactions. Therefore, investment banking will be the corner stone on which the BSE can prosper.

C- Capital Inflow:

The reintroduction of the Beirut Stock Exchange will yield a higher level of capital inflow coming from abroad. This will happen on condition that this stock exchange flourishes and gains a lot of regional and international confidence along with the famous Lebanese law on banking secrecy. Due to all this, it is hopeful that Arab and international businesses will be motivated in such a market where they will have the chance not only to achieve but also to maximize profits.

D- Know-How Inflow:

During the Civil War, many professional bankers together with other financial analysts were obliged to emigrate abroad to advanced countries where they have been able to achieve their professional goals along with high salaries and enjoyable social lives. But after Lebanon recovered from the war, along with the establishment of the Beirut Stock Exchange, and the presentation of investment banking, it has been hoped that these human resources will be motivated to return especially if similar opportunities are to be offered for them (Abelson, 1990).

E- Corner Stone for Reconstruction Program:

Two decades of war destroyed much of the economic structure of the country. This is why the reconstruction of Lebanon has been a top priority to make it possible for the country to regain its place in the international community. However, this reconstruction should not only involve the central district of Beirut but also the other different destroyed regions of the country. Therefore, it should involve the entire infrastructure such as electricity, water, sewage, telecommunication, roads, buildings, bridges, hotels, beaches and many others, and not only the banking sector. All of these construction projects need long term financing at the time when most commercial banks - if not all - cannot supply these projects with such kind of finance. As a result of all this, the establishment of investment banking became essential and crucial to finance these projects with the necessary funds.

> Moreover, “statistics showed that the national emergency reconstruction program will cost about $2.3 billion which will be spent on a wide range of infrastructure projects which are considered as basic services like electricity, water and telecommunications. In addition to this, there are another $600 million of expenditures that are part of this program and which are planned to be spent on improvement in the fields of housing, education and health care; in addition there are $500 million more as expenditures on other sorts of improvements like the public transportation, the roads, and Beirut Airport. Furthermore, the Council of Development and Reconstruction (CDR), in Lebanon, has expected that the growth in gross domestic product (GDP) over the next ten years will be about 8% per annum (Saba, p.43).

All of these high expenditures along with the expected growth of gross domestic product have been enough to justify the importance of establishing investment banking in Lebanon. This is why investment banking has become a necessity to cover all of the above mentioned expenditures and to maintain the expected growth in gross domestic product (Abelson, 1990).

F- Efficient Allocation of Resources:

As has been explained previously, one of the functions of investment banking is arbitrage. Arbitrage helps the allocation of resources to be efficient and effective. Arbitrageurs will continue buying at a low price from one market and then selling at a higher price in another market until the price becomes the same in both markets. Therefore, arbitrage enforces the application of the economic law of one price which states that “at any given moment in time, identical assets or goods should sell at identical prices everywhere in the world” (Saba, p.337). Consequently in order to maintain the same profit margins as before, businesses can monitor the cost of operations instead of charging higher prices.

G- Efficient and Equitable Sector Allocation of Credit:

Table 1: Evolution of the different sectors of the Lebanese economy over three decades

The table below presents the growth in the major sectors of the Lebanese economy throughout three decades, from 1973 until 1993.

Source: Saba, year: p.58

Sector	1973	1983	1993
Agriculture	2.8%	2.1%	1.28%
Industry	16.0%	15.8%	8.90%
Construction	11.3%	12.8%	9.05%
Commerce	51.8%	49.8%	53.69%
Other	18.1%	19.5%	27.08%
Total	100%	100%	100%

According to the above table, one can observe that the allocation of credit among the different sectors is not equitable at all; during the last two decades, 50% of the credit given by commercial banks was allocated to the commercial sector. In addition, the share of funds to the industrial sector fell from 16% in 1973 to 8.90% in 1993. Moreover, the agricultural sector was not granted even 3.0% of the funds during this period. One can therefore conclude that under such a credit allocation, both the agricultural and industrial sectors cannot progress according to their potential. This is why, upon the establishment of investment banking, there will surely be a fairer funds allocation among the different sectors favoring the expansion of businesses in need and making it possible to cope with advanced technology that would improve the productivity and efficiency of resources (Saba, p.58).

3.4 Constraints of Investment Banking

There are also many factors that obstruct the further development of investment banking activities in Lebanon. These constraints are the following:

A- Political Constraints:

The political situation in Lebanon and the Middle East presents a constraint on investment banking. Lebanon does not enjoy full sovereignty because foreign arms have invaded some of its territories. As a result, Lebanon lacks the capacity of controlling all its land. In addition to this, the Middle East Peace Process is still facing some obstacles; consequently, the political situation of the whole area has become critical which in turn has created a negative atmosphere for investment in Lebanon.

B- Lack of Specialists:

There are very few investment banks in Lebanon as well as few experts and institutions in this field. Due to the lack of educational programs that might produce these specialists, commercial banks could provide their expertise to investment banking firms because these banks, especially foreign banks, tend to be well versed and trust worthy vis-à-vis other financial institutions (Abelson, 1990). In other words, foreign banks interact in respect to the performance of other financial institutions.

C- Legal Constraints:

There are no laws that explicitly prohibit the establishment of investment banking in Lebanon. The *Code of Money and Credit* together with Law 22/27 (and its amendments) however include a number of articles which constitute serious obstacles hindering the “universal” concept of banking from being applied in Lebanon. This “universal” concept of banks, primarily European, does not draw any demarcation lines between commercial banking and investment banking activities. Some of these articles include: Article 154 of the Code of Money and Credit prevents commercial banks from acquiring corporate stocks in excess of a given margin. Law 22/67 and its amendments explain and define the objective of specialized banks so restrictively that they have not been able to develop and undertake the full line of merchant and investment banking activities including the underwriting of securities, financial planning, trading, trust services and corporate restructuring (Saba, 2006: p.58). (This thesis was completed and presented over a year ago. I don’t remember which quote I used from which book or source.)

D- <u>Institutional Constraints:</u>

The majority of Lebanese business enterprises are family owned and managed. As a result, this creates a lack of variety in the securities of the market that hampers introducing new investment banks in Lebanon.

E- <u>Inefficient Accounting and Auditing System:</u>

The accounting and auditing systems in most corporations and business firms in Lebanon are poor. There are few, if any, clear laws and regulations regarding the formation and operation of accounting and auditing systems of joint stock companies. Investors may abstain from investment in Lebanon if this situation is not changed.

F- <u>Lack of Government Support:</u>

Although investment banking is crucial for the government, since it helps in the issuance of public and debt securities, the Lebanese government has not initiated any kind of support for investment banking. Instead, it has allowed current laws to restrict investment banking from expanding significantly in the economy.

G- Lack of an Effective Telecommunication System:

Telecommunications in Lebanon are much better than they used to be in the past. However, the fact that telecommunications are relatively very expensive in Lebanon make investment banking in turn very difficult. Besides, the telecommunications system in Lebanon still needs a lot of upgrading and development until it becomes more reliable.

H- Investment in Real Estate:

A huge part of the investments made in Lebanon is routed towards real-estate, which is highly illiquid. This creates a liquidity problem which reflects negatively on the prospects for investment banking.

I- Uncompetitive Interest Rates:

The interest rates on Treasury bills have historically been very high in Lebanon, reaching up to 38.8% in 1995. Since these securities are risk free, they are considered to be more competitive than other securities. Since other securities issued by investment banks will include risk, they will be set at higher interest rates, which make them too risky.

It can be said that the interest rate policy of the government is a mixture of failures and successes. Even when we are talking about the influence of the interest rate policy on the public sector, failures can be detected. It is this policy that resulted in increasing the domestic public debt, and burdening the economy for generations to come with liabilities resulting from short term and long term commitments to high levels of debt. It is also the interest rate policy of the government that has squeezed money out of the economy, leaving little space for investors and businesses to contribute to reconstruction and to growth. All in all, the interest rate policy of the government succeeded in 1993 and 1994, but from then on, its impact on the economy began to worsen. Today, there is a necessity to change this policy.

The interest rate policy has also harmed investment in a serious way, namely by impacting the stock market in Lebanon. Stock prices usually fall when interest rates are set at high levels. In 2008, Solidere stocks fell for the first time since the establishment of the company to lower than their par values. This tells us that the policy of interest rates in this country has to be changed immediately because investment and economic growth cannot continue while the costs of money are so high. Supporting the currency was one of the successful achievements of the interest rate policy set at this high level, but it is also obvious that the Lebanese economy cannot afford these high prices for money any more.

3.5 Alternatives

The constraints on investment banking can be reduced and eliminated through proposing alternatives. First of all, the government must do its best to create a stable political situation in the country. Secondly, it should encourage universities to establish educational programs to help graduate individuals with experience in investment banking and securities analysis. Commercial banks are the only means now available for investment banking. Therefore, the government should encourage commercial banks to become involved in investment banking. The government should also set and enact more clear and reliable laws to regulate accounting and auditing systems for joint-stock corporations and businesses, otherwise, investment banking could be impossible (Abelson, 1990).

In addition, the government should establish tax policies that will encourage and facilitate investment banking in the country, mainly by offering investment banks a sufficient grace period to operate without taxation. While improving the legal situation will help encourage investment banking, encouraging technological development in the country will be of great value to investment banking, especially through introducing technologies such as fiber optics telecommunications. But more important is opening the floor for competition. Since the inflation rate now is at 12%, the interest rate on Treasury Bills should also be 12% in addition to a small margin.

Reducing the interest rate in Lebanon is the most important single factor that will encourage investment banking in the country. A decrease in the interest rate will lead to decreasing the discount rate on Treasury Bills, which will encourage banks and investors to diversify their investments towards the purchase of securities other than Treasury Bills. Yet, such an option might not be very favorable for the government, especially that it will reduce the proceeds the government will get from Treasury Bills which will create liquidity problems for the government as it attempts to finance its projects.

Investment banking is an important factor in any economy, and in the Lebanese case, the need for investment banking is even more crucial. Investment banking initiates issuance of public securities and debt securities. Therefore, it is a very important tool in the economy, particularly as it influences the monetary instruments of the government, since it directly and indirectly influences the money supply in the economy.

Investment banking is a necessity in Lebanon. The constraints and the challenges are very large, but there is no alternative except to encourage investment banking and to introduce all the necessary changes in order to make investment banking applicable in the economy. It is hoped that investment banking will be presented and applied in Lebanon as soon as possible in order to establish the capability of competing and progressing in the coming era. Although there is some investment banks already established in Lebanon, the market is not really active since these are not well-developed yet.

Chapter Four:

The Banking Sector in Lebanon

In this chapter, all aspects of the banking sector in Lebanon will be described and analyzed. The Lebanese banking sector is characterized by a variety of strengths. However, it is also subject to several influences that are both political and financial.

The major attribute of the Lebanese banking sector is the importance of the deposit base as a basis for funding. “Local banks have always relied on deposits from the millions strong Lebanese Diaspora to strengthen their balance sheet.” (Allen, 1990: p. 12). The high interest rates on deposits I local and foreign currencies, in addition to the banking secrecy and the high yields on Treasury Bills, has been the main appeal for the expatriates to invest their capital in the banking sector. “As a result, customer deposits have steadily increased since 1992, accounting for 83.79% of total sources of funds by the end of 2004”. (Allen, 1990: p. 12). The key competitive advantage of banks in Lebanon will consist mainly on the constant ability of banks to attract customer deposits. However, the increased cost of maintaining deposits and lower interest rates on government paper is forcing banks to consider alternative sources of funding (Allen, 1990, p. 12).

What is also interesting here and will be analyzed at length later in the paper is the Lebanese banking sector’s ability to attract deposits from outside of the country during periods of political instability. Building on the central research question of this paper; one needs to ask what makes it possible for banks to attract such high levels of foreign (here meaning money from outside the boundaries of Lebanon) capital? (Frederick, 2003).

“There are 70 commercial banks operating in the country, with the top 19 banks accounting for 80% of the market,”[8] all operating in an aggressive environment. “The branch network is also well developed with an aggregate of 742 branches and a ratio of one branch per 5,500 inhabitants”.[9]

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[8] Francis, Jack. Management of Investment, 1988.
[9] Marchal, John. Investment Banking and Brokerage, 1986.

In comparison, banks in the rest of the Middle East average one branch per 20,000 people and the European average is one per 4,500 people.[10]

> The Central Bank of Lebanon is the principal controller of the banking sector. The Central Bank has been encouraging mergers and acquisitions to consolidate the sector and has welcomed the presence of foreign banks.[11] A conservative and pro-active regulator, the Central Bank has introduced a number of prudent guidelines and regulations to bring the sector in line with international standards. Further, several top-tier banks have acquired smaller institutions; a sign of the system's consolidation (BDL, 2007, p. 3).

Lebanese banks faced, in 2003, a set of new challenges. Slower growth in loans and deposits as well as restricted spreads and increasing bad debt expense affected banks' earnings negatively. And so, the many basic changes that took place in the Lebanese banking sector in the past decade have resulted in the alteration of both quantitative and qualitative characteristics of the sector, whether affecting the size, the profitability, but also their strategy and their product offerings. Thus, supporting this change in the sector, we have witnessed the rise of four different trends: Retail banking, universal banking, regional banking and consolidation. Each of these trends will be considered in turn.

4.1 Retail Banking

Retail Banking is a banking system in which the bank is in direct relationship with consumers rather than with separate entities, and accepts deposits and gives loans. This trend is progressively being adopted in Lebanon and it constitutes an unexploited segment that covers a significant market and commands high spreads.

[10] Marchal, John. Investment Banking and Brokerage, 1986.
[11] Saba, Sharif. Thesis on Investment Banking in Lebanon, 1995, as noted in BDL, 2007, p.3.

4.2 Universal Banking

"Economies of scale and scope on the regional and international levels have put increasing pressure on Lebanese banks to broaden their range of services and improve efficiency" (Allen, 1990: p15).

As a result, banks have widened their products by offering services in either completely new areas or complementary ones. These areas range from insurance to portfolio management and even, investment banking such that most of the top banks in Lebanon are now trying to build and increase their expertise in investment banking, capital markets, and private banking arms (Allen, 1990).

4.3 Regional Banking

In order to keep up in this very competitive environment and for large banks not to lose their top positions in the market, these banks need to take advantage of the opportunities that the globalization is offering. This means that staying local means losing their market share. And thus regionalization, if not also globalization, is a requirement if the bank wants to better serve its corporate clients and expatriates. Going regional or global is vital not only to serve better the clients, but also for banks to be more efficient and take advantage of economies of scale.[12].

4.4 Consolidation

The Central Bank has been encouraging mergers and acquisitions to consolidate the banking sector by offering incentives such as soft loans[13] and limiting banks to opening two new branches per year. In the years to come, consolidation is likely to be in the form of large banks acquiring small or medium-sized ones. Mergers among large banks are not favored by the Central Bank of Lebanon. The Governor of the Central Bank stated that the Central Bank will block any large-scale merger between the country's top ten banks in order to keep competition healthy (Allen, 1990:

[12] Ibid
[13] Offering loans with interest rates lower than the market

p.23). Larger banks are expected to grow faster than smaller ones as they have better access to outside capital, marketing, technology, and human resources. In addition, size, parochial ownership structure, and the inability or unwillingness to invest in the necessary human and operational infrastructures, present serious incentives for smaller banks to merge or be acquired (Barth, 2001). Within this context, the *Banque du Liban* or BDL plays a major role. The *Banque du Liban* was established by the Code of Money and Credit promulgated on August 1, 1963, by Decree no. 13513. It started to operate effectively on April 1, 1964.[14]

BDL is a legal public entity enjoying financial and administrative autonomy. It is not subject to the administrative and management rules and controls applicable to the public sector. Its capital is totally controlled by the state. The BDL is vested by law with the exclusive right to issue the national currency. As stipulated by article 70 of the Code of Money and Credit, the BDL is entrusted with the general mission of safeguarding the national currency in order to ensure the basis for sustained social and economic growth. This mission consists specifically in the: safeguarding of monetary and economic stability; safeguarding the soundness of the banking sector; development of money and financial markets; development and regulation of the payment systems and instruments; development and regulation of money transfer operations including electronic transfers; and development and regulation of the clearing and settlement operations relative to different financial and payment instruments and marketable bonds

The BDL is given the legal prerogative to fulfill its mission. It can use all measures it deems appropriate to ensure exchange rate stability, specifically intervention in the foreign exchange market by buying and selling foreign currencies.

The BDL controls bank liquidity by adjusting discount rates, by intervening in the open market, as well as by determining credit facilities to banks and financial institutions. It regulates banks' credit in terms of volume and types of credit, by imposing credit ceiling, by directing credits

[14] Ibid

towards specific purposes or sectors and setting the terms and regulations governing credits in general (Barth, 2001).

The BDL has many key characteristics. It imposes on banks reserve requirements on assets and/or loans as determined by the BDL, as well as penalties should shortfalls occur. Investment in financial instruments such as tabs may be considered by the BDL as part of the reserve requirements. The BDL grants licenses for the establishment of banks, financial institutions, brokerage firms, money dealers, foreign banks, leasing companies and mutual funds in Lebanon. The Banking Control Commission, an administratively independent body established in 1967 by law no. 28/67 and composed of five members who are appointed by the council of ministers for a five-year term, controls and supervises these institutions but in close coordination with the Governor of the Central Bank. The BCC has a separate budget approved by the Higher Banking Council (HBC), and funded by the Central Bank (Barth, 2001: p.25).

With the Association of Banks, the BDL issues circulars and resolutions governing the relations of banks with their customers. There is regular coordination between the BDL and the Government in order to ensure consistency between BDL's objectives and those of the Government. Cooperation with the Government implies coordinating fiscal and monetary policy measures. The BDL informs the Government on economic matters that might negatively affect the national economy and currency and suggests measures that might benefit the balance of payments, the price level, public finance and offers advice on how to promote economic growth. It also ensures the relations between the Government and international financial institutions (Barth, 2001).

4.5 SWOT Analysis for Lebanese Commercial Banks

The Lebanese commercial banks operate in a highly competitive environment and thus, they can be characterized by their strengths, weaknesses, opportunities and threats. A SWOT analysis is used in order to shed some light on the characteristics of the Lebanese banking system.

4.5.1 Strengths

The strengths are represented by the liberal economic system. They include mature central banking authority, a widespread and developed banking culture, support from BDL in the case of a crisis, and enhanced BDL regulations and supervision, a healthy banking system, a Banking Secrecy Law, sound bank management, improved risk management, diversity in bank funding activities: core deposits, Certificates of Deposits (CD)[15], Preferred Shares, IFC[16], syndicated loans. Other factors of strength include high systemic liquidity, overall confidence and trust in Lebanese banks[17], and safety of depositors' funds (these are in junior or senior position in comparison to shareholders' equity) (BDL Reports, 2004).

4.5.2 Weaknesses

A very important weakness is denoted by the fact that the Government is financed by banks even with a lack of acceptable standards. Other factors of weaknesses include the very weak corporate governance, the gradual disappearance of the bill of exchange (i.e. draft) in trade financing, the lack in economic recovery fundamentals and the lack of transparency in the annual reports of many banks, information and analysis (BDL Reports, 2004).

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[15] A money deposit that cannot be withdrawn for a certain period of time.
[16] International Finance Corporation, a member of World Bank Group that helps in financing the private sector in developing countries.
[17] The Reports of Riad Salameh mainly during periods of crises is evidence of this.

4.5.3 Opportunities

As for the opportunities, they are demonstrated by the potential benefits privatization could create: ample opportunities for economic growth (e.g., electricity, general distribution, collection…), the "Banking Over Borders" concept – extension to regional countries. The securitization of government assets will create new assets for banks. Moreover, likely opportunities include a change in CB legislation to own equity shares in subsidiaries other than insurance and financial sector (e.g., aviation, industry, hotels…) and the reestablishment of discount houses[18] (Berger, 2001).

4.5.4 Challenges

The challenges are represented by the weight of the public debt – a potential threat in case financial reforms are not introduced. Basel II requirements might defy the existence of smaller banks in the system and the unstable political environment.

In summary, Lebanese banking system has all the characteristics, from attractive interest rates to banking secrecy law, to attract local and foreign deposits. And with the four distinct banking trends: retail, universal, regional and consolidation, the Lebanese banking sector is serving better its customers and responding faster to their needs whether locally or even internationally. This positive atmosphere would have not been effective had the BDL, the Lebanese Central Bank, not imposed regulations such that to optimize the sector's performance. Moreover, despite the political instability, the banking system in Lebanon benefits from many important strengths that allows the smart and major players to take advantage of the good opportunities that the market is presenting, and mitigate the challenges these banks are facing.

[18] Activities include using deposits and other funds for investment purposes

Chapter Five: Discussion and Analysis

5.1 Discussion

This study evaluates the key performance indicators of the banking sector in post war Lebanon in an attempt to assess the true determinants of the profitability of the Lebanese commercial banks. This chapter will shed light on the determinants of profitability in the Lebanese banking system as well as how the Lebanese banking system is affected by the political situation in Lebanon. In this respect, what are the determinants of the strengths of the Lebanese banking system?

As a proxy for profitability, the Return on Equity (ROE) will be used. ROE is chosen as a proxy because it is the most accurate measure of profitability for commercial banks. Essentially, ROE reveals how much profit a company generates with the money shareholders have invested in the company. And it is useful for comparing the profitability of the banks between each other.

ROE is the dependent variable. As independent variables eight different factors will be tested in order to determine if they are true determinants of the banks profitability in the Lebanese market. The study concentrates on the early 2000's.

Loans and Deposits will be tested because they are vital factors for banks; banks depend a lot on their loans and deposits, they are essential for the profitability of the bank, because if the bank does not have sufficient deposits, it will not be able to give enough loans (source of revenue for the banks). Liquidity and Profits are also included as banks are very concerned about their liquidity and profitability. When a bank has a high liquidity ratio (Current Assets / Current Liabilities) and is profitable, its bankruptcy risk is diminished. Size and Growth are very important factors as well; depending on its size, the bank will choose if it wants to make more profits, or cut its profits in order to grow. In this, one can see that the strategy of the bank is also important. And finally, Inflation and Exchange Rate are assessed, although both of them are exogenous factors that the bank cannot control but that play a major role in determining the profitability of the banks, because they can affect the banks dramatically if an unexpected or un-hedged situation occurs.

On the one hand, a positive relation is expected between Liquidity, Profits, Loans, Deposits, Size, and Growth with ROE. On the other hand, there is an expected negative relation between Inflation and Exchange Rates, with ROE (Berger, 2001).

5.2 Data and Analysis

This section will tackle the banking system through analyzing the performance of the major banks in Lebanon. The attached appendix includes the analyzed financial statements for 15 Lebanese banks. These banks are the following:

A- BBAC Bank
B- BLOM Bank
C- Federal Bank of Lebanon
D- HSBC Bank
E- Jammal Trust Bank
F- Lebanese Canadian Bank
G- Saradar Bank
H- Lebanese Swiss Bank
I- Intercontinental Bank of Lebanon
J- First National Bank
K- FransaBank
L- Citibank
M- Finance Bank
N- Byblos Bank
O- BEMO Bank

P- Habib Bank

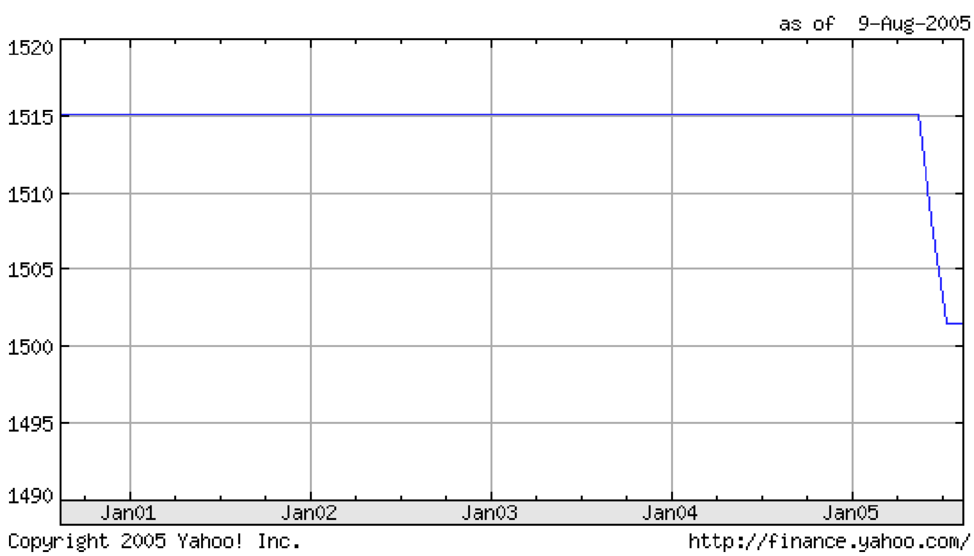
These banks were chosen because they are the most important banks in the Lebanese banking industry. They are also considered of the most profitable banks in the Lebanese banking system.

The data on these banks was entered into the SPSS software package and a regression analysis was run in order to come up with relationships among the dependent and the independent variables.

To start with, it is worthwhile to shed light on the inflation rate in Lebanon for the years, 2001, 2002 and 2003.

Inflation Rate	**Year**
0.5	2001
3.5	2002
2.5	2003

The exchange rate between the US dollar and the Lebanese pounds during the same period was as follows:



Thus, for the three consecutive years, 2001-2003, the exchange rate was stable at 1515.

The accumulated data were all entered into the SPSS. The results are apparent in the appendix of the paper. However, it is worthwhile to comment on these results in order to draw relationships between the dependent variable, which is the ROE, and the independent variables which are the identified variables.

In the table presented below, the correlation and regression analysis for BEMO bank is obvious. BEMO bank is one of the most successful banks in the Lebanese market. Clearly, we can draw a regression and correlation relationships among the dependent and the independent variables. To start with, the ROE is highly correlated with the growth of the banking financial position. In other words, to illustrate, the higher the ROE, the better the financial liquidity and performance of banks. The Pearson correlation level is .610 which is rather a high correlation level and which means that the higher the growth, the higher the ROE level. The significance of this correlation is not low. It is .582 which is a good significance level for the years, 2001-2002-2003.

In addition, ROE is highly and positively correlated with profits, deposits, and size with a rather above average significance level. However, the ROE is negatively correlated with inflation and liquidity with a low significance level for liquidity and a high significance level for inflation. The Pearson correlation between the ROE and the Loans is very low: 0.32.

Table 2: BEMO Bank

		ROE of BEMO	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of BEMO	Pearson Correlation	1.000	.610	.032	.771	.827	1.000	-.304	.	-.999
	Sig. (2-tailed)	.	.582	.980	.439	.380	.016	.803	.	.030
	N	3	3	3	3	3	3	3	3	3

In the table below, BLOM bank is studied. It is considered one of the most successful banks in the Lebanese market. Here, there are two categories of correlations among the dependent and the independent variables. The negative correlations are between ROE and the following variables:

- Growth: -.963
- Profits: -.999
- Deposits: -.920
- Size: -.108
- Inflation: -.722
- Liquidity: -.926

The positive correlation is between ROE and the loans and which is .954 at a significance level of .195. Thus, the negative correlation reflects the image that BLOM ROE is negatively correlated with the determined variables. In other words, the higher the ROE, the lower the determined independent variables.

Table 3: BLOM BANK

		ROE of BLOM	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of BLOM	Pearson Correlation	1.000	-.963	.954	-.999	-.920	-.108	-.722	.	-.926
	Sig. (2-tailed)	.	.174	.195	.031	.257	.931	.486	.	.247
	N	3	3	3	3	3	3	3	3	3

Thus, from a comparative perspective, we do not find similarity in the performance between the BLOM and BEMO banks. BLOM's ROE is driven by different profitability determinants that that of BEMO; The profitability determinants are in a chaotic position. (Refer to pg 58 to the summary of this chapter for the meaning of this study).

As for Byblos bank, the ROE is negatively correlated with the following independent variables: profits, size, inflation and liquidity. As for profits, the correlation level is at -.985 with a significance level of .112, which means for the time being that the ROE is not determined by the profits variable only. There are other more important variables that push up the profitability of the bank. Concerning size, the size of the bank is not related to the growth of the ROE for the bank since I was able to detect a negative correlation between these two variables and it is -.977 with a significance level of .137. Also, the ROE is negatively correlated to the inflation which means that the higher the inflation, the lower the ROE. The Pearson correlation level reaches -.425 at a high significance level of .720. Liquidity is negatively correlated with the ROE. The level is -.770 at a significance level of .441.

However, the ROE is positively correlated with the growth, loans and deposits at a level of, .669, .970 and .052 respectively. Therefore, it is noticeable that the higher the growth, loans and the deposits, the higher the ROE (Berger, 2001).

<u>Table 4: BYBLOS BANK</u>

			GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of BYBLOS	Pearson Correlation	1.000	.669	.970	-.985	.052	-.977	-.425	.	-.770
	Sig. (2-tailed)	.	.534	.156	.112	.967	.137	.720	.	.441
	N	3	3	3	3	3	3	3	3	3

The image for Citibank is rather different. The ROE is negatively correlated with the loans level only at a correlation level of -.668 and an above average significance level of .535. This image reflects the fact that the ROE declines as a results of increase in loans and the opposite relation is valid. However, the ROE for Citibank is positively correlated with all other independent variables. The correlation levels are as follows:

- Growth: .711

- Profits: .977
- Deposits: .840
- Size: .962
- Inflation: .879
- Liquidity: .660

Table 5: CITIBANK

		ROE of CITY BANK	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of CITIB	Pearson Correlation	1.000	.711	-.668	.977	.840	.962	.879	.	.660
	Sig. (2-tailed)	.	.497	.535	.138	.365	.177	.316	.	.541
	N	3	3	3	3	3	3	3	3	3

The significance level of the entire positively correlated variables is close to the average. This regression analysis shows that ROE increases as a result of an increase in the above determined independent variables.

As for the Federal Bank of Lebanon, the image is rather different. The ROE is positively correlated with the following variables:

- Growth: .019 (close to 0; we can say that there is no correlation. The direction of the two variables move randomly)
- Loans: .986
- Size: .989

However, a negative correlation exists among ROE and the following variables:

- Deposits: -.212
- Inflation: -.129
- Liquidity: -.982

Table 6: FEDERAL BANK OF LEBANON :

Thus, the negativity in the correlation reflects an inverted performance among ROE and the other variables. Thus, to take the size for example, it grows when the ROE declines but at a rather less level than the relationship that takes place between the liquidity and the ROE. As liquidity grows, the ROE significantly drops because the negative correlation is as high as .982.

		ROE of FEDERAL	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of FEDERA	Pearson Correlation	1.000	.019	.986	.	-.212	.989	-.129	.	-.982
	Sig. (2-tailed)	.	.988	.105	.	.864	.093	.918	.	.121
	N	3	3	3	0	3	3	3	3	3

As for the Finance Bank, the image is different. For ROE and Growth, the correlation is -.236 at a significance level of .848. This correlation reflects that fact that ROE declines as a result of an increase in growth and vice versa. The significance level is high and it tells us that any minor change in the growth will cause an opposite change in the ROE. The sensitivity level is high. For ROE & Loans, Profits, Deposits, Size, Inflation, and Liquidity, the correlation is positive and high among ROE and the other variables. The significance level is around the average. This correlation reflects a positive change in the ROE as a result of a positive change in the other variables. Thus, it is apparent that ROE is highly determined by profits, size, inflation, loans and liquidity in the finance bank of Lebanon.

Table 7: FINANCE BANK

		ROE of FINANCE B	**GROWTH**	**LOANS**	**PROFIT**	**DEPOSITS**	**SIZE**	**INFLATION**	**EXCHANGE**	**LIQUIDITY**
ROE of FINANCE B	Pearson Correlation	1.000	-.236	.939	.919	-.503	.692	.918	.	.514
	Sig. (2-tailed)	.	.848	.223	.258	.665	.513	.259	.	.656
	N	3	3	3	3	3	3	3	3	3

As for the First National Bank ROE, it is positively correlated with inflation, liquidity and profits and negatively correlated with the other variables. The significance level of correlation is diverse and goes above and under the average.

Table 8: FIRST NATIONAL BANK

		ROE Of FIRST	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE Of FIRST	Pearson Correlation	1.000	-.942	-.896	1.000	-.998	-.176	.423	.	.891
	Sig. (2-tailed)	.	.217	.293	.	.036	.887	.722	.	.300
	N	3	3	3	2	3	3	3	3	3

Thus, from a general perspective, it is apparent that the profitability determinants differ from one bank to the other. Every bank has different conditions than another bank. There is no stable correlation between the dependent and the independent variables. This is a reflection of the internal situation in Lebanon. In this respect, the conditions of every bank are not highly attached to the conditions of the general Lebanese economy and political stability.

The following table depicts the regression and the correlation analysis for FransaBank. It is apparent throughout the table that the ROE is positively correlated with the following variables:

- Growth: .859 vs .342
- Profits: .617 vs .577
- Deposits: .979 vs .132
- Inflation: .030 vs .981
- Liquidity: .943 vs .215

A high Pearson correlation level reflects a high relation between the ROE and other variables. Accompanied with a high significance level, the high positive correlation level drags with it the ROE at sensitive measures. However, the ROE is negatively correlated with the following variables:

- Loans: -927 vs .245
- Size: -.985 vs .110

<u>Table 9: FRANSABANK</u>

		ROE of FRANSA BANK	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of FRASABANK	Pearson Correlation	1.000	.859	-.927	.617	.979	-.985	.030	.	.943
	Sig. (2-tailed)	.	.342	.245	.577	.132	.110	.981	.	.215
	N	3	3	3	3	3	3	3	3	3

The figures related to Habib Bank are different. The regression analysis shows a negative correlation between ROE and the following variables:

- Growth: -.427 vs .719
- Loans: -.528 vs .646

- Deposits: -.787 vs .424
- Inflation: -.887 vs .305

The positive correlation appears among ROE and the following variables:

- Profits: .899 vs .289
- Size: .765 vs .445
- Liquidity: .825 vs .382

Table 10: HABIB BANK

		ROE Of HABIB	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of HABIB	Pearson Correlation	1.000	-.427	-.528	.899	-.787	.765	-.887	.	.825
	Sig. (2-tailed)	.	.719	.646	.289	.424	.445	.305	.	.382
	N	3	3	3	3	3	3	3	3	3

Furthermore, the HSBC bank reflects a different scenario of correlations. The ROE is positively correlated with growth, loans, deposits and inflation. However, the ROE is negatively correlated with profits and inflation (Berger, 2001).

Table 11: HSBC BANK

		ROE of HSBC	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of HSBC	Pearson Correlation	1.000	.497	.999	-1.000	.070	- .862	.647	.	-.999
	Sig. (2-tailed)	.	.669	.033	.	.955	.338	.552	.	.020
	N	3	3	3	2	3	3	3	3	3

In this context, it is apparent that every bank has a different scenario of correlation. But in general, the ROE is affects by at least some of the determinant variables. The ROE of the Intercontinental Bank faces a negative correlation with the loans level only. It is -.986 with a significance level of .100. However, the ROE of the Intercontinental Bank is positively correlated with the rest of the variables. The Pearson correlation is extremely high for growth, deposits size and liquidity and it is above .955 on average. Thus, the image of the intercontinental banks reflects the fact that the ROE is highly determined by the independent variables discussed. This regression analysis, as for the rest of the banks, is drawn for a period of three years, which are 2001, 2002, 2003. Thus, the time period is long enough for us to decide and draw a meaningful relationship.

Table 12: INTERCONTINENTAL BANK

		ROE Of INTER	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE Of INTER	Pearson Correlation	1.000	.988	-.986	.575	.993	.998	.656	.	.997
	Sig. (2-tailed)	.	.100	.106	.610	.074	.036	.544	.	.048
	N	3	3	3	3	3	3	3	3	3

As for Jammal Trust bank, the figures are very similar to those of the Intercontinental bank where the ROE of the bank is negatively correlated with only loans and positively correlated with the rest of the variables. The Pearson negative correlation reaches the level of -.806 with a significance level of .402. However, the positive correlation has an average Pearson correlation level above .95 at a significance level that averages almost 0.40.

Table 13: JAMMAL TRUST BANK

		ROE Of JAMMAL	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE Of JAMMAL	Pearson Correlation	1.000	.902	-.806	.499	.987	.538	.989	.	.879
	Sig. (2-tailed)	.	.284	.403	.667	.104	.638	.095	.	.317
	N	3	3	3	3	3	3	3	3	3

The Lebanese Canadian bank presents a different correlations and regressions scenarios than the other banks. In this respect, it has a positive correlation with growth and loans only. However, it has negative correlations with the rest of the variables which are profits, deposits, size, inflation and liquidity.

Table 14: LEBANESE CANADIAN BANK

		ROE of LEBCAN	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of LEB CAN	Pearson Correlation	1.000	.999	.509	.412	.663	.971	.978	.	.582
	Sig. (2-tailed)	.	.025	.660	.730	.539	.155	.134	.	.604
	N	3	3	3	3	3	3	3	3	3

The Lebanese Swiss Bank has also a similar correlation and regression level to both Jammal Trust Bank and the Intercontinental Bank expect for the inflation correlation level. The ROE is negatively correlated with both the loans and the inflation and positively correlated with the rest of the variables. The negative and positive correlations with their corresponding significance levels are as follows:

- Growth: .558 vs .623
- Loans: -.743 vs .467
- Profits: .515 vs .656

- Deposit: .673 vs .530
- Size: .901 vs .286
- Inflation: -.522 vs .651
- Liquidity: .998 vs .03

The sensitivity and significance levels of positive correlations are high on average and so are the levels of the negative correlations (Gertler, 1994). In other worlds, the interaction between ROE and other variables are correlated negatively and positively. So, the return on equity of banks is sometimes affected by inflation, size, liquidity, deposits and growth but it is not affected in some cases.

Table 15: LEBANESE SWISS BANK

		ROE of LEBSW	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of LEBSW	Pearson Correlation	1.000	.558	.743	.515	.673	.901	.522	.	.998
	Sig. (2-tailed)	.	.623	.467	.656	.530	.286	.651	.	.036
	N	3	3	3	3	3	3	3	3	3

The figures for the bank, Audi Saradar, are very similar to the Intercontinental, Jammal Trust and the Lebanese Swiss banks. The ROE of the bank is negatively correlated with only loans and positively correlated with the rest of the variables. This relationship depicts the scenario that when loans grow, ROE declines and vice versa. However, as the rest of the variables grow, the ROE will certainly grow. The sensitivity levels of the correlations are below the average which means that the movements are not highly correlated.

Table 16: AUDI SARADAR BANK

		ROE of SARAD	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of AUSAB	Pearson Correlation	1.000	.988	.893	.703	.989	.478	.636	.	.849
	Sig. (2-tailed)	.	.100	.298	.504	.094	.682	.561	.	.355
	N	3	3	3	3	3	3	3	3	3

From another perspective, the BBAC bank has the following correlations and significance levels:

- Growth: -1.00 vs .018
- Loans: .900 vs.287
- Profits: .380 vs .752
- Deposits: -.859 vs .342
- Size: .390 vs .745
- Inflation: -.806 vs .403
- Liquidity: -.942 vs .218

Table 17: BBAC BANK

		ROE of BBAC	GROWTH	LOANS	PROFIT	DEPOSITS	SIZE	INFLATION	EXCHANGE	LIQUIDITY
ROE of BBAC	Pearson Correlation	1.000	-1.000	.900	.380	-.859	.390	-.806	.	-.942
	Sig. (2-tailed)	.	.018	.287	.752	.342	.745	.403	.	.218
	N	3	3	3	3	3	3	3	3	3

Thus, the ROE of the BBAC is positively correlated with loans, profits and size. However, it is negatively correlated with growth, deposits, inflation and liquidity.

Finally, from a general perspective, the analysis for the sixteen chosen banks shows that ROE movements highly depend on growth, liquidity, inflation, size, profits, and deposits for some of these banks especially, the Intercontinental, Lebanese Swiss and Jammal Trust banks. However, for the rest of the banks the correlation between ROE and the other variables varies. In other words, the analysis of some banks reflects the fact that there is a negative correlation between the ROE and numerous independent variables such as loans, inflation, liquidity, growth and all others.

The results of the analysis limited since the ROE is influenced by other factors than the independents factors I tackled. Other factors influence the profitability of commercial banks in Lebanon and among the most important factors are the competitive factors in the Lebanese banking system.

Still, the ROE of all the banks studied appeared by be influenced both negatively and positively by the independent variables which are loans, size, growth, deposits, liquidity, exchange rates, inflation and profits. However, the Pearson correlation as well as significance levels differed from one bank to the other. Thus, I was able, through the empirical analysis to shed some light on the relationship between banking characteristics and performance measures in commercial Lebanese banks. It seems, though I did not test it directly, that the Lebanese banking system has adapted to the political instability of Lebanon. In other words, the Lebanese banking system is not negatively affected by the Lebanese political situation and has the ability to cope with it.

First, the factors that could be directly measured demonstrate that the Lebanese commercial banks profitability measures respond positively to the increases in capital and loan ratios. This result is intuitive and consistent with previous studies. It indicates that adequate capital ratios and loan portfolios play an empirical role in explaining the performance of Lebanese commercial banks. Second, the results also indicate the importance of customers' deposits, non-interest earning assets, and banks' profits. In addition, the results suggest that the liquidity factors are very important in the determination of bank performance. The inverse and statistically significant effects of liquidity in general indicate that financial repression and domination are distorting the performance of Lebanese commercial banks. The negative effect of inflation in some of the banks studied reflects a negative correlation between the ROE and inflation which means that the higher the inflation, the lower the profitability of the banks.

Yet, numerous sources note that the current political stalemate is taking a heavy toll on the Lebanese economy. One study reports that 40% of Lebanese of working age (22–62 years) were employed outside the country.[19] Remittances reached nearly $6 billion in [2002], or about $1,500 per citizen, which is considered a very high rate.[20] In part, this influx of remittances explains how—despite the acute political and administrative crises—the country's banking system remains extraordinary strong and stable.

According to the Central Bank report of 2006 (cite), "Forty-five percent of the remittances come from the Gulf, where more than 400,000 Lebanese work", Salameh said. Today, the heavy cash inflow from millions of Lebanese in the oil-rich Arab gulf, Africa, Europe and the United States have helped hundreds of thousands of families at home to weather one of the worst economic hardships to hit the country in recent years (World Bank, 2000).

It is estimated that millions of Lebanese live abroad, with the bulk of them based in South America. But officials say that most of the second- and older generations Lebanese in South America hardly send any money to Lebanon anymore because they have lost contacts with their relatives. Rather, it is more recent emigrant that sends the bulk of the remittances home to their families. "Most of these remittances are sent to Lebanese families to buy food, clothing, houses, and to pay for medical examinations and also to educate their children in schools and universities," Salameh said. He added that Lebanon is ranked among the top countries in the world in terms of remittances compared to the GDP ratio (World Bank, 2000).

[19] Boyd and Gertler, The Role of Large Banks in the recent US Banking Crisis, 2003, p. 19.
[20] Boyd and Gertler, The Role of Large Banks in the recent US Banking Crisis, 2003.

Joe Sarrouh, advisor to the chairman of FransaBank, said in an article in *The Daily Star* on 15 February 2007, that the annual cash flow from Lebanese expatriates improves the balance of payments and stimulates the economy. “The Lebanese expatriates are one of Lebanon's biggest assets,” he said. He added that Lebanese expatriates are now using their money to buy houses and land. “In the past Lebanese expatriates used to send $200 to $300 a month to their families. Now they prefer to make investments in their own country in case they decide to come back.” In conclusion, Sarrouh said that remittances have always been and always will be the biggest support for the local economy.

Many local banks are offering special housing loans to Lebanese expatriates, especially those who live in the Gulf. A banker said that most of the Lebanese expatriates in the Arab Gulf region eventually return to Lebanon. According to *Workers Remittances in Mediterranean Partner Countries* (MPC) led by the European Investment Bank (EIB) for the Migration and Development Conference Washington DC, of 24 May 2007, remittances have considerable economic importance to MPC’s (Lebanon, Jordan, Morocco, Tunisia, Egypt, Syria, Algeria, Turkey), but not uniformly across the region. The study proves that despite Lebanon’s heavy exposure to governmental debt and political instability, its relatively sophisticated financial sector is able to absorb large and relatively stable remittances flows. The EIB also support the first remittance securitization operation in Lebanon (Frederick, 2003).

In conclusion, remittances contribute to improve the funding of financial institutions and consequently to strengthen the financial sector and finally to financial development leading to economic growth (Haslem, 2003).

5.3 Laws and regulations fostering the strength of the Lebanese banking system

Prior to the crisis of 1975-1976, the Lebanese banking system had come to acquire a growing world-wide reputation. Beirut was regarded as “the financial center of the Middle East”.

One indicator of the commercial banking system's importance was the very high ratio of deposits to national income which in 1973 exceeded 100%, a level comparable to that of Switzerland. This was the result of two developments: the post 1973 dramatic rise in Arab oil surpluses and the beginnings of the emergence prior to 1975 of a capital market in Lebanon. Unfortunately, the breakout of the civil strife in 1975 led to a radical change in the situation. As a result of this strife, the Lebanese economy was greatly damaged and, as of mid 1976, became to a large extent fragmented. After the Taif accord was signed in 1991, hopes that a unified Lebanon would regain its political stability reemerged. However, the problems of economic reconstruction that faced Lebanon were immense. Numerous monetary and banking policies were necessary to aid the process of recovery. But the assessment of the role that the banking and monetary sectors could play must be discussed in the light of Lebanon's experiences in the monetary and banking fields up to 1974. These experiences formed the basis upon which governmental policies were built in order to help restore confidence in the Lebanese economy and banking system.

Before April 1964, when the new Monetary Law came into force, banking activity in Lebanon was regarded as an ordinary commercial activity subject to the commercial code which contained very few provisions relating to commercial banks. This is why the enactment of the Law on Money and Credit establishing a Central Bank marks the beginning of a new era in the Lebanese economic and financial policies.

When in 1967, the worst liquidity crisis in history of the Lebanese banking system culminated in the collapse of one of its biggest members, the Intra Bank, new legislation and changes in the institutional framework occurred. Drastic measures aimed at safeguarding the whole banking structure were formulated and implemented. The ensuing measures played a great role in restoring confidence in the banking system and eliminating some of its weak elements. The series of measures adopted by the Central Bank in 1974 seem to indicate a greater willingness on its part to play a more active role in the country's monetary management (Haslem, 2003).

However a few laws designed to attract an increasing volume of deposits into the commercial banking system and to improve its efficiency were enacted before 1964. In September 1956, Parliament approved the Banking Secrecy Law which guaranteed the confidentiality of relations between a bank and its clients. Earlier, in December 1961, a law was passed that allowed banks to open joint accounts for two or more persons. Any one holder of the joint account was then allowed to dispose freely of the entire balance was promulgated (in the event of the death of one of the holders of the account, the inheritance tax is not applicable). Another Law exempting the holders of savings accounts from paying any income tax was passed in August 1963. In June 1962, a decree required all state-approved banks to adhere to the "Risk Center" established with the B.S.L in 1953 which aimed at exchanging information on the lines of credit extended to each and every client.

By virtue of the Law dated September 7, 1948, Lebanon established with the Ministry of Finance an exchange control office. Less than two months later, controls were restricted to a few "hard" currencies and then gradually May 30, 1952, all exchange transactions had been freed and exchange rates came to be determined on the free market by demand and supply conditions.

Haslem (2003) describes the process by which the Lebanese government further loosened controls on the banking system. On the first of April 1975, decree No. 29 formulated a free banking zone by giving the Lebanese government the right to except non-residents' deposits and liabilities in foreign currency from: the income tax on interest earned, the obligatory reserves levied by the *Banque du Liban* by virtue of article 76 of the Code of Money and Credit, and the premium of deposit guarantee levied on bank deposits to the profit of the National Deposit Guarantee Institution. Both article 16 of law No. 282 dated December 30, 1993 and article 12 of decree No. 5451 dated August 26, 1994, provide a kind of exemptions from income tax on all interest and revenues earned on all types of accounts opened in Lebanese banks.

In this respect, the SIC states clearly that "money laundering is an illegal act intended to conceal the source or use of illicit funds, by converting cash into untraceable bank transactions. The process goes through three main stages":

- Placement: the launderer introduces the illegal proceeds into the financial system.
- Layering: the launderer engages in a series of operations on the illicit funds movements, in order to distance them from their source. This involves using different channels that make reverse tracing impossible.
- Integration: the funds re-enter the formal financial system, and the launderer can invest the funds in any business of high-value assets (Haslem, 2003).

One of the major laws that allow the banking sector to prosper is Law 318 enacted in 2001. Law No.318 (as amended by Law 547 dated 20/10/2003) under article 1 criminalizes illicit proceeds that are derived from the following offences:

> The growing, manufacturing, or trading of narcotic drugs. Acts committed by associations of wrongdoers, that are specified by Articles 335 and 336 of the Penal Code, and internationally identified as organized crimes. Terrorist acts, as specified in Articles 314, 315 and 316 of the Penal Code. The financing or contribution to the financing of terrorism, terrorist acts, or terrorist organizations, in accordance with the concept of terrorism as specified by the Lebanese Penal Code. Illegal arms trade. The offences of theft or embezzlement of public or private funds or their appropriation by fraudulent means, counterfeiting, or breach of trust, affecting banks, financial institutions, and institutions listed in Article 4 of this Law, or occurring within the scope of their activities. The counterfeiting of money, credit cards, debit cards or charge cards, or any official document or commercial paper, including checks (Demirguc, 2000, p. 15).

Money-laundering operations may occur in any business especially: banks, other financial institutions (insurance, mutual funds, etc), money exchange firms, antique dealers, and real estate and jewelry dealers.

In addition, the sole role of the special investigation commission is to apply the laws and regulations in force. This happens through internal and global cooperation for fighting local and international money laundering crimes.

Historically, the Lebanese political system has tended more to be a sectarian political struggle rather than one against liberalism. Lebanon, precisely because of its sectarianism and factionalism, is a country that has long rested on an imperfectly liberal, sometimes even libertarian, social contract: the state remains fairly weak amid strong religious communities are allowed to develop as they see fit. Consequently no one side, least of all the state, can dominate the country's disparate groups or its economy. This is why Lebanon, unlike most Arab countries, has been unkind to budding dictators. The fractured political structure has also led to the growth of a fairly free and pluralistic media. However, the weakness at the center has left much space for a free-market economy; despite the persistence of oligopolies in some sectors; as well as openness to private investment and a carefree embrace of the benefits of globalization (Allen, 1990).

When the Taif Agreement was signed in 1989, it was intended to provide the basis for ending the Lebanese civil war and to regain a relatively stable if not peaceful situation. Although Israel withdrew from the south of Lebanon only in 2000, the post-Taif period was a relatively stable one until Hariri's assassination in February 2005. The ensuing periodic assassinations, the polarization of Lebanon into two camps, the Israeli war on Lebanon in July 2006, and the Nahr al Bared war in summer 2007, again made Lebanon's reputation that of a location that suffers from chronic instability. During all this period, the Lebanese financial sector persisted in being bank-centric and was also acknowledged to be exceptionally large and relatively stable.

The Lebanese economy has always been a liberal one with almost no interference from the government. There is a favorable business environment and investment incentive framework characterized by liberal trade and investment policies with no significant restrictions on foreign investment, a comprehensive banking secrecy law and free currency exchange with completely relaxed restrictions and no control on capital flows, a flat 10% corporate tax and free access for foreign investors, a strong and well defined legal rights for property and an extensive business law with ten different types of companies.

The free-enterprise economy, which is inherent to the political system

> in Lebanon, has also become part of the collective mindset of its people. It is this unwavering adherence to free enterprise that explains to a considerable extent the country's prosperity in the decades before the outbreak of the internal war, its resilience during the excruciating test of the war for a decade and a half, and its ability to re-emerge with unscathed potentials for recovery. Three pervading principles lay at the foundation of economic and investment legislation in Lebanon (Lebanese American Association, 2008: p2)

Frederick (2003, p. 15) goes on to note three principles on which he argues the Lebanese agree regarding the banking sector.

> The first of these principles is the safeguarding of private ownership of assets with no discrimination between foreign and local ownership. The second principle is the freedom of entrepreneurial activity, which implies that no law, decree or regulation may be designed to unduly influence business decisions. The third principle on which Lebanon's economic legislation rests is the unrestricted competition in the business sector.

This first principle discussed above also implies that foreign investors have a full control over their own assets and businesses with no intervention from any third party in the matters of their personal resources.

The second principle, in continuity to the preceding one, gives no room to the Lebanese legal system to channel investors in engaging their personal resources in any particular field. Investors are given complete freedom in choosing the business in which they want to invest, on the grounds that asset allocation is a business decision implying a business risk personally born by these investors and is thus of no concern to public authorities.

The third principle implies that the Lebanese economic legislation forbids any discriminating tax policy or other incentives favoring any business over its competitors. Thus, businesses can operate in a free and healthy competitive environment.

The safeguarding of private ownership, freedom of entrepreneurial activity and unhampered competition, these three principles provides Lebanon a comparative advantage to the region, illustrating its traditional believe that wealth does not come from restrictions, discriminations or barriers but on the contrary from openness.

It is apparent from the conducted study that the Lebanese political system does not affect directly the Lebanese banking system that already developed immunity against the political turbulence. The Lebanese banking system remains healthy despite all the political problems that take place in Lebanon.

Chapter Six: Conclusion and Recommendations

The Lebanese commercial banks in Lebanon operate within a complex and competitive environment that make the banks rally to reap profits. Reaping profits can happen through a variety of banking roads. These roads might include loans, credits, deposits, investments and many others. Yet, for the Lebanese commercial banks, generating profits has become troublesome due to the competition. The study I conducted was able to shed light on the profitability determinants for Lebanese commercial banks. Thus, at the end of the study, I was able to conduct a correlation between ROE which is the measure of profitability for commercial banks and many other variables such as inflation, exchange rates, liquidity, growth, deposits, profits, size and loans. While the positive performance of some of these variables affects the ROE positively, the positive performance of the rest of these variables affects the ROE negatively.

The thesis also included significant discussion on the liberal structure of the Lebanese economy and the regulatory and legal structures that have allowed the banking sector to prosper in spite of the chronic political instability of the country. Still, the there are some limitations in this study. First, the scope of this paper is limited as several Lebanese commercial banks are not included and several interesting questions are not answered. Also, because of the size of our sample and many missing observations, our results should be interpreted cautiously. As has been the case of many recent studies, the results are not very robust and may be sensitive to the type of measure of performance used. Last, the nature of the political dimension was rather general as specific variables were not included in the quantitative study.

Thus, the banks themselves, to a certain extent, are supposed to highly monitor and be successful in increasing the contributions of each variable in order to maintain a high profitability rate. For example, the positive correlation among the variables pushes the banks to increase the performance of the concerned variables. However, the negative correlation pushes the banks to decrease the contributions of the concerned variables. In addition, the government and the state have been steadfast in trying to maintain a strong regulatory and legal structure in which the banking sector can operate.

From a future perspective, several global economic factors will have an impact over the profitability of commercial banks. In this context, ROE determinants will go beyond the national boundaries to include global factors such as global competition and major global banking regulations. Thus, the ROE of commercial banks will be subject to various global competitive and regulatory factors in the near future. Will not it?

Still, especially to the outsider, the success of the banking sector in Lebanon throughout periods of sometimes intense civil strife and a virtually absent state is puzzling. It is hoped that this thesis, through its focus on both the internal, financial dynamics of banking as well as the external legal and political structures existing in Lebanon, has provided a better understanding of the ongoing profitability of this sector of the Lebanese economy. Last, the strong commitment of Lebanese expatriates – perhaps born by their desire to return to their native land in better times – has created a long-term high level of remittances to the country, many of which flow directly into the banking system.

All together, then, the success of the banking sector in Lebanon – even in troubled times – no longer seems like a puzzle. Security and prosperity are two interrelated concepts. Lebanon’s prosperity would most likely be greater under different political circumstances; however Lebanon’s ability to survive is subject to the world stupefaction. The reform-minded administration which goes to the United

Nations says that the nation's prosperity is a mystery. In short, Lebanon, in economic terms, should not survive, they note. After months of exhaustive study the report comes in with this conclusion similar to that of Allen (1990) regarding the banking sector in Lebanon: "We don't know what you're doing, but whatever it is, keep doing it" (Allen, 1990, p.23).

Obviously, the historically stable and positive impact of remittances and well-defined rules, laws and regulations provide a good basis for the banking system. In addition, the absence of state interference and an imperfect liberal system have played and will continue to play a major role in the profitability of the Lebanese banking system. In the long run, increasing the rate of growth of the banking income will require a higher level of investment which should preferably be matched by an increase in domestic savings; taking into consideration, the unpredictable international and Arab capital movements (Ingelby, 2008).

For most of 2007 and the first half of 2008, Lebanon experienced some political uncertainty when opposition parties boycotted the government and parliament. However, since the Doha Accords of May 2008 and the election of a new president, there is renewed hope of things moving forward again.

Despite the political deadlock, we have witnessed some developments in Lebanon's legal framework, notably in relation to the issue and transfer of Lebanese banks' shares, company law, Islamic finance laws, and so forth. Nevertheless, numerous legislative projects remain pending before parliament, and it is hoped that these will start moving through the legislative process again. These draft laws aim to bring significant reforms to the financial and business environment (Ingelby, 2008).

Despite the political situation, the dynamic and evolving banking infrastructure is securing and strengthening the banking and financial sector and the Lebanese economy in general. The Banking Secrecy Law of 1956 binds Lebanese banks to absolute secrecy with respect to their client accounts. Secrecy can only be lifted with the client's prior authorization, in the event of bankruptcy or in the event of a conflict between the client and the bank arising from banking relations.

The Anti-Money Laundering Law of 2001 is not an exception to the banking secrecy obligation. It was drafted in compliance with international standards to create an efficient bank controlling system in order to avoid involvement in potential money laundering operations, notably by keeping records of client identities and transactions. However, client secrecy is only lifted by this law in the event that a specially formed committee rules to that effect.

The Fiducie Law of 1996 remains a valuable tool for transactions. It sets out a trust-like structure where the assets held by the fiduciary agent are separated from the assets of the settlor and are thus protected from its creditors, except in the event of the settlor's bankruptcy. These assets are also separated from the fiduciary agent's patrimony and cannot be seized by its creditors (Ingelby, 2008).

One of the most recent developments in banking law concerns the transfer and issue of bank shares. Law No 308 of 2001 provides that any transfer of more than 5% of a Lebanese bank's shares shall require the prior authorization of the Central Bank (BDL). BDL decision No 9893 of May 15, 2008 extends the prior authorization requirement and imposes the obtaining of an authorization from the BDL for the indirect acquisition of Lebanese banks' shares, except when acquired by banks and financial institutions duly incorporated in their country of origin. The amendment aims to further monitor and control the shareholding of Lebanese banks and protect them from having their shares indirectly transferred to unknown foreign investors.

In 2004, the incorporation of Islamic banks and Islamic transactions became regulated in Lebanon. These structures are destined to attract individuals and companies reluctant to deal with traditional banks and to develop a new source of funding for projects unable to find financing through conventional means. Since the enactment of the 2004 Law, the BDL has issued several decisions governing the operations of Islamic banks in Lebanon. Three new Islamic banks were incorporated in 2006, one in 2007 (Ingelby, 2008). In addition, in December 2005, Laws on securitization and collective investment schemes were enacted. Consequently, the BDL issued (in 2005 and 2007) decisions specifically regulating Islamic collective investment schemes.

Another significant legislative development is BDL decision No 9382 of July 26, 2006, setting out the basic principles of corporate governance applicable to Lebanese banks. Similarly, a recent development in corporate governance is BDL decision No 9725 of September 27, 2007, which sets out rules relating to corporate governance applicable to Lebanese Islamic banks. One of its principal rules is the obligation for Islamic banks to create an independent corporate-governance unit to ensure the development and application of sound internal corporate-governance rules (Ingelby, 2008).

Finally, a draft Capital Markets Law, which deals with significant reforms of the financial markets, bringing them into line with international standards, is pending before parliament. The draft law primarily aims to protect the investing public and better regulate financial activity in Lebanon, notably by creating an independent regulatory authority for financial markets and transactions. It also creates a specialized court to settle disputes in the markets, as well as a compensation fund for investors (Ingelby, 2008).

In this thesis, we demonstrated that bank's profitability is not directly affected by political instability. And thus banks should play on the set of variables that directly contribute to the success and the bottom line of the bank's balance sheets.

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